

OIL AND GAS PRIVATE OFFERINGS

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Most sales of securities to investors are registered with the Securities and Exchange Commission (the “SEC”) and under applicable state securities laws. However, certain offerings are exempt from registration under Regulation D of the Securities Act of 1933. See 17 CFR 230.501-506. According to a statement issued by the magazine Private Equity International in May 2007, the total private equity capital raised by the top 50 private equity firms since January 1, 2002 totaled \$551 billion. *Executive Summary, Private Equity International, May 2007*. The private equity market allows emerging companies in many industries, such as oil and gas, to cost effectively raise capital through a private placement memorandum.

Regulation D sets forth the rules governing the limited offer and sale of securities without registration. Issuers commonly claim exemptions under rules 504, 505 and 506 of Regulation D. Rule 506 acts as a safe harbor for the private offering exemption. Pursuant to Rule 506, issuers are able to raise an unlimited amount of capital. Although there is no general solicitation or advertising, this exemption applies to an unlimited number of accredited investors and up to 35 sophisticated investors. The benefit to emerging companies is that under Rule 506 the issuer has the ability to determine what form of disclosure documents to give to the accredited investors. In addition, accredited investors have access to the issuer’s information at any time, so long as the request is reasonable. In contrast, the issuer must give to the non-accredited investors disclosure documents that can be as extensive as those used in registered offerings. If there are non-

accredited investors in the offering, all disclosure documents that are given to the non-accredited must also be given to the accredited investors.

The federal securities laws define the term accredited investors as: (1) a bank, insurance company, registered investment company, business development company, or small business investment company; (2) an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million; (3) a charitable organization, corporation, or partnership with assets exceeding \$5 million; (4) a director, executive officer, or general partner of the company selling the securities; (5) a business in which all the equity owners are accredited investors; (6) a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$1 million at the time of the purchase; (7) a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or (8) a trust with assets in excess of \$5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes. See 17 CFR 230.501.

Small emerging companies wishing to utilize a national NASD (now FINRA) broker-dealer network may find that getting the acceptance of these larger brokerage firms to offer the securities to their clients can almost take as much effort, time and expense as going through a public offering. Emerging issuers are essentially unknown to larger firms, so the broker-dealer must engage in a due diligence process to determine the validity of not only the offering, but the issuer's operations. Due diligence can allow the

broker-dealers to develop a level of trust wherein the broker-dealer develops a level of comfort with the issuer and the issuer's operations. Some broker-dealers engage an outside due diligence firm, whereas others perform their own due diligence or combine it with the outside firm's report. This report contains an objective analysis on both the issuer and the validity of the investment opportunity offered by the issuer from an investor's perspective.

Petroleum resources are critical to the economies of all industrialized nations. Given the rising price of oil and gas, investors are looking for opportunities to directly invest in oil and gas drilling programs. In particular, oil and gas programs which drill in the geological formation known as the Appalachian Basin, found in states such as Ohio and Pennsylvania, can offer tax benefits to high net-worth and high income investors while providing a fairly certain expectation on return without substantial risk. However, investors need to be cautious about with whom they invest. In many instances, the due diligence process can allow broker-dealers to distinguish valid offerings from potential scams.

When looking at oil and gas offerings, the first element of the offering examined through due diligence is the sophistication and validity of the issuer's operations. This includes the history and track record of the well production of the issuer and its general reputation and experience, as described in the private placement memorandum.

In addition to examining the internal operations of the issuer, due diligence examines the specific program structure. Most oil and gas private placements offer investors a limited partnership structure in which the investor general partners convert to investor limited partners after the completion of the drilling and development of the well.

This structure allows investors to realize the IRS-permitted tax benefits for the intangible drilling and development costs and, upon conversion to a limited partner, subsequently provides a limitation on the investor's liability after the well has been drilled.

Due diligence typically also reviews the amount of the issuer's contribution to the offering. If the issuer is investing its own capital in the offering, that contribution evidences the issuer's commitment to the offering. When examining oil and gas offerings, it is particularly important to note (1) the geological report as it pertains to the targeted drilling areas; (2) the location of drilling leases and production history of the wells; (3) the issuer's lease inventory; (4) how the natural gas is going to be marketed pursuant to contracts; and (5) the pipelines available to deliver the gas to the market.

When examining any offering, investors should carefully review the issue of revenue sharing between the issuer and investor and what is a fair and reasonable allowance for the managing general partner/issuer based on its contribution. In addition, investors should review the financial strength of the issuer and any indemnification provisions disclosed in the private placement memorandum for their protection.

These items are particularly important when due diligence officers review an oil and gas program. However, strict scrutiny of the issuer's internal operations is also crucial for any offering for compliance assurance. Any issuer wishing to raise capital through an offering exempt from registration pursuant to rule 506, must file a Form D with the SEC. In addition, issuers utilizing the broker-dealer network must have a selling agreement with the participating broker-dealers with the provisions for indemnification of the parties to each other for their participation and compliance provisions. Issuers should also expect to provide to due diligence a blue sky memorandum which focuses on the

target states where the broker-dealers are located and/or where the securities are to be offered for sale.

Counsel for an issuer may want to conduct a preliminary survey of all states where it is anticipated that securities will be offered for sale, including research to confirm each state's filing procedures and filing fees for exempt transactions and/or exempt securities. The issuer should also implement an internal docketing system to track the distribution of each private placement memorandum to ensure compliance with Regulation D, to authenticate that each recipient of a private placement memorandum is an accredited investor, and to show that proper acknowledgments, notarizations and subscription procedures have been followed.

Although this article profiles oil and gas offerings, these basic principles and methods of constructing a private placement memorandum can easily be translated to many other forms of enterprise such as alternative fuels, real estate and technology innovations. For an emerging company looking to extend its operations dramatically, the entry into the private placement market offers a unique alternative to bank financing or even other limited forms of registered offerings for capital access. While compliance initially may seem overwhelming, once entered, the opportunity to return to satisfied investors or to attract new investors becomes more easily obtained.