When is an Oil & Gas Joint Venture Interest a Security?

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Oil and gas industry professionals have long struggled with how to identify when an interest in an oil and gas venture is a security. If one sells an interest in an oil and gas venture that is a security, the seller must comply with the Securities Act of 1933 (the "Securities Act"), and other applicable state and federal securities laws. If the interest is a security, sales of the interest must be registered with the Securities and Exchange Commission ("SEC") or be exempt from registration. Securities laws may require the disclosure of information prior to the sale of the security, which can be costly and time consuming. Violation of the registration or disclosure obligations can result in significant penalties, including potentially giving the investor a right to demand a return of their investment.

On July 27, 2019, the United States Court of Appeals for the Fifth Circuit issued an opinion in the case of *SEC vs. Arcturus*, which provides guidance on when an interest in an oil and gas venture will be considered a security.

The Securities Act defines a "security" broadly to include notes, stocks, bonds, and other financial instruments, including "investment contracts." The Securities Act does not define "investment contracts," so courts have had to determine what sorts of contractual arrangements are included in the definition of "investment contracts" for the purposes of the Securities Act.

In 1946, the United States Supreme Court, in the seminal case of *SEC v. Howey*, identified factors which characterize an investment contract. Under the *Howey* test, an investment contract is "a contract, transaction or scheme whereby [1] a person invests his money in a common enterprise and [2] is led to expect profits [3] solely from the efforts of the promoter or a third party."

In 1981, in the case of *Williamson v. Tucker*, the Fifth Circuit identified three non-exclusive factors that would be used to determine if the "solely from the efforts of others" prong of the *Howey* test had be met. Under *Williamson*, an investor is deemed to depend solely on the efforts of a third party if: (i) the investor has so little power that the investor's voting rights resemble those of a limited partner investing in a limited partnership, (ii) the investor is so inexperienced or unknowledgeable that the investor cannot meaningfully exercise the investor's voting rights, or

(iii) the investor is so reliant on the special skills of the promotor or manager that the manager cannot reasonably be replaced.

The *Arcturus* court evaluated each of the *Williamson* factors in light of the facts of the case. Although the managers controlled the day-to-day operations of the joint venture, many major operating decisions required the approval of the investors. Also, investors owning 60% of the joint venture could remove the managers. The court noted that the investors had access to information, some ability to communicate with each other, and the ability to exercise their voting powers, so the first Williamson factor did not indicate that the investors had invested in a security.

Next, the *Arcturus* court evaluated the experience and sophistication of the investors in the oil and gas industry as the second *Williamson* factor. The trial record was inconclusive on this issue, so the court concluded that it could not make a determination as to the second *Williamson* factor without a further factual record.

Finally, the *Arcturus* court evaluated the third *Williamson* factor: whether or not the managers had special skills, abilities, or other factors that made them essentially irreplaceable. The court found nothing in the record that indicated that the managers were irreplaceable. Even causing the joint venture to enter into contracts with the managers to provide drilling services was not problematic, as presumably the joint venture could assert its rights under the drilling contracts regardless of who served as its manager.

The SEC was unable to convince the *Arcturus* court (as it had the trial court) that the joint venture's structure, operations, and management were such that the investors were unable to meaningfully manage the venture or replace its managers. The court remanded the case to the trial court to further develop the factual record.

The *Arcturus* case is a reminder that sales of interests in oil and gas joint ventures may be deemed to be investment contracts, and therefore securities subject to the Securities Act, if the investors are not given contractual and practical ability to control the joint venture and its management.

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