Case Study: *Cases of Misconduct in Private Placements: Case #1 – Provident Royalties*

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Sponsor: Provident Royalties, LLC ("**Provident**")

Issuer: Shale Royalties 7, Inc., et. al.

Offering dates: Dec. 13, 2007 as to Shale Royalties 7, Inc., with other programs that followed

Significance: Deemed a case of "*massive fraud*" by FINRA/SEC
See, SEC Litigation Release No. 21118 (July 7, 2009)

Part of the "*Big Three*" trilogy of sponsors to come out of the Great Recession of 2009 (i.e., Provident, Medical Capital, and DBSI)

Structure of Shale Royalties 7, Inc.:

$35 million raise

Most of the Provident offerings followed this corporate preferred share structure

The Issuer mentioned above was formed as an IRS Subchapter C Corporation with the investors sold preferred stock

- Class A Preferred, 18% per annum dividend, 1.5% per month, 3-year anticipated redemption date
- Class B Preferred, 15% per annum dividend, 1.25% per month, 2-year anticipated redemption date
- Dividends on both Preferred Share Classes began in the 5th month following the issuance of the shares
- The Dividends can be paid out of the Issuer's Capital Surplus (i.e., gross capital less debt if any) (**not earnings based**)
- Provident held the Common Equity of the Issuer and stood to receive all upside above the payments to the Preferred Shares
- The Issuer's Corporate Charter says the dividends can be suspended by the Sponsor in its discretion (*Dividends are payable if and when declared by the Issuer's Board, i.e., Provident*)

Business Plan:

Acquire producing and non-producing mineral interests, royalty interests, and working interests anywhere in the U.S., with Provident focusing its prior acquisitions in the Woodford Shale Play of Oklahoma (i.e., the Arkoma Basin) (**investment plan was open ended and not specific**)

The Issuer's PPM did **not** require a specified allocation of capital among minerals, royalties, leaseholds, producing assets, and/or undeveloped assets

Per case study author's site visit communications with Provident's management (December 2007), there was an **unstated goal** by Provident to deploy 70% of the Issuer's net capital in working interests and 30% in royalties

Provident's Activities Through Dec. 2007:

9 prior programs

The initial two programs syndicated in 2006 (the "**2006 Programs**") were small and collectively raised $620,000 in Q1-Q2 of 2006

Provident represented that its 2006 Programs sold their assets in less than a year for a 135% Cash on Cash return

It later came out that these sales were to a Provident managed program (i.e., Shale 5 or 6) (*which was done for marketing purposes to show evidence of a full cycle program*)

The seven "**2007 Programs**" collectively raised $100 million in that year

Per offering materials, and at the time due diligence was being conducted on the Issuer (Dec. 2007), the 2007 Programs paid $2.556 million in dividends to investors through Dec. 2007, **but**

Per gross revenue information provided by Provident's management pursuant to the case study author's due diligence, the 2007 Program's gross revenues were **only** $1.035 million through Dec. 2007

The 2007 Programs acquired significant mineral assets (i.e., covering approx. 90,000 acres) in the Woodford Shale Play in 2007, and SinClair Oil Corp. ("**SinClair**") took notice of this in Q3 2007

For sake of clarify, SinClair is the oil company that uses a green dinosaur as its trademark

In Q3 2007, and based upon its desire to build an asset position in the Woodford Shale, SinClair and Provident entered into a joint venture agreement whereby these entities would work together to accumulate assets and build value

Frost Bank issued Provident a "**Credit Line**" of $100 million in late Oct. 2007, which was backed by the assets of the 2007 Programs and was guaranteed by SinClair

Per terms of the Credit Line, a portion of the line of credit could be used to pay dividends to the co-signer programs (i.e., which was done as an accommodation to Provident to service dividend payments during the time that assets were being positioned for divestiture)

By end of Dec. 2007, $75 mm of Credit Line was used, **<u>85%</u>** of which was used to buy non cash flow producing oil/gas assets, and with a limited amount of the funds used to fund drilling costs on wells or other assets that could provide cash flows relatively quickly to fund dividends to the 2007 Programs

<u>Red Flags</u>:

The 2007 Programs raised $100 million in 2007, which is fast for a <u>new</u> sponsor in the retail channel

Provident didn't have its accounting system fully operational (Provident's management said it was 80% done as of Dec. 2007)

There is no method for managing Provident's deployment of the $100 million Credit Line

- Provident deployed $75 million in 2-3 months
- Six of the 2007 Programs signed the loan, but Provident didn't allocate interests in the acquired assets to most of these entities
- Provident deployed 85% of the $75 million on non-yielding assets (i.e., undeveloped leaseholds)
- *Provident's Apparent Goal*: buy a lot of leases in a hot play, drill a couple wells, flip, and figure out how to divide the treasure later (which was developed in SinClair's deposition testimony during post-bankruptcy litigation)

The Preferred Shares were to receive 15-18% dividends per annum (*from a comparative standpoint, debt/preferred stock offerings generally set the coupons at 7-11% of invested principal depending upon the risk of the business*)

The 2007 Programs paid monthly dividends in 2007 but did not cover them with earnings from oil/gas production or asset sales (*program level financials pointed this out as early as March 2008, but sales kept coming based upon the promising facts and circumstances set forth in the next case study sub-part)*

The Issuer's offering documents allow it to buy and sell assets to and from Provident's affiliates (i.e., allowing an earlier entity to sell its assets to a later entity to fund dividend payments)

In addition to the 2006 Programs having sold their assets to a Provident managed entity, some of the mineral assets of the initial 2007 Program (i.e., "**Shale 2**") were acquired from an entity in which Provident's CEO was a principal of

- No appraisals were obtained to substantiate the fairness of the insider transactions

<u>Noise (why were we not focused on the red flags?):</u>

Per media coverage (e.g., *Oil & Gas Investor Magazine 2006-2007*), the Woodford Shale Play was the next hot shale play in the U.S., with many majors taking positions there (e.g., Newfield, St. Mary's, Chesapeake, among many others per production data obtainable through Drillinginfo.com)

Natural gas was $8 mcf and that price was rising (up from $3-4 mcf two years prior)

Provident's 2007 Programs acquired 90,000 acres of minerals, royalties, and working interests in the core region of the Woodford Play - an undisputed fact that was established in the later bankruptcy/receivership case

- There were reserve reports and a $100 million credit line issued on these assets

Sinclair, a prominent oil and gas company in the U.S., joined Provident in a collective effort to buy acreage in the Woodford Play, develop it, and flip it for gain

Sinclair co-signed on the $100 million Credit Line

Beginning in Q4 2007, Provident did leverage SinClair's name and presence within Provident's business plan significantly to help promote Provident offerings in the retail broker-dealer channel (i.e., an affinity marketing tactic also used by Triton Realty, LLC in 2007-2009)

The land consulting firm that handled Provident's title work advised in Dec. 2007 that Provident was working in good faith to get its assets positioned for a major divestiture, and the firm estimated the exit would reasonably occur in 4-6 months

That land consulting firm helped another company exit out of a similar asset position in the Barnet Shale in 2004 at a big sales multiple

The Corporate Charters of the Issuer and of the 2007 Programs say that Provident can stop paying dividends at any time (i.e., Provident in its discretion doesn't HAVE to pay the dividends)

The Credit Line allows loan proceeds to be used to pay dividends to the co-signing 2007 Program entities (i.e., which were the entities that had, in fact, received $2.55 million of dividends through Dec. 2007)

What happened:

Retail money kept coming into Provident's later offerings to the tune of an additional $350 million through Q4 2018

The core of the Woodford Play, however, was off limits to later Provident entities by virtue of Provident's written agreement with SinClair

The later Shale 10 – 22 entities had to go to other basins to acquire assets

Provident did manage to get the 2007 Program assets positioned for a sale by June/July of 2008 **but**

- there were some title-related quirks the land consultant failed to quickly address that delayed the ability of the 2007 Programs to execute a profitable flip

While Provident sought to address its title-quirks, Chesapeake was ready to execute and sold its position to BP for about $1.9 billion in June 2008

Provident banked on its ability to flip the 2007 Program asset – there were some bites in later months after the Chesapeake/BP sale, but no one else wanted the 90,000-acre deal

Natural gas prices fell in Sept. 2008

Too late to pursue a back-up plan because a lot of money is tied up in non-cash flow producing leases during a time in which the gas market is down.

All of Provident's managed programs were struggling from a liquidity standpoint in early Q4 2008

- By Q4 2008, Provident's managers used money from later managed programs to pay investor dividends in earlier programs (i.e., which is the conduct that gave rise to the DOJ's criminal indictment in 2012)
- We note that a number of broker dealers that initiated due diligence on Provident in 2006-2007 did not update their due diligence files through the period in which troubles began to surface (which was reported by Marshall Gandy, SEC enforcement attorney, at a TNDDA presentation on private placement misconduct cases in 2011)

Gas prices continued to fall into Q1-Q2 2009 with the Great Recession

B/D sales end because Provident's future prospects don't look good in Q4 2008.

Provident suspended distributions to all programs by January 2009

Provident and its managed programs entered bankruptcy in June 2009 because no one was buying minerals at the asset prices Provident's programs needed to pay back the investors

Lessons learned (i.e., what should we have anticipated and demanded back in December 2007 through Q1 2008):

- Require the Issuer and all other future Provident programs to acquire a sufficient amount of cash flowing oil/gas assets to help support the dividend targets (you can't pay yield on a non-yielding asset)
- Take note of the fact that Provident's full-cycle deal was an affiliate sale
- Require Provident's accounting system to be operational and **require** Provident to produce program/sponsor level financials
- Require Provident to demonstrate a disciplined method for managing the Credit Line funds

- Either prohibit or substantially limit the affiliate sales/buys (with an exception perhaps for **cash flowing** assets valued by an engineering firm not affiliated with Provident)
- Request that Provident's program structure be converted from preferred stock to common equity
- Take serious notice if the earnings do not cover the dividends
- Wait to see how money is deployed in Provident Shales 6 – 8
- Suspend selling agreements until the above issues are reasonably corrected

Why due diligence fell short (the attitude):

Provident is so close to executing, we can't cut it off now!

SinClair and Frost Bank both have skin in the game too (affinity marketing noise)

We got to wait it out and *let Provident's accounting catch up to the fund raising*

Moral of the case study:

- No sponsor comes into the retail channel to commit wrongdoing (i.e., they come in with the best intentions at the beginning)

- **Noise** can cause selling group members to lose focus on due diligence priorities and to neglect on-going due diligence activities (the hype of a seemingly hot asset and a strong affinity marketing campaign)

- **Require** accounting/financial discipline at the **front end** of due diligence

- Pay attention to program structure in each offering, i.e., a program design with
  (i) sound distribution provisions;
  (ii) reasonably-specified investment mandates;
  (iii) substantial limitations on affiliate transactions;
  (iv) reasonable manager kick-out rights; and
  (v) sound financial reporting requirements

- Conduct ongoing due diligence of sponsors that present multiple offerings a year and **don't** give a *free pass* to a sponsor on essential NTM 10-22 deliverables because the sponsor's business plan sounds good or seems to be going well