INVESTOR ALERT:
OIL AND GAS INVESTMENT FRAUD

BACKGROUND

State securities regulators around the country warn that oil and gas investment scams are alive and well. High oil prices have created a heightened interest in investments in energy-related business ventures.

Many oil and gas investment opportunities, while involving varying degrees of risks to the investor, are legitimate in their marketing and responsible in their operations. However, as in many other investment opportunities, it is not unusual for unscrupulous promoters to attempt to take advantage of investors by engaging in fraudulent practices.

Although some of the con artists moved on to more lucrative venues since the oil boom ended in the mid-1980s, many continued to linger on in the oil field. Now with the constant fluctuation of oil prices, some of these people have made their way back to these kinds of scams. When there is a highly publicized economic circumstance, which creates an opportunity for money to be made legitimately, scam artists follow in the shadows to take advantage of the situation.

WHAT ARE OIL AND GAS INVESTMENTS?

Oil and gas investments take many forms, including limited partnership interests, ownership of fractional undivided interests in leases, and general partnerships. Tax consequences and investor liability vary according to the type of program. True general partnerships, in which investors actively participate in the operations of the venture, are not securities. A general partner, however, is personally liable for partnership debts.

In a drilling limited partnership, an oil or gas company sells partnership units to investors and uses the money it raises to lease property and drill wells. In return for managing the project the sponsor company usually takes an upfront fee that averages about 15-16 percent of one's investment (commonly referred to as tangible and intangible drilling costs) and also shares in a percentage of any revenue generated. In return, the promoter offers the investor the prospect of a substantial first year tax write-off and quarterly cash distributions from the sale of any oil and gas the partnership finds until the wells run dry.

Drilling partnerships have always been a gamble, but recently, they have proven somewhat riskier than usual. This type of investment is very speculative, is a highly illiquid investment and can have a long holding period.

LARA
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FRAUDULENT SALES TECHNIQUES

Fraudulent oil and gas deals are frequently structured with the limited partnership (or other legal entity) in one state, the operation and physical presence of the field in a second state, and the offerings made to prospective investors in states other than the initial two states. Thus, there is less chance of an investor dropping by a well site or a nonexistent company headquarters. Such a structure also makes it difficult for law enforcement officials and victims to identify and expose the fraud.

BOILER ROOMS & INTERNET PITCHES

In order to attract the interest of potential investors, unprincipled promoters frequently use the Internet and "boiler room" offices with banks of phones manned by salespeople with little or no background in energy exploration, but plenty of experience in high-pressure sales. Their techniques include repeated unsolicited phone calls to members of the public, hyping the profitability of the deal. Some swindlers use professionally designed brochures. Beware of unsolicited oil and gas promotions on the internet and through e-mail. State securities regulators caution potential investors to beware of the following claims in a typical high-pressure sales pitch, whether through unsolicited telephone calls or e-mail messages:

> You will have an interest in a well that cannot miss.

> The risks are minimal.

> A geologist has given the salesperson a tip.

> The salesperson has personally invested in the venture.

>The promoter has "hit" on every well drilled so far.

>There has been a tremendous "discovery" in an adjacent field.

> A large, reputable oil company is operating or planning to operate in the area.

>Only a few interests remain to be sold and you should immediately send in your money in order to assure the purchase of an interest.

>This is a special private deal open only to a lucky, chosen few investors.

INVESTOR CHECKLIST: HOW TO AVOID BEING SWINDLED

State securities regulators advise potential investors not to be afraid to ask the hard questions when solicited for oil and gas investment opportunities. Investors wanting to make oil and gas investments should consider oil exploration and producing companies which are well-established and listed on the New York Stock Exchange.

You can minimize the risk of being swindled if you resist pressures to make hurried, uninformed investment decisions. There are several steps you should take before parting with your money. State securities regulators have developed a checklist of five key areas to examine before investing.

1. The Registration Requirements

- Ask if the offering is filed with the office of the state securities commission in your state or the state in which the promoters are located. If so, contact that agency for any information it may be able to provide. If the promoter claims that the offering is exempt from registration requirements in the particular state in which the offers and sales are made, find out which of the exemptions is claimed and the terms of the exemption.

2. The Salesperson

- If it is a legitimate deal, the salesperson will not be reluctant to answer questions or provide written explanations to questions. Ask the name of the person offering you the security, where he is calling from and his background, particularly in other oil or gas ventures. Ask what commission and/or other compensation the salesperson will receive.

- Contact your state securities agency to find out if the promoter or salesperson has been sanctioned for previous violations of securities laws.

3. The Company

- Ask the names of the principals of the company or the general partners offering the security, their backgrounds and experience in the oil and gas industry, and how long they have been associated with the company. Find out the history of the company, its capitalization, assets and retained earnings. What contingent liabilities does it have from other ventures? Does it have sufficient funds to cover unexpected costs? Is the tax treatment of the investments, as claimed by the promoters, supported by the Internal Revenue Service?

- Find out the company's or general partners' history in drilling operations. In particular, ask how long it has been in the oil and gas business, the number of

wells drilled, the number of wells completed as producing wells, and whether the company retained its interests in the wells it drilled. Determine if conflicts of interest involving the promoter are disclosed. All the above information should be contained in a prospectus or "offering documents" that the promoter must furnish potential investors before they commit their funds.

4. The Investment

- Make sure funds raised are kept in a separate escrow account until used and that they won't be commingled with other funds. Also, be certain the funds will not be used for purposes other than those specified. Ask how much money is to be raised and the cost per fractional interest. Ask how much of the money will pay for advertising, salaries, sales commissions, and any estimated profit to the company. Ask what type of conveyance document will be provided after any investment is made.

- Assuming the well is completed, ask what the completion costs will be for each investor, including additional commissions to be paid (the purpose and amount), and whether investors may be obligated to pay in more money in the future. Ask what tax incentive might be available if a dry-hole is encountered and for intangible drilling costs. Finally, evaluate the risk involved in making the investment. Is the well to be drilled a wildcat (drilled in territory not known to be productive) or is the drilling to be done in an area of proven oil reserves?

5. The Lease

- Secure a legal description of the property on which the program is to be drilled. How and when was it acquired? Is the principal selling the lease to the venture at the acquisition cost, and if not, how much profit is being made? Ask for a description of surrounding property, including local well completions and a geologist's report on the area. You will want to know if the lease is already in default and whether there is any overriding royalty or landowner's royalty or other leasehold burden being paid.

- Ask for a disclosure of the person(s) selling the lease, the cost of the lease and any relationship between the lessor and the operator. Secure a statement of the depth of the well to be drilled and an indication of when drilling is to begin. Insist on seeing a copy of the operator's contract with the promoter.

ADDITIONAL QUESTIONS TO ASK BEFORE INVESTING

The checklist of questions to ask and information to obtain is long and it will take time and perhaps even money invested in outside consultation before you feel comfortable risking your money in the investment. It is always advisable to seek the advice of a neutral expert before committing your funds to any investment deal. Be sure to consider the following questions:

- Who will be responsible for payment of taxes? Will they be paid out of the investor's share?

- What is the location of available pipelines, or what method will be used to transport and sell the products?

- What is the name and address of the operator? What is her/his experience with ventures of this nature? What are the terms of the agreement with the operator, including the compensation terms?

- How will the decision be made for completing the well or abandoning it? Who will make that decision? What is to become of funds received from the salvage value of equipment on the lease?

WHERE TO TURN FOR HELP

The securities administrator in your state, province or territory is responsible for the protection of investors. If you have questions about an investment, contact your securities administrator. You can locate your securities administrator on NASAA's website at www.nasaa.org. It is a good idea to contact your securities administrator *before* you invest.

In Michigan, contact the Corporations, Securities & Commercial Licensing Bureau (CS&CL), Securities and Audit Division, Phone: (517) 335-5237. The **Michigan Investor Guide** can service as an additional resource at **Investor Education web page**. Go to michigan.gov/securities.