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MCC GUIDE TO IN-HOUSE TECH

DATA, DATA, DATA

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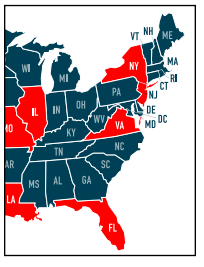

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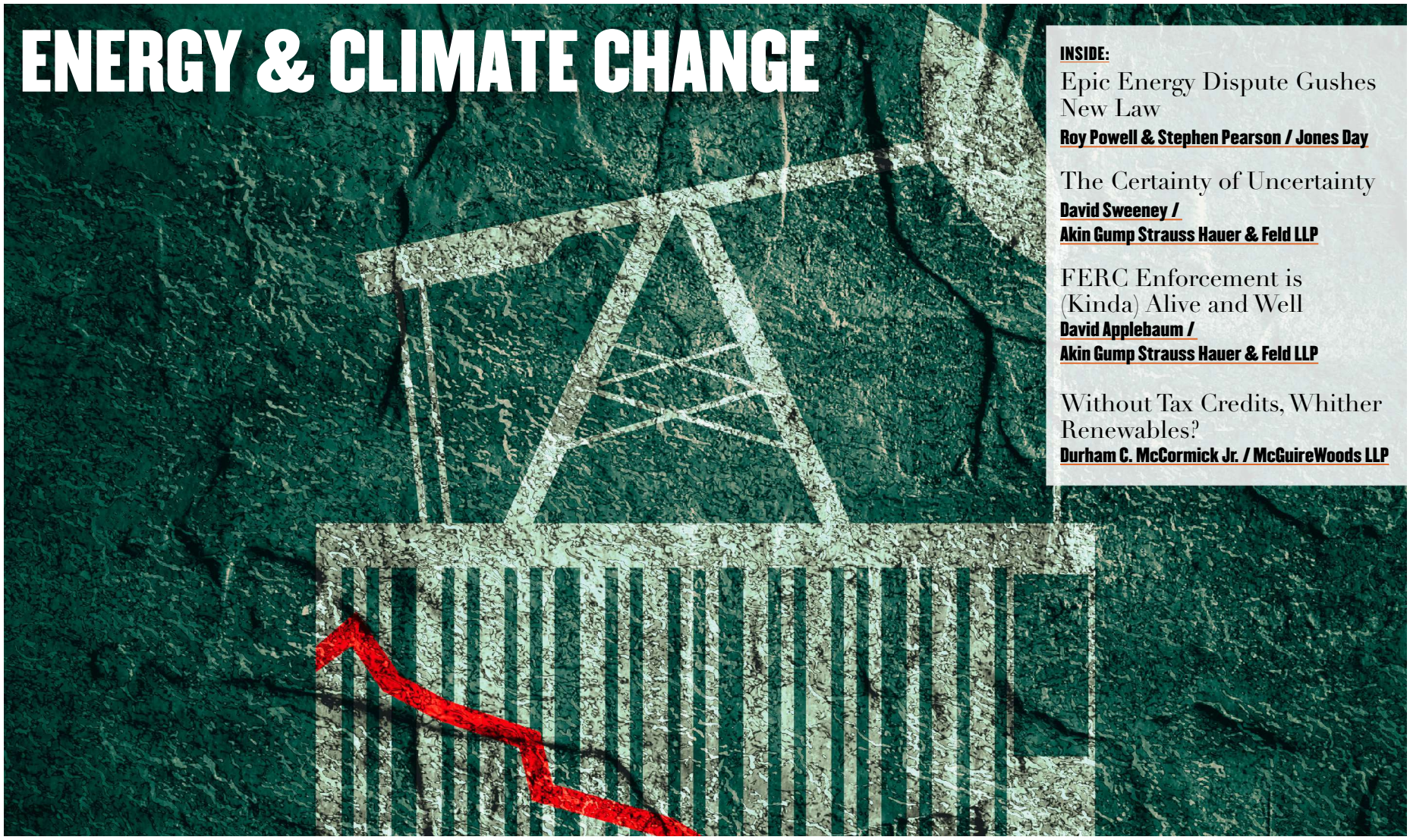

Epic Energy Dispute Gushes New Law

Funders bear same costs as unsuccessful litigants

MCC INTERVIEW: Roy Powell & Stephen Pearson / Jones Day

*For **Jones Day** partners **Stephen Pearson** and **Roy Powell**, it was a surreal litigation experience lasting some six years. The most recent turns in energy company Keystone's epic, multifront battle against Excalibur and its infamous founder, Rex Wempen, over an estimated $1.6 billion stake in a Kurdistan oil bonanza concern the litigation funders who backed the losers and now find themselves on the hook for the winner's costs. Below, Pearson and Powell discuss the case in remarks that have been edited for length and style.*

MCC: Please tell us about your backgrounds, particularly as they relate to the Keystone litigation?

Powell: I started with Jones Day when we opened an office in Pittsburgh and have been with the firm 28 years. My practice is complex commercial and construction litigation. Even before Marcellus and Utica Shale became what they have now become in the Appalachian basin, we were representing a number of energy companies in commercial and construction disputes. One of those companies, Texas Keystone, was run by an entrepreneurial family, the Kozels. One of the brothers, Todd Kozel, was interested in international opportunities and was tasked with developing what eventually became Gulf Keystone, which became a standalone public company after an IPO.

Pearson: I'm a dual-qualified lawyer in English and New York law. I split my time between Jones Day offices in New York and London. I came to New York in 2007 during the financial crisis. The firm thought it would be sensible to have an English-qualified lawyer on board to handle the proliferating cross-border financial cases. In New York, I handle a lot of the cross-border cases coming out of Europe and other offshore jurisdictions, and in London, I handle the cross-border cases coming out of the U.S. I thought I would be staying three years, but I've stayed in New York for 10 years.

MCC: Please explain to readers who have not followed it closely the nature of the dispute in Texas Keystone.

Powell: Over the years leading up to what became the Excalibur case, we did significant litigation and transactional work with a number of the Kozel family-related companies in everything from land acquisition to exploration and development. They also had a drilling company and were significant players in the Appalachian basin. When Gulf Keystone and Texas Keystone were sued shortly before Christmas in 2010, in both London and a separate ICC action in New York, we were asked to ramp up quickly and respond on multiple fronts to claims by the Excalibur team of an alleged $1.6 billion interest in the Kurdistan oil fields. Excalibur had tried to obtain a worldwide freezing injunction in London while simultaneously pursuing the same claims in the ICC

In 2006, after the second Gulf War, Gulf Keystone started looking at the possibility of exploration in the Kurdistan region of northern Iraq, which had opened up for oil and gas exploration. Gulf Keystone, in a joint effort with Texas Keystone, secured a concession for a region within Kurdistan and Iraq for oil and gas exploration and

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Stephen Pearson'*s practice focuses on complex international litigation and arbitration. He is dual qualified (England/Wales and New York) and actively practices in the courts in both jurisdictions. He can be reached at sjpearson@jonesday.com.*

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production. Early on, they met the now infamous Rex Wempen, who indicated that he had significant contacts and was interested in doing something with Gulf Keystone and Texas Keystone in Iraq. That was the beginning of the relationship, and several agreements were prepared to pursue those efforts.

The concession in Kurdistan was obtained and required significant upfront payment to the government, as well as agreements as to how the exploration and production will be pursued and how the profits will be shared. Mr. Wempen, it turns out, did not have the relationships he claimed he had and, in fact, was not in favor in the Kurdistan government. Most importantly, when it came time for him and Excalibur, a company he founded, to put up their share of the initial payments, he was unable to do so. As a result, Gulf Keystone pursued the concession and began exploring in Kurdistan without Mr. Wempen or Excalibur. With the discovery of significant oil and gas reserves, Gulf Keystone was becoming more and more valuable and the Wempens and Excalibur returned and in 2010 began the litigation

> ***If you back a funder, you back not only the claimant but also the witnesses, the experts and the legal team running the case. If they fall down, you're likely to get stuck with the bill if the litigant can't pay.***
>
> ***– Stephen Pearson***

Pearson: Essentially, they went away and bided their time. After significant amounts had been spent on exploration, which could have been entirely wasted if oil had not been found, it became clear there was a biblical amount of oil, and Wempen and Excalibur suddenly re-emerged to claim a 30 percent interest in the oil fields and revenues. They sued for recognition of an interest they claimed was theirs from the beginning.

They had a strategy. They had an arbitration clause in the contract, so they wanted this to be an ICC arbitration on the merits in New York. But they also knew that in England you can get injunctions in aid of foreign arbitrations and you can sometimes go to the English courts and attempt to freeze assets pending the outcome of the foreign proceeding. They tried the twin strike. They filed an arbitration request in New York just before Christmas, and they also went to the English court to freeze the defendants' assets. Gulf Keystone had been the subject of rumors about a takeover bid that received a lot of publicity. I'm sure the strategy was that if the injunction was granted and froze the assets, there would be a quick settlement to avoid the negative impacts. The problem was that the English court was not impressed with the application and turned down their injunction request even though it was made without the defendants' knowledge or participation.

Then they made a misstep in England. They took too many steps aside from just seeking the injunction. They essentially had started two sets of proceedings, both of which were substantive. That allowed us to argue that they should be stuck with England as a forum, whereas they had always wanted the U.S. to be their primary forum. There was a battle over which of the proceedings should go forward and which should be stopped. Our first success in the English courts was to persuade the English court to grant an anti-suit injunction and stop the U.S. arbitration on the basis that most of the defendants were not parties to the arbitration clause. Our injunction application was successful. We'd seized the forum we preferred, and they lost the forum they preferred. That was their first foot fault in the game.

MCC: Tell us what this case means for coordinated global litigation that GCs and CLOs should take note of.

Pearson: When you have proceedings in more than one jurisdiction, large corporations will have preferred law firms in different locations. They sometimes retain multiple law firms to handle different pieces of a problem even though the proceedings are related and even though they need to be carefully coordinated to get the best result. That can be inefficient because law firms in competition with one another typically don't work together very well. There's often some rivalry and a bit of tension or even a turf war that goes on when there's a genuine choice between forums. They don't think about the interest of the client. They think about whether they're going to keep the case. With a firm like Jones Day, which can handle a case on the ground in all the relevant places, there isn't that turf war. We can put the client's interest first. We ended up needing a team that included our offices in London, Pennsylvania, New York, Texas and elsewhere. It was all coordinated centrally by a small team led by Roy and myself. Our ability to be field marshals for the worldwide venture in multiple jurisdictions was instrumental in achieving the outcome we did.

Powell: The challenge of this case was clear early on. The strategy that was being implemented by Excalibur was essentially to do a Pearl Harbor-like attack on Christmas Eve and see if they could get a worldwide freezing injunction, which would have had a devastating effect on a publicly traded company. It was a difficult time of year when we became aware of the filings in multiple jurisdictions. It took about eight hours to put a team of more than 20 lawyers on the case around the world to respond through Christmas Day and New Year's. By the beginning of January, we had developed an effective strategy with a well-coordinated group working toward the same end. It's in some ways unique for a firm to be able to do that worldwide.

MCC: Please describe the English commercial court trial, which we understand was epic.

Pearson: It lasted 57 days, which I think is the third longest trial in the history of the Commercial Court. The English system is more forensic than the American system. American judges and courts don't have the time to spend weeks and weeks picking apart every detail of a case. In England, there tends to be more of an autopsy-like forensic analysis of almost every point presented. That means cases can go on far longer than they would in other jurisdictions.

It was fairly clear from the beginning that the Excalibur case was unraveling, and that the evidence put forward by Rex Wempen and his brother, Eric, was false. We managed to expose their lies. I'll give you an example. One of Rex's big themes was that he was a former U.S. special forces officer with a sterling service record, and he'd been unfairly cut out of this deal and it was a disgrace. He was playing the hero cheated out of the deal by greedy corporate types. By getting some discovery out of the U.S. courts, we got records from his brothers' email account at UBS in Connecticut, where he worked, and other sources, including public military sources, and found a number of things that exposed the truth about the Wempens. For example, Rex had been dishonorably discharged from the military for, among other reasons, falsifying records. His brother, while at UBS, had been trying to do a deal with his own employer to raise money for Excalibur while using UBS facilities to negotiate that deal. That led to an internal investigation at UBS, and he was dismissed. The judge found them both to have lied under oath about many things. Their primary expert, a lawyer from Canada who Excalibur put forth as the leading light in the oil and gas world, was found by the judge to have been a completely unacceptable expert. I could go on and on. The case they tried to put on unraveled during the course of 57 trial days. They had nothing left to cling to by the end of the trial.

The judgment came in a few months later. It was over 300 pages of misery for Excalibur and the Wempens as all of their claims were dismissed on all grounds and the court awarded indemnity costs for bringing claims that should not have been brought as they were so deeply flawed legally and based on untruths.

Powell: There's one other significant point. It was a given that Excalibur and Rex Wempen could not fund their buy-in. They did not have the money. Their theory of the case was that they were precluded from raising the funds because of bad conduct on the part of the defendants. That forced them to identify entities and individuals they believed would have provided them with the funding had Gulf Keystone been more forthcoming with information. Through U.S. discovery, which is very different than what's available in the UK, we were able to disprove that. The groups that they were trying to raise funds from simply would not have invested the money based upon what Excalibur was bringing to the table. It became a central issue in the case. It's one of the main reasons they had such a difficult time, beyond their own lack of truthful testimony, in front of the judge. It turned the tide against them.

MCC: Tell us about the litigation funding aspects of the matter and the disputes regarding the funders' liabilities.

Pearson: Excalibur couldn't have brought this litigation without outside funding. It didn't have the resources to finance the proceedings or pay security for the costs of the defendants, which is required in the UK. We knew there must have been someone in the background funding them. We managed to out the identity of the funders because it was relevant to certain issues in the case.

After Excalibur lost and didn't have the money to fund the shortfall between the costs that we'd incurred and the security they had put up, we went after the funders. These people facilitated the litigation, we convinced the court, and if not for them we wouldn't have incurred these costs. Excalibur is bankrupt, so the court issued a cost order that said that all the syndicate lenders that backed Excalibur should be joint and severally liable with Excalibur for the costs.

There was a fight over that principle, we won, the funders appealed, and the Court of Appeals, grappling with some of these funding issues for the first time, upheld all of the cost orders against the funders. A number of the funders are now in some form of bankruptcy or liquidation process. One is subject to U.S. criminal indictments. There are not many of them left standing.

Powell: The cost-shifting approach under the English system is very different than the U.S. system. However, the concept of third-party funding for litigation is gaining traction everywhere. Sophisticated investors are taking investment positions in litigation every day. Stephen and our London team were

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Uncertainty

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You don't own resources outside of the U.S. They're owned by the sovereign country. We have a very unique system in that respect.

In you have an oil and gas lease, so much of what we do and say is derived from the idea of ownership of the minerals. When I was writing my book, the challenge was to talk about what happens if you don't have a joint operating agreement because in the U.S. there's a very well-defined standard, although it's not as certain as having an agreement in place. Outside of the U.S., if you're drilling a $200 million well without an agreement, which happens frequently, there's not much of a standard for how you're going to split costs and so on. I wish my land experience were more common. It makes it easier to understand the industry.

MCC: What are the key regulatory issues facing the energy industry in the coming years and how are you advising clients given the current domestic and international political uncertainty?

Sweeney: The single biggest hot button, on the tip of everybody's tongue, is hydraulic fracturing. We've been hearing about things like induced seismicity and earthquakes for years. Air quality permitting is also going to be extremely important. There are substantial new regulations that a lot of newer wells are subject to and are not always taking into account. An unsettled issue, less in Texas and more in other places, is state vs. local preemption, i.e., whose law governs.

Take, for example setbacks from roads for well pads, or certain landscaping requirements. Whose law governs if the state says one thing and the local government says another? What if the local government wants to regulate drilling out of existence, or not permit it in certain areas? That carries over outside the U.S. When I was in-house, we were dealing with the Dutch sector of the North Sea. There was a backlash, both in the UK and the Netherlands, against hydraulic fracking. It's not certain how it's going to play out. We're seeing it on a large stage with the North Dakota pipeline. Induced seismicity has come up in Texas and Oklahoma, as well as places like Cushing. I don't know if it's even linked to oil and gas operation via hydraulic fracturing or injection wells, but these are the issues you expect when interests butt up against each other.

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able to make some new law clarifying that if you're going to take a risk with a big upside, you have to assume the downside risk. I think that ruling will have implications worldwide as people recognize this is not a free-pass investment.

MCC: Where does that leave the practice of litigation funding in the UK?

Pearson: Litigation funding is part of the fabric of the English legal system. This won't make it disappear. At least now there is some clear guidance about certain principles that will apply to litigation funding and how responsible funders are expected to behave. If that means that they get hit with costs for reasons that had nothing to do with their personal conduct, that's tough. If you back a funder, you back the witnesses, you back the experts, you back the legal team that's running the case. If they fall down on the job and a large cost order comes the way of the litigant, you're stuck with the bill as the funder. That's the new general principle. The court also made it clear that it will expect funders to conduct rigorous due diligence not only before the claim is funded but during the case. It isn't just a one-time analysis at the start.

MCC: What, if any, impact will this have on third-party funding in the U.S. or in other jurisdictions?

Powell: The analysis done by the court was much more rigorous than is done in the U.S. system, where the backstop for these activities is Rule 11 of the Federal Rules of Civil Procedure, which requires parties to have a good-faith basis for their claims. Many state courts have similar rules. The implications are that courts are beginning to look at the puppeteers, if you will, funding the litigation as being equally responsible for taking good-faith positions supported by the law and the facts. The pendulum is moving in the direction of making the funders as responsible as the named parties.

Pearson: The key takeaway is that funders need to understand the local markets in which they're funding. A lot of American funders thought they could simply apply the same methodology they use in the states to a case that ends up being tried in the UK. That's overly simplistic. If you're a funder, you have to understand the nuances, the risks involved in any market in which you fund. It may well be very different from your home jurisdiction.

MCC: Is there anything that either of you would like to add?

Powell: The case went on for six years. Millions of documents were produced. Sitting in the courtroom was a surreal experience because of the number of lawyers and barristers, and often 50 to 100 observers interested in the case. The courtroom experience was unusual in the extreme for me.

Pearson: Surreal is a good word. Some people were making cartoons of the proceedings and putting them on YouTube as a weekly update of the trial. Some were doing amateur sleuthing to figure out who these mysterious funders were. It was like a mystery novel in which they felt they could play some part.

FERC Enforcement

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MCC: You recently wrote a blog post about two important FERC white papers: one on energy trading compliance and the other on market manipulation. You called the papers notable for providing the first guidance from FERC staff since the EPAct on interpretation of the anti-manipulation rule and on shaping compliance programs to avoid violations. As a longtime FERC insider, give us your perspective on the evolution of the anti-manipulation rule and what the FERC guidance means for clients.

***Applebaum*:** The anti-manipulation rule paper is significant because it gathers together, at a high level, what the agency believes warrants a market manipulation enforcement action. This is very useful for market participants. The positions have been stated in various briefs and orders over the past few years, but this guidance brings them together and summarizes settlements and orders in cases brought so far and puts them into three categories.

The first is outright fraud or misrepresentation, an example of which is where a market participant lies about its costs or the operating capabilities of a generation unit to extract some market payment it shouldn't get. Those cases are straightforward, and FERC is always going to bring them.

A second is called a cross-market or related position case. This is where a market participant attempts to move a physical natural gas or electric price for a purpose such as benefiting a derivative. Some of those cases are complex, and some are closer calls than they appear, but this guidance paper shows that FERC has been committed to these kinds of cases, and I think that staff will continue to be committed to them.

The third category is gaming electric markets. For the reason I mentioned earlier, there could be some changes in how the new commission views those cases.

The real story, however, is what's happening in federal courts. In the past year or so, the federal district courts for the first time have been weighing in on FERC's legal theories of manipulation, including the categories of cases just mentioned. These decisions have been on motions to dismiss rather than on the merits, so I don't want to overstate their importance, but some of these courts have gone out of their way to comment on FERC's view of market manipulation beyond simply denying the defendant's motion. By and large, these decisions have been favorable to FERC, and enforcement staff is likely to feel emboldened by them. Still, until there have been some final decisions on the merits, and appellate courts have weighed in, there will remain many undecided questions on the scope of FERC's anti-manipulation rule.

MCC: What about the trading compliance white paper?

***Applebaum*:** That could be helpful to market participants because it goes beyond high-level generalities and offers specific ideas about compliance such as training employees and staffing compliance programs. This white paper also, while stating clearly that energy companies have flexibility in designing and implementing compliance programs, says there is no one-size-fits-all approach. The paper makes clear that FERC enforcement expects energy trading companies, particularly large, sophisticated companies that trade both physically and financially, to have robust compliance programs.

MCC: You will be bringing your insider perspective to the Akin annual energy briefing in January. To the extent we haven't already spoken about it, can you give us a preview of the key points you plan to make about FERC's top enforcement priorities in the years ahead?

***Applebaum*:** A key priority for the agency will be litigating what is going to be an active federal court docket. Also, depending on what the commission does with a pending natural gas manipulation case, there could be a complex trial before an ALJ. And there is yet another pending natural gas case that involves some interesting jurisdictional issues on appeal. For the agency to figure out how to do all of that work with the same number of staff and then handle all the ongoing and new inquiries, investigations and self-reports is going to be a challenge and a key priority. I'll provide more thoughts during the annual briefing.

One thing that I'll talk about in more detail is that there are some specific enforcement policies and practices where market participants, counsel and other commentators on enforcement might be able to persuade the agency to change course and make some modifications that will help the investigative process and add additional protections for market participants. One particular area is FERC's Notice of Alleged Violations policy.

In a nutshell, FERC has an unusual policy among federal enforcement agencies of publicizing the existence of otherwise nonpublic enforcement investigations. Most significantly, the agency identifies the company and subjects of the investigation and makes the information public before the matter has been resolved through settlement, or before FERC has decided to bring an enforcement action. We think that is a bad policy and should be rescinded. We are publishing an article in the *George Washington Journal of Energy and Environmental Law* early next year on this issue. We then expect to follow up with the agency about the policy. I'll talk about that, and some other potential changes to enforcement processes and policies, at our briefing.