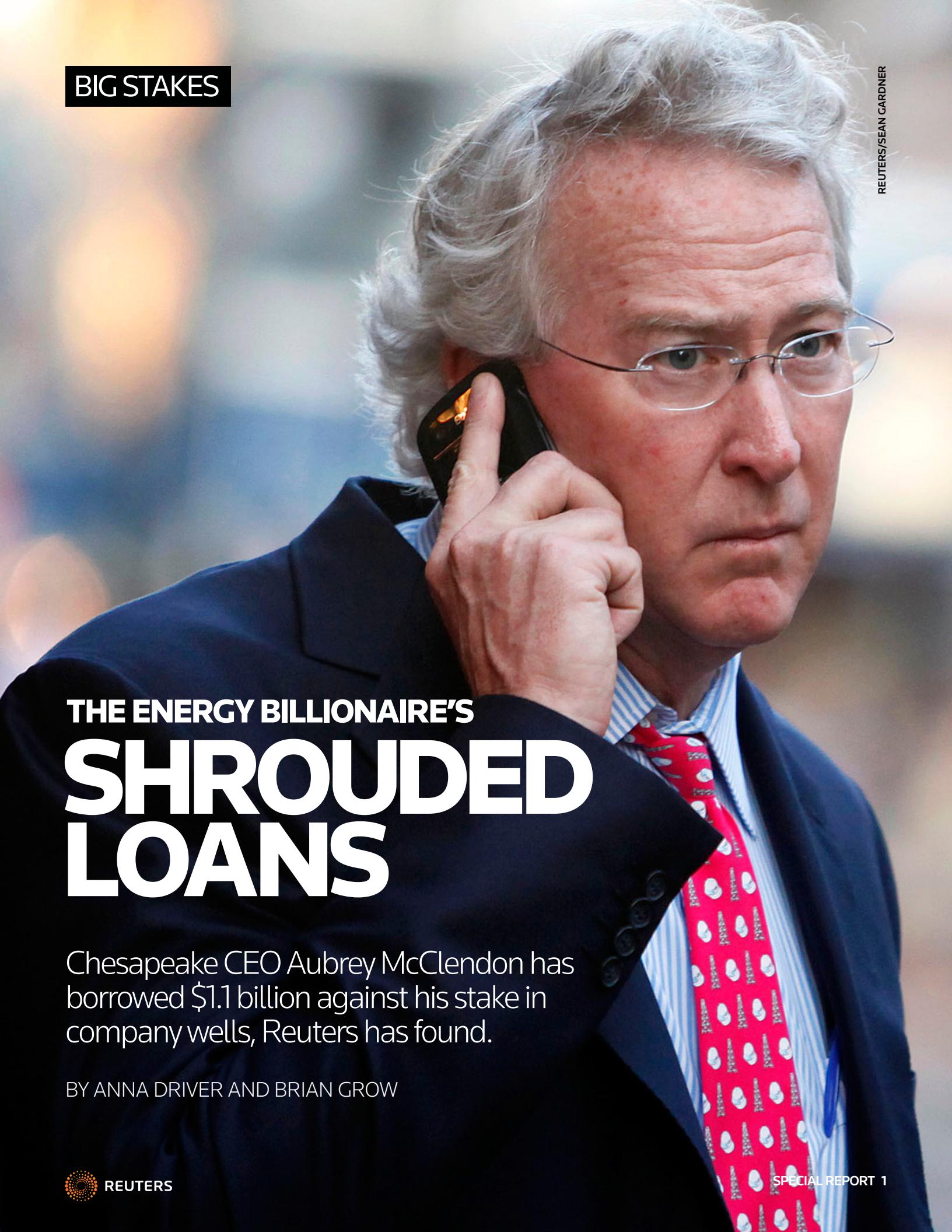


BIG STAKES

REUTERS/SEAN GARDNER



# THE ENERGY BILLIONAIRE'S SHROUDED LOANS

Chesapeake CEO Aubrey McClendon has borrowed \$1.1 billion against his stake in company wells, Reuters has found.

BY ANNA DRIVER AND BRIAN GROW

# BIG STAKES THE ENERGY BILLIONAIRE'S SHROUDED LOANS

APRIL 18, 2012

**A**ubrey K. McClendon is one of the most successful energy entrepreneurs of recent decades. But he hasn't always proved popular with shareholders of the company he co-founded, Chesapeake Energy Corp., the second-largest natural gas producer in the United States.

McClendon, 52, helped cause Chesapeake shares to plummet amid the financial crisis when he sold hundreds of millions of dollars in stock to raise cash for himself. Later, to settle a lawsuit by shareholders, he agreed to buy back a \$12 million map collection that he'd sold to Chesapeake.

His approach to running his company also is renowned: Among other employee perks, on-site Botox treatments are available at its headquarters in Oklahoma City, Oklahoma.

Now, a series of previously undisclosed loans to McClendon could once again put Chesapeake's CEO and shareholders at odds.

McClendon has borrowed as much as \$1.1 billion in the last three years by pledging his stake in the company's oil and natural gas wells as collateral, documents reviewed by Reuters show.

The loans were made through three companies controlled by McClendon that list Chesapeake's headquarters as their address. The money is being used to help finance what could be a lucrative perk of his job — the opportunity to buy into the very same well stakes that he is using as collateral for the borrowings.

The size and nature of the loans raise concerns about whether McClendon's personal financial deals could compromise his fiduciary duty to Chesapeake investors, according to more than a dozen academics, analysts and attorneys who reviewed the loan agreements for Reuters.

"If Mr. McClendon has \$1 billion in debt through his own companies — companies operating in the same industry as Chesapeake — he has or could have a high degree of risk for conflicts of interest. As in,

whose interest will he look out for, his own or Chesapeake's?" said Joshua Fershee, an associate professor of energy and corporate law at the University of North Dakota.

The revelation of McClendon's bout of borrowing comes as he is scrambling to help Chesapeake avert a multi-billion-dollar cash shortfall amid a plunge in natural gas prices.

It also exposes a potentially serious gap in how U.S. regulators scrutinize corporate executives, a decade after those rules were tightened in the wake of major accounting scandals.

The loans portend a number of possible problems, the analysts said. McClendon's biggest lender is simultaneously a major investor in two units of Chesapeake. That connection raises questions about whether Chesapeake's own financing terms could be influenced by its CEO's personal borrowing.

**“**The more information the company releases to shareholders the better – particularly when it's such a large amount of money.

**Mike Breard**

Oil and gas analyst

Another concern: A clause in the deals requires McClendon "to take all commercially reasonable action" to ensure that other owners and operators of the wells — including Chesapeake — "comply with...covenants and agreements" of the loans. Such clauses are common in energy-finance deals. But it is rare for the CEO of a major energy company to be personally subject to one involving the corporation that he runs. That means McClendon could have an incentive to influence Chesapeake to act in the interest of his lenders, rather than of his shareholders.

"Basically what you have here is a private transaction that could potentially impact a public company, depending on the manner in which the clause is interpreted and applied," says Thomas O. Gorman, a partner at law firm Dorsey & Whitney in Washington, D.C., and a former special

trial counsel at the Securities and Exchange Commission (SEC). "That may create a conflict of interest."

As a result, the loans should have been fully disclosed to Chesapeake shareholders, the academics, attorneys and analysts said.

## NO CONFLICT

Both McClendon and Chesapeake say the loans are purely private transactions that the company has no responsibility to disclose or even to vet. And they disputed the view that the deals could create a conflict of interest.

"I do not believe this is material to Chesapeake," McClendon said in an email response to questions. "There are no covenants or obligations in my loan documents or mortgages that bind Chesapeake in any way."

Chesapeake general counsel Henry Hood said in a statement that the clause in the loan agreements questioned by analysts — called "Compliance by Operator" — is "typical boilerplate language" used in oil and gas mortgages. It requires borrowers to exercise their rights with operators of wells, such as Chesapeake, on behalf of the lender.

Neither the existence of McClendon's loans nor their terms create the possibility of a conflict of interest, Hood said, in part because the company has a first lien on McClendon's share of company wells. That would mean Chesapeake gets paid before all other creditors in the event that McClendon defaults on his debt.

"Any loans are Mr. McClendon's personal business and not appropriate for review or monitoring by the company or public comment," Hood said.

The company has many checks to protect against conflicts, Hood said. Among them: Some of the world's largest energy companies own a share of Chesapeake wells and "monitor the actions of the Company" via well audits, government filings and participation in development plans, Hood said.

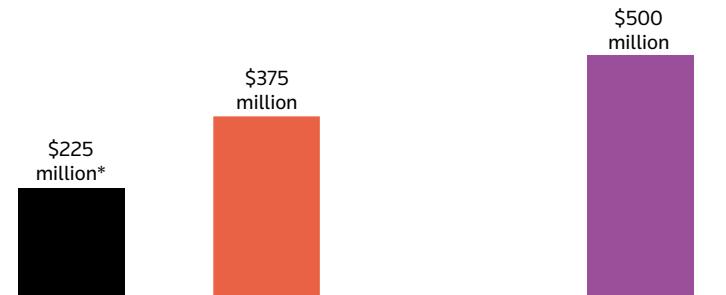
He added that Chesapeake now employs more than 13,000 people and drills

## Beneath the surface

A look at some borrowing by Chesapeake's CEO

### THE LOANS

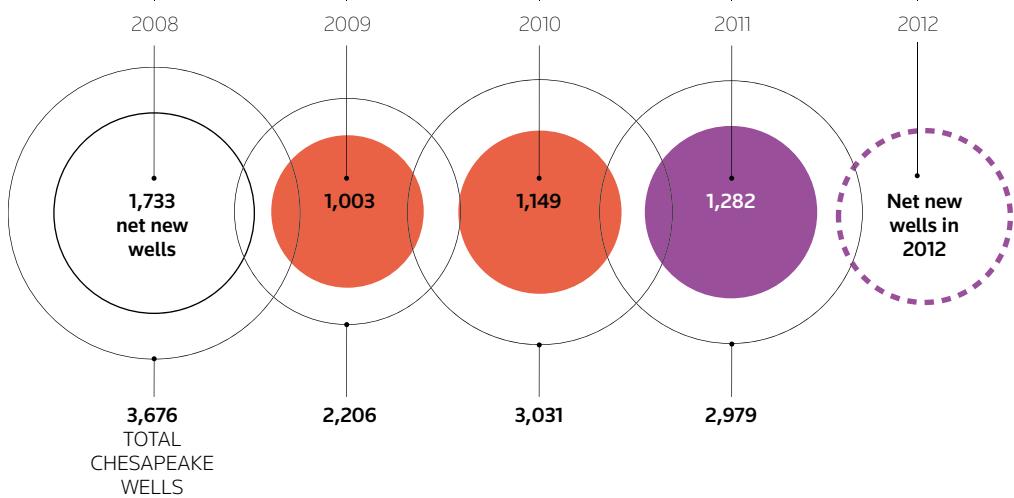
Loan amounts made to  
Aubrey McClendon



### THE COLLATERAL

McClendon secured the loans with his 2.5 percent working interest in new Chesapeake wells drilled each year

*(Color indicates the loan supported)*



\*Collateral not known

Sources: Financing statements filed in Louisiana and Texas (loans); Securities and Exchange Commission filings (wells)

more than 2,000 wells per year, "all of which minimizes the ability of any one person" – McClendon included – "to influence actions on any single well."

Less than four years ago, a personal transaction by McClendon did negatively influence the company.

To buy more Chesapeake stock, McClendon borrowed money from his brokers – what's called "buying on margin." In October 2008, just after the financial crisis erupted with the bankruptcy of Lehman Brothers, he was forced to sell more than 31 million Chesapeake shares for \$569 million to cover margin calls from those brokers. The company's stock fell nearly 40 percent the week of McClendon's share sales. McClendon issued an apology but the company's credibility with many shareholders suffered significantly.

Chesapeake's board of directors is aware

that McClendon has borrowed against his share of company wells, Hood said, but "the board did not review or approve the transactions." Nor did the company vet the loan terms for possible conflicts. "If there were any conflicts of interest," Hood said, "they would have surfaced by now."

Chesapeake board members contacted declined to comment. Marc Rome, Chesapeake's vice president for corporate governance, did not respond to requests for comment.

The loans reveal how McClendon is using an unusual corporate incentive as collateral. The perk, known as the Founder Well Participation Plan, grants Chesapeake's billionaire co-founder a 2.5 percent stake in the profits – and makes him pay 2.5 percent of the costs – of every well drilled during each year he decides to participate.

Today, Chesapeake is the only large publicly traded energy company to grant its CEO the opportunity to take a direct

stake in wells it drills. Chesapeake says the well plan is a uniquely powerful incentive because it aligns McClendon's personal interests with those of the company.

The well plan does not allow McClendon to select the wells in which to invest; Chesapeake says the program is an all-or-nothing proposition so that McClendon can't cherry-pick only the most profitable wells.

"He has to eat his own cooking here," said company spokesman Michael Kehs.

But because McClendon is using the loans to finance his participation in the well plan, he defrays his risks. Two of McClendon's lenders, both private equity firms, in turn spread the loan risks to other investors by raising money from state pension funds and other investors to fund them. Those insights emerge from a February 2011 document detailing a meeting between McClendon's largest personal lender and a prospective investor.

## BIG STAKES THE ENERGY BILLIONAIRE'S SHROUDED LOANS



AT WORK: Chesapeake's 50-acre campus in Oklahoma City, Oklahoma, boasts a state-of-the-art gym and offers employees Botox and teeth whitening treatments. **REUTERS/STEVE SISNEY**

"If he hasn't had to put up any of his own money, how is that alignment" of McClendon and Chesapeake's interests, asked Mark Hanson, an analyst with Morningstar in Chicago.

Chesapeake says McClendon's loans are "well disclosed" to company shareholders. General Counsel Hood cited two references in the company's 2011 proxy. In them, the firm refers to McClendon's personal "financing transactions," including one in a section entitled "Engineering Support" that discusses McClendon's use of Chesapeake engineers to assess well reserves.

Nowhere in Chesapeake proxy statements or SEC filings does the company disclose the number, amounts, or terms of McClendon's loans. Veteran analysts of the company said they were never aware of the loans until contacted for this article.

"We believe the disclosures made by the company have been appropriate under the circumstances, particularly since the disclosure of the loans is not required in any event," Hood said in a statement.

**“**If Mr. McClendon has \$1 billion in debt through his own companies — companies operating in the same industry as Chesapeake — he has or could have a high degree of risk for conflicts of interest.

**Joshua Fershee**

Associate professor of energy and corporate law

Legal experts say the size and terms of McClendon's borrowing are unusual — and highlight a gap in regulatory scrutiny of American corporate executives.

In the past, major Wall Street banks formed separate companies — or special purpose vehicles, just as McClendon has — to allow select employees to borrow from the employer and make investments. The WorldCom accounting scandal was, in part, fueled by more than \$1 billion in loans taken out by former chief executive Bernard Ebbers that were secured by his shares of company stock. And energy giant En-

ron used off-balance-sheet entities to hide debt from investors. New accounting and corporate governance laws and regulations banned such transactions or required their disclosure.

In September 2006, the SEC revised its related-party transaction rules to require companies to disclose when executives pledged corporate stock as collateral for loans. "These circumstances have the potential to influence management's performance and decisions," the SEC wrote.

McClendon's loans — backed not by stock but by stakes in company wells — aren't covered by the SEC rule. "Because they have decided to compensate him with a business interest, it kind of falls through the cracks," says Francine McKenna, an accounting expert and author of the accounting-related blog *re: The Auditors*.

As a result, no SEC regulation precludes McClendon from using his well plan stake as loan collateral. The SEC declined to comment on the McClendon loans.

### TEETH WHITENING

Tall and thin, McClendon is a tireless booster for the oil and gas industry — and of his company. At an energy conference in November in Houston, he sported a tie printed with tiny drilling rigs. His daring deals and stirring speeches to investors have attracted some adoring followers.

During one speech last September, McClendon said opponents of a controversial drilling technique called hydraulic fracturing were interested in "turning the clock back to the Dark Ages."

"What a great vision of the future!" he said sarcastically. "We're cold, it's dark, and we're hungry!"

McClendon's investor presentations are standing-room-only. But he often bristles when his business model is questioned by analysts, frequently arguing that Wall Street does not understand the company.

That tension has intensified as Chesapeake scrambles to shed more than \$10 billion

## BIG STAKES THE ENERGY BILLIONAIRE'S SHROUDED LOANS

in debt through the rapid-fire sale of assets amid the lowest natural gas prices in a decade.

McClendon continues to treat his employees well. In recent years, he built a 50-acre red-brick campus in Oklahoma City as Chesapeake headquarters. It boasts a 72,000 square-foot state-of-the art gym, visiting doctors who provide lunchtime Botox treatments for employees, and dentists who whiten teeth.

A part owner of the NBA's Oklahoma City Thunder and supporter of charitable causes in the state capital, McClendon holds considerable sway in Oklahoma. Former U.S. Senator Don Nickles and former Oklahoma Governor Frank Keating, both Republicans, are members of the Chesapeake board.

McClendon's close relationship with the board hasn't left him immune to tensions with stockholders.

After Chesapeake's board agreed to buy McClendon's map collection in 2008 for \$12.1 million, shareholders sued. The lawsuit was settled in November 2011, when McClendon agreed to refund the \$12.1 million, plus interest, and hold stock worth 500 percent of his annual salary and bonus. Chesapeake also agreed to hire Rome, the vice president of corporate governance, and an executive compensation consultant to evaluate corporate pay packages.

The well participation plan, which was approved by shareholders in 2005 and cannot be discontinued until 2015, has remained unaffected.

Disgruntled investors continue to launch challenges. On March 13, New York Comptroller John C. Liu and the \$113 billion New York Pension Funds called on Chesapeake to let large long-term shareholders put up their own nominees for the board of directors.

Key aspects of McClendon's loans remain hidden from shareholders. Because promissory notes underpinning the loan agreements are private, the interest rate, the exact amount borrowed and other terms of the transactions are not publicly known.

But the loan agreements demonstrate the extent to which McClendon has leveraged his interests: He has pledged as collateral almost every asset associated with his share of Chesapeake wells. Oil, gas and land interests, platforms, wells and pipelines, hedging contracts, geological and business data, and intellectual property are among scores of well-related assets that can be seized should McClendon default.

Chesapeake said it would be "unaffected by any dispute" between McClendon and a lender in the event of a default because of its first lien on oil and gas production, equipment and land leases.

**“**We believe the disclosures made by the company have been appropriate under the circumstances, particularly since the disclosure of the loans is not required in any event.

**Henry Hood**

Chesapeake general counsel

The company also says that McClendon's share of "related assets" pledged as collateral - such as business data and hedging contracts associated with wells - is completely separate from similar assets owned by Chesapeake. That means Chesapeake would not become entangled should McClendon default, the company said.

Chesapeake "does not have an interest in the (McClendon's) related assets ... and Mr. McClendon does not have an interest in the company's related assets," general counsel Hood said in a statement.

In explaining why Chesapeake's board isn't obligated to monitor McClendon's personal loans, Hood cited a September 2003 decision by a Delaware Chancery Court. The ruling in Beam v. Stewart found the board of Martha Stewart Living Omnimedia did not breach its fiduciary duty to shareholders by failing to monitor her personal investments. (Stewart served five months in prison in 2004 following her conviction for obstruction of justice in an unrelated insider-trading case.)

Given the size, scope and complicated



ENJOYING THE GAME: Actor Rob Lowe (L) and Chesapeake CEO Aubrey McClendon watch the Oklahoma City Thunder play the Los Angeles Lakers in February. **REUTERS/STEVE SISNEY**

## BIG STAKES THE ENERGY BILLIONAIRE'S SHROUDED LOANS

terms of the loans, their particulars constitute important stockholder information and therefore should be more fully disclosed, said David F. Larcker, a professor of accounting at Stanford University's Graduate School of Business.

Some shareholders agree. "While recognizing (McClelland's) right to privacy, the more information the company releases to shareholders the better – particularly when it's such a large amount of money and related to the oil and gas business," said Mike Breard, oil and gas research analyst at Hodges Capital Management in Dallas, which owns Chesapeake shares.

As with a mortgage on a residential home, state law requires ownership rights to physical property be recorded with county clerks.

Reuters found McClelland's loan agreements by following the trail of well and land lease transfers from Chesapeake to three companies that list McClelland as their corporate representative, according to state deed records.

In county courts in Louisiana, Texas, Arkansas, Pennsylvania and Oklahoma, where Chesapeake operates thousands of

wells, the company regularly files a form called a conveyance. In keeping with the corporation's well participation program, the conveyance grants McClelland a 2.5 percent share of each well and of the leased land on which it is drilled.

For years, Chesapeake has distributed 2.5 percent shares in wells and land to three McClelland-controlled companies – Chesapeake Investments LP, Larchmont Resources LLC and Jamestown Resources LLC.

Since he co-founded Chesapeake in 1989, McClelland has frequently borrowed money on a smaller scale by pledging his share of company wells as collateral. Records filed in Oklahoma in 1992 show a \$2.9 million loan taken out by Chesapeake Investments, a company that McClelland runs. And in a statement, Chesapeake said McClelland's securing of such loans has been "commonplace" during the past 20 years.

But in the last three years, the terms and size of the loans have changed substantially. During that period, he has borrowed as much as \$1.1 billion – an amount that coincidentally matches Forbes magazine's estimate of McClelland's net worth.

The \$1.1 billion in loans during the past

three years breaks down this way:

In June 2009, McClelland agreed to borrow up to \$225 million from Union Bank, a California lender, pledging his share of wells as collateral.

In December 2010, he borrowed \$375 million from TCW Asset Management, a private equity firm.

And in January 2012, McClelland borrowed \$500 million from a unit of EIG Global Energy Partners, a private equity firm formed by former TCW executives.

It is unclear how much, if any, of those loans have been repaid.

Randall Osterberg, a senior vice president at Union Bank who signed the loan agreement, declined to comment. TCW and EIG also declined to respond to questions.

### REAL LOSS?

At first blush, what the company tells shareholders suggests the well plan is a money-loser for McClelland.

In its proxy statements, Chesapeake says McClelland lost \$116 million in 2009, and \$141.9 million in 2010.

It's unclear whether McClelland has suffered any real losses, however. Asked about the calculations, Hood said McClelland's net loss is a byproduct of his drilling costs being "front end loaded," while his revenues accrue over many years.

"If they are showing that kind of negative cash flow, the wells don't have value," said Phil Weiss, oil analyst at Argus Research who has a sell rating on the company's shares. But given that McClelland has borrowed more than \$1 billion based on the value of his well stakes, "I really don't think (the company's disclosures) tell me much," Weiss said.

Chesapeake has resisted attempts by regulators to get more information on McClelland's well-participation plan before. In 2008, the SEC requested more information about McClelland's benefits from the well plan as part of a review of the company's 2007 annual report.

## Margin fall

Chesapeake Energy's daily share price



Source: Reuters

## BIG STAKES THE ENERGY BILLIONAIRE'S SHROUDED LOANS

From May to October that year, Chesapeake and SEC officials exchanged at least eight letters and held negotiations on the issue. After first refusing to provide more information, Chesapeake ultimately agreed to provide shareholders a chart detailing well plan revenues and costs, a review of the letters shows.

Chesapeake's Hood said in a statement that the company's disclosures are "fully compliant with all legal and regulatory requirements." The chart and other SEC filings contain "all material facts that Chesapeake was required to disclose," he said.

A spokesman for the SEC declined to comment.

McClendon's biggest personal lender, EIG, has been a big financer for Chesapeake, too.

In November, Chesapeake raised \$1.25 billion from a group of investors including EIG through the sale of "perpetual preferred shares" in a newly formed entity, Chesapeake Utica LLC, which controls about 800,000 acres of oil and gas-rich land in Ohio. The sale offers lucrative terms to EIG investors, paying an annual dividend of 7 percent and royalty interests from oil and gas wells, according to analysts.

On April 9, the company announced a nearly identical deal to raise another \$1.25 billion from EIG and other investors, in another new subsidiary called CHK Cleveland Tonkawa.

Dividends on preferred shares are controversial because they are paid before regular dividends owed to common shareholders. "Basically it's a form of more expensive debt," Morningstar's Hanson said. "It makes it appear that it's not debt, but it sits on top of obligations to the common shareholder."

The fact that McClendon's largest personal lender received favorable terms on its Chesapeake investments caused some Wall Street analysts to call for more information about McClendon's loans.

"I think the company should disclose this information. One reason is that the



DRILLING DOWN:  
A worker at a  
Chesapeake rig  
site in South Texas  
walks past stacks  
of drill pipe used  
to tap oil and gas.

REUTERS/ANNA  
DRIVER

## A lucrative deal for the CEO's financier

The lender behind \$500 million worth of Aubrey McClendon's personal loans is a private equity firm with headquarters across the street from the White House and the Chinese government as a minority owner.

The firm, EIG Global Energy Partners, is run by R. Blair Thomas, an attorney and veteran energy investor. Formerly the Energy & Infrastructure Group of Trust Company of the West, EIG spun out of TCW in January 2011. It had \$9.5 billion under management at the end of last year.

Those deep pockets – along with special ties to McClendon – have enabled it to bankroll his share of Chesapeake wells, according to minutes of a February 2011 meeting between EIG and the New Mexico State Investment Council, the state's public investment fund.

At the meeting, EIG chief operating officer Randall Wade sought a \$50 million investment from New Mexico. Asked about a prior EIG investment in McClendon's well interests, Wade boasted EIG had known Chesapeake for more than 25 years and "provided pre-IPO financing for them in the late 1980s."

Those tight bonds, Wade said, have created other unique opportunities for EIG.

"In fall 2008, Mr. McClendon didn't have liquidity to participate in the (well) program in 2009, at which point EIG entered into discussions with him and ultimately" formed a special purpose vehicle called Larchmont Resources, Wade said.

Through Larchmont, EIG acquired the rights to all of McClendon's well stakes for 2009 and 2010. EIG then set up a new special purpose vehicle – Jamestown Resources – to control McClendon's well shares in 2011, with rights to 2012, Wade said.

EIG's investments have been extremely profitable. "EIG sweeps 100 percent of the cash flow generated by those projects until EIG has gotten all of its money back plus a 13 percent realized return," Wade told New Mexico investors. EIG also gets a 42 percent cut of McClendon's share of the well profits "in perpetuity," he said.

EIG declined comment.

In February, EIG announced that China Investment Corp. (CIC), China's sovereign wealth fund, had acquired a minority stake for an undisclosed amount. CIC declined comment.

*Reporting By Brian Grow and Anna Driver; editing by Blake Morrison and Michael Williams*

# BIG STAKES THE ENERGY BILLIONAIRE'S SHROUDED LOANS

CEO is taking out loans from at least one entity, EIG, which recently provided financing to Chesapeake," said Joseph Allman, oil and gas industry analyst at JPMorgan in New York, who reviewed the loan agreements. "In the same way that investors want to know the counterparty to significant Chesapeake transactions, they would want to know if one of those firms has significant private dealings with the CEO."

Chesapeake's Hood acknowledged there could be "some theoretical possibility of a conflict of interest" with the company and its CEO borrowing from the same lender. But because Chesapeake does not believe there is "an actual conflict of interest," more disclosure is not required, Hood said.

## CLOSING A GAP

McClendon's personal loans highlight a gap in current SEC rules governing disclosures of related-party transactions, say accounting experts. The SEC requires disclosure of any transaction over \$120,000 involving a company and a related party, such as the CEO, directors and certain family members, "with direct or indirect material interest."

Chesapeake said the SEC's related-party rule doesn't apply to McClendon's loans - only to his participation in the well plan. That's because Chesapeake believes the loans "do not constitute a material transaction with Chesapeake or even involve Chesapeake," Hood said.

That disclosure gap may be closing. A proposed new standard, released for public comment by the Public Company Accounting Oversight Board on Feb. 28, would require auditors to identify and evaluate "significant unusual transactions" with executives connected to publicly traded firms. The board defined such transactions as those "outside the normal course of business or that otherwise appear to be unusual due to their timing, size or nature."

Board chairman James R. Doty de-



INVESTED IN COMPANY: Chesapeake CEO and co-founder Aubrey McClendon has taken out personal loans to invest in the company's oil and gas drilling efforts. **REUTERS/SEAN GARDNER**

scribed the proposal as a way to scrutinize transactions that have played "a recurring role in financial failures." The oversight board declined to comment on McClendon's loans.

For now, said analyst Weiss, Chesapeake and McClendon are pushing the limits. "If Chesapeake were trying to make things muddy and unclear without breaking the law, this would be a good way to do it."

*Reporting by Anna Driver in Houston and Brian Grow in Atlanta; additional reporting by Joshua Schneyer in New York; editing by Blake Morrison and Michael Williams*

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"PEACE PIPE"



**From:** Aubrey McClendon [mailto:aubrey.mcclendon@chk.com]  
**Sent:** Sunday, October 17, 2010 5:36 AM

**To:** Wojahn, Jeff

**Subject:** RE: Natural Gas Forum For Landowners - EnCana putting leasing on hold

Understand our teams are working on cooperative approach to state leasing, that's good I think. Anything else out their encouraging to talk about? thanks



Emails show Chesapeake and Encana hatched plans to tame an oil-acreage rush in Michigan, Reuters found

# Energy rivals plotted to suppress land prices

BY BRIAN GROW, JOSHUA SCHNEYER AND JANET ROBERTS

GAYLORD, MICHIGAN, JUNE 25, 2012

**From:** Wojahn, Jeff [mailto:Jeff.Wojahn@encana.com]

**Sent:** Wednesday, October 20, 2010 10:19 AM

**To:** Aubrey McClendon

**Subject:** RE: Natural Gas Forum For Landowners - EnCana putting leasing on hold

We just finished our board meeting and we have our conference call today. I will be on the western slope touring Randy around our operations tonight and tomorrow..

From what I understand John Schopp has been leading the charge on working with your team on arranging a bidding strategy. I have a meeting with John planned on Friday and a review with Randy Monday.

Jeff



## "PEACE PIPE" ENERGY RIVALS PLOTTED TO SUPPRESS LAND PRICES

Under the direction of CEO Aubrey McClendon, Chesapeake Energy Corp. plotted with its top competitor to suppress land prices in one of America's most promising oil and gas plays, a Reuters investigation has found.

In emails between Chesapeake and Encana Corp, Canada's largest natural gas company, the rivals repeatedly discussed how to avoid bidding against each other in a public land auction in Michigan two years ago and in at least nine prospective deals with private land owners here.

In one email, dated June 16, 2010, McClendon told a Chesapeake deputy that it was time "to smoke a peace pipe" with Encana "if we are bidding each other up." The Chesapeake vice president responded that he had contacted Encana "to discuss how they want to handle the entities we are both working to avoid us bidding each other up in the interim." McClendon replied: "Thanks."

That exchange – and at least a dozen other emails reviewed by Reuters – could provide evidence that the two companies violated federal and state laws by seeking to keep land prices down, antitrust lawyers said.

"The famous phrase is a 'smoking gun.' That's a smoking H-bomb," said Harry First, a former antitrust lawyer for the Department of Justice. "When the talk is explicitly about getting together to avoid bidding each other up, it's a red flag for collusion, bid-rigging, market allocation."

The revelation of the discussions between Encana and Chesapeake, the second-largest natural gas producer in the United States, comes at a time when McClendon already is under fire.

The company's board stripped him of his chairmanship after Reuters reported that he took out more than \$1.3 billion in personal loans from a firm that also finances Chesapeake. The IRS and the Securities and Exchange Commission have launched inquiries.

The talks to suppress land prices could



BID RIGGING? Former Department of Justice attorney Darren Bush said the emails between Chesapeake and Encana seem little more than an effort to suppress land prices in Michigan.

REUTERS/RICHARD CARSON

prove even more damaging – for McClendon, Chesapeake, Encana and other top executives with both companies.

Private industry cartels are forbidden in the United States, where price-fixing between competitors is illegal under the Sherman Antitrust Act. Violations carry stiff penalties. Companies can be fined up to \$100 million and individuals up to \$1 million for each offense. Jail sentences – which are rare – can be as long as 10 years, and collusion among competitors can lead to prosecution or fines for mail and wire fraud. Victims of bid-rigging can also seek triple the amount of damages.

Chesapeake and Encana say they discussed forming a joint venture in Michigan but opted against it. Typically, such partnerships can defray the steep costs of

**“**It's a red flag for collusion, bid-rigging, market-allocation.

**Harry First**  
Former Justice Department lawyer

shale development, which include amassing thousands of acres of land and drilling dozens of wells.

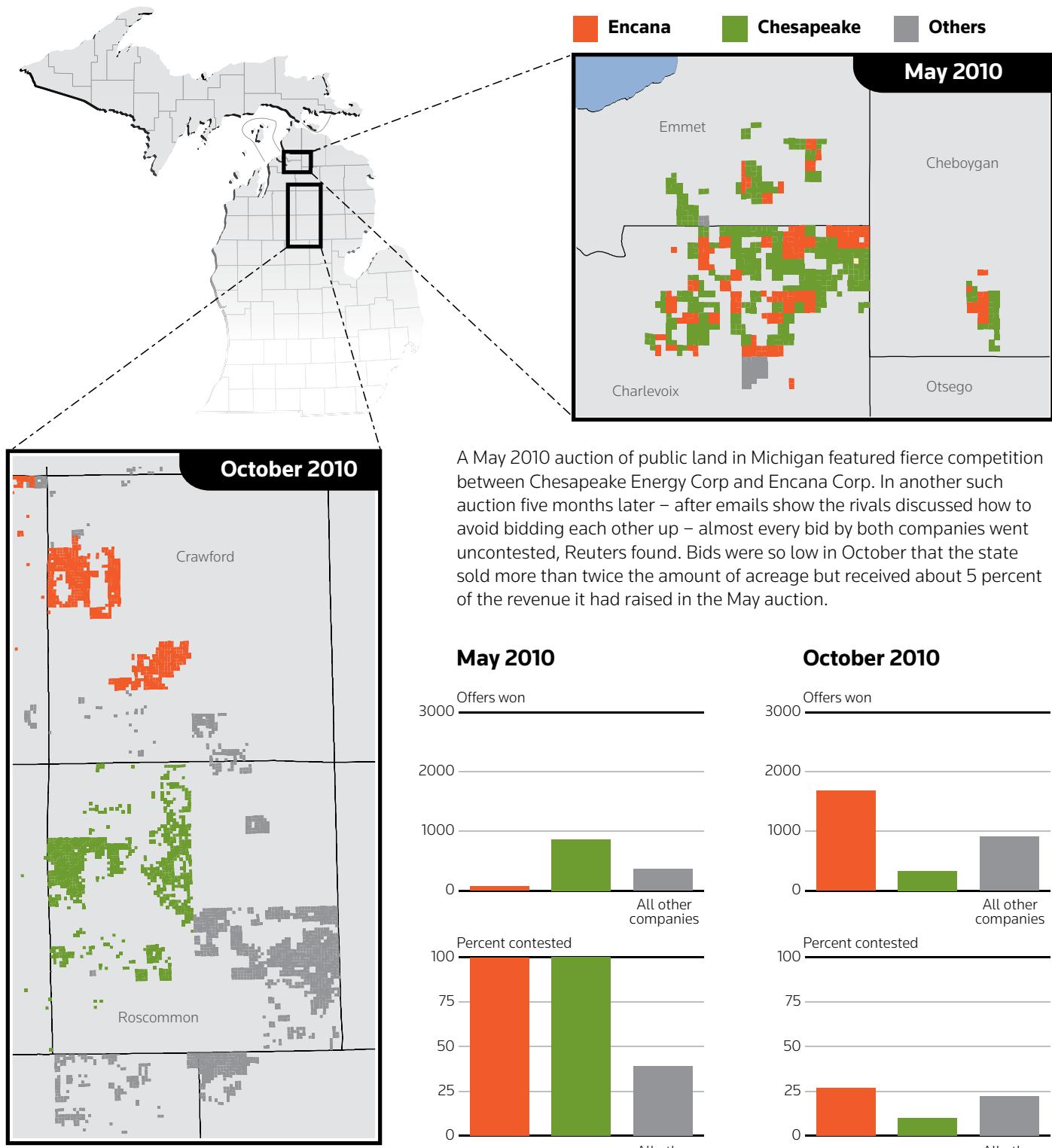
In response to detailed questions from Reuters, Encana said it was undertaking an internal investigation, saying it "is committed to conducting its business in an ethical and legal way." It acknowledged that its U.S. branch "discussed, but did not go forward with, a joint venture with Chesapeake Energy," but added that it "cannot specifically address the questions posed at this time."

Chesapeake spokesman Jim Gipson also said there had been discussions with Encana about "forming an 'area of mutual interest' joint venture" in Michigan. But he said "no such agreement was reached between the parties.... Nor did Encana and Chesapeake make any joint bids."

Antitrust lawyers said the fact that the companies discussed a formal joint venture wouldn't dispel legal concerns.

"Nothing in the documents suggests any benefit to the joint venture other than making the price fall," said Darren Bush, a former attorney in the Antitrust Division of the

## Auction revenues in Michigan: going, going, gone



Source: Reuters analysis, Michigan Department of Natural Resources

## "PEACE PIPE" ENERGY RIVALS PLOTTED TO SUPPRESS LAND PRICES

Department of Justice and a law professor at the University of Houston. "If it has no other purpose, then it's just a shell and doesn't change the liability for illegal conduct."

### LAND RUSH

The discussions about how to team up in Michigan apparently began in early June 2010, when Chesapeake and Encana were competing fiercely to acquire land in the Collingwood Shale formation in Northern Michigan.

The shale formation is a layer of oil- and gas-rich rock lying thousands of feet below the rolling hills, cherry groves and family farms of northern Michigan. It extends from beneath the dunes on Lake Michigan and Lake Huron's shorelines to the center of the mitten-shaped state.

In 2010, the region was at the forefront of America's shale boom – a buying frenzy made possible by the innovative drilling technology known as hydraulic fracturing, or "fracking." The technique has fueled the largest U.S. land grab since the Gold Rush of the 1850s – and Chesapeake and Encana are among the biggest players nationwide.

Chesapeake's McClendon has been the single most acquisitive buyer. In the last 10 years, his company has amassed more than 15 million acres of land in the United States – an area about the size of West Virginia. Encana has leased 2.5 million acres. In Michigan alone, the two companies combined hold more than 975,000 acres of land – an area about the size of Rhode Island.

At a May 2010 auction of public land run by Michigan's Department of Natural Resources, Chesapeake and Encana had been the dominant buyers. Through intermediary bidders, the two giants spent almost \$165 million combined – 93 percent of the record \$178 million taken in by the state – to acquire more than 84,000 acres of land. Chesapeake alone spent \$138 million, according to a Reuters review of state data. Firms bid an average of \$1,413 per acre for

# It's time to "smoke a peace pipe"

### Inside the Chesapeake-Encana talks

**May 6, 2010:** At a record-breaking Michigan state auction, Chesapeake and Encana bid against each other; state raises record \$178 million.

**June 6:** A Chesapeake official reaches out to Encana to discuss teaming up. The email is copied to Chesapeake CEO McClendon and Jeff Wojahn, president of Encana U.S.A.

**June 15:** McClendon asks top Encana and Chesapeake officials which company should handle bidding with one land owner who "wants us to bid against each other..."

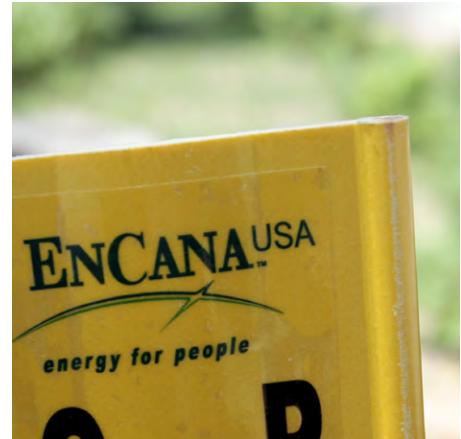
**June 16:** McClendon tells a top deputy it's time "to smoke a peace pipe" with Encana "if we are bidding each other up" in one land deal.

**June 18:** Chesapeake's internal logs say one Chesapeake vice president is "working with ECA to try and avoid bidding each other up." ECA is Encana.

**June 25:** A Chesapeake internal log says one top official continues to work on a deal with Encana "so we don't continue to push the price up."

**July 2:** A map of Michigan prepared by Chesapeake divides the state into proposed areas that Chesapeake would operate and areas Encana would control.

**July 16:** A land broker for Chesapeake asks company officials if it's just "coincidence" that both Chesapeake and Encana have cut back their bids significantly.



REUTERS/REBECCA COOK

**Oct. 14:** An Encana U.S. official emails a Chesapeake colleague that he "wanted to identify Encana's suggested contract lands and bidding responsibilities so you can take a look" before an upcoming Michigan state auction.

**Oct. 19:** A map prepared by Chesapeake shows projected acreage to be bid on at state sale. The map shows a breakdown that would give the two companies virtually identical positions of coveted oil acres

**Oct. 20:** Wojahn, president of Encana's U.S. operation, sends McClendon an update: One Encana official has been "leading the charge on working with your team on arranging a bidding strategy."

**Oct. 23:** An internal Chesapeake document says Chesapeake no longer is "interested in MI state sale joint-bid strategy."

**Oct. 26-27:** At the Michigan state land auction, Chesapeake and Encana buy no land in the same counties. Competition is virtually non-existent.

## "PEACE PIPE" ENERGY RIVALS PLOTTED TO SUPPRESS LAND PRICES

the right to extract oil and gas from the state-owned land.

Meanwhile, private landowners – aware that major energy companies were paying top dollar to lease property – sought competing bids from rival drillers. Some landowners were being offered more than \$3,000 per acre in June 2010, documents reviewed by Reuters show.

Top executives from Chesapeake and Encana were growing weary of the rapidly escalating prices. In early June, Chesapeake vice president Doug Jacobson reached out to Encana to discuss what the emails characterized as an "area of mutual interest" in Michigan – regions where the two companies would have the option to share mineral leases equally after they were purchased.

### A COMMON PRACTICE

Area-of-mutual interest agreements are common in the oil industry. They allow drillers to share in the risks and rewards of developing an energy play. But they aren't meant to allow the discussion of strategies to divide territory or avoid competitive bidding, say oil and gas industry attorneys.

In subsequent months, the emails show, top officials discussed ways to prevent land prices from escalating. The solution they proposed: dividing up Michigan counties and private landowners between them.

From June 6 to June 15, 2010, the two companies swapped proposals. In many of the emails, officials refer to the companies by their three-letter stock abbreviations: CHK for Chesapeake and ECA for Encana.

On June 6, Chesapeake vice president Jacobson sent an email with the subject line "CHK/ECA – MI" to Encana vice president John Schopp. It was copied to McClendon and to Jeff Wojahn, Encana's U.S. president. "Our proposal is pretty simple, but hopefully should be effective for us both," Jacobson wrote.

He outlined a strategy that included swapping land already leased in Michigan and dividing up counties and private land-

owners where new leases might be secured.

Both Chesapeake and Encana "will have the option of acquiring 50% of the acreage acquired by the other" within the area of mutual interest "on the same terms as the initial acquiring party," Jacobson wrote.

Jacobson added that "the parties will work together to decide the best way to make a deal with Merit," a Dallas-based energy company that owned more than 200,000 acres of land in Michigan. Chesapeake, he wrote, "has met with them twice to date. They will be tough and expensive."

Merit declined to comment.

### 'HAIL MARY PASS'

On June 15, Jacobson reiterated Chesapeake's desire to strike a deal with Encana. In an email to Schopp, the Encana vice president, Jacobson suggested they discuss plans to split up where, and from whom, each company would lease land in Michigan. The reason, the email shows, was to ensure each company could acquire more land without bidding against the other.

"Also, when you are back in the saddle, I'd like to visit with you about the implications of the impact of our competition on acreage prices and whether or not the sooner we do this the better shot we have of keeping acreage prices from continuing to push up," Jacobson wrote to Schopp.

Two minutes later, Jacobson forwarded that email to Chesapeake CEO McClendon and three other Chesapeake executives,

**“**Nothing in the documents suggests any benefit to the joint venture other than making the price fall. If it has no other purpose, then it's just a shell and doesn't change the liability for illegal conduct.

**Darren Bush**

Former attorney in the Antitrust Division of the  
Department of Justice

documents show. The next day, McClendon sent his "peace pipe" email to Jacobson – an email that former Justice Department lawyer First said could be "government exhibit No. 1" in an antitrust case.

"It's what the prosecutor puts up in a PowerPoint presentation for the grand jury," said First, now a professor at New York University. "It would take a Hail Mary pass to defend that."

To be sure, the documents reviewed by Reuters don't provide a complete picture of what went on between the two companies. One unanswered question is whether Chesapeake and Encana consummated any collusive agreements – a condition that might be necessary to convince a jury that the companies broke the law.

One internal Chesapeake document indicates McClendon may have backed away from what a company memo characterized as a "joint-bid strategy" relating to a Michigan state land auction in October. The emails also don't make clear what became of efforts between the companies to decide which of them would handle the bidding for land held by private owners.

But in the weeks after the discussions began, Chesapeake and Encana sharply cut the prices they were offering for land in Michigan, and average lease prices plunged in areas that had previously been hotly contested. At the time, the two companies were by far the largest lease buyers in the state.

Chesapeake did some of its buying through contractor David McGuire, who secured Michigan leases on the company's behalf. In a July 16 email to Chesapeake executives, McGuire reported that both companies had cut the maximum per acre amount they were bidding by 50 percent. In the email, McGuire asked the executives whether this was a "coincidence?" In response, Chesapeake's Jacobson didn't address the question directly. Instead, he told McGuire to pare back further lease buying.

Other documents show that in July, Chesapeake put on hold more than a dozen

## "PEACE PIPE" ENERGY RIVALS PLOTTED TO SUPPRESS LAND PRICES



DEALS VANISHED: Weeks after Encana and Chesapeake vied for land owned by Walter Zaremba, Zaremba said both companies withdrew their offers. He's now suing Encana. **REUTERS/REBECCA COOK**

en deals it had been negotiating with large private land owners. The documents show that both Encana and Chesapeake simultaneously stopped negotiating with one land owner, Walter Zaremba, and both withdrew offers for his land.

"We suspected collusion when Encana called and said the deal was off, and Chesapeake lost interest at the same time," Zaremba said after Reuters showed him several of the emails, none of which he had previously seen. He was already in litigation with Encana, claiming that it reneged on a deal for about 20,000 acres he owns. "Sure as hell something happened because things don't just break down like that overnight."

Oil and gas industry lawyers said the cooperation plan outlined in the emails under the auspices of an "area of mutual interest" isn't how joint ventures are meant to be handled.

**“**We suspected collusion when Encana called and said the deal was off, and Chesapeake lost interest at the same time. Sure as hell something happened because things don't just break down like that overnight.

**Walter Zaremba**

Michigan land owner

"These agreements are not a way in which companies divide up territory together or avoid sellers playing them off each other," said Bruce Kramer, an expert on oil and gas law.

Chesapeake and Encana have never publicly disclosed any joint venture, and oil and gas industry analysts consider them fierce rivals. Each holds major land

positions in several of the same shale-rich states. Their competitive streaks make the behind-the-scenes communications all the more striking.

At least a dozen emails between top-level executives of the two firms address themes that competitors are warned not to discuss with each other, according to anti-trust guidelines set by the American Petroleum Institute, the leading U.S. oil industry trade group.

To avoid potentially illegal behavior when competitors meet at an industry conference, for instance, the trade group warns against discussing any number of topics, most of which Chesapeake and Encana covered in the emails reviewed by Reuters.

Among the subjects the institute says competitors should avoid: sharing confidential or proprietary information; discuss-

## "PEACE PIPE" ENERGY RIVALS PLOTTED TO SUPPRESS LAND PRICES

ing agreements, either explicit or implicit, on pricing; company purchasing, merger or divestment plans; market allocation and development plans; inventories or costs. "Any discussion regarding potential energy or economic scenarios that may arise must be limited to generalities," the guidelines say.

Attempts at price-fixing by rival corporations are typically difficult to prove in court. That's because competitors rarely commit collusive agreements to writing.

Top Chesapeake and Encana executives, however, spelled out their ideas in great detail, the emails show, from the beginning of June 2010 through that October.

"This looks like a great start," Encana's Schopp replied June 7 to Chesapeake's Jacobson's proposal to divide bidding responsibilities. "A few suggestions that would maximize our effectiveness."

Among his recommendations was that the companies split owners into two groups; Chesapeake would handle negotiations with one and Encana with the other. That way, the two wouldn't bid against one another. Also copied on the June 7 email from Schopp: Encana CEO Randy Eresman.

About one week later, June 15 at 6:51 a.m., McClendon himself weighed in. He copied Encana's U.S. president Wojahn and Eresman. Referring to one company that owned mineral leases on more than 30,000 Michigan acres, McClendon wrote that it "looks like Northstar wants us to bid against each other next week, let's discuss who should handle that one – thanks."

NorthStar is an energy company based in Traverse City, Mich. The company declined to comment.

Another note about NorthStar appeared in a June 16 Chesapeake summary of Michigan land deals. It said that McClendon "does not want to complete (sic) with Encana on this deal if CHK is interested."

"We call that bid rotation," a violation of antitrust law in which participants in a transaction select who will be the winner in advance of bidding, said Herbert Hoven-

kamp, a law professor and antitrust expert at the University of Iowa.

Later on June 16, Jacobson asked Schopp how soon he thought Encana could craft a formal deal to work together. Chesapeake, he added, was largely amenable to the "county split."

That's when Jacobson urged quick action to keep "acreage prices from continuing to push up."

### DIVIDING MICHIGAN

Perhaps the most sophisticated plan the two companies forged was developing a bidding strategy for the auction of state land in Michigan on October 26, 2010.

Bidding at the state's May 2010 auction had been vigorous and contested. That helped the state raise a record \$178 million from the sale of more than 118,000 acres, according to a review of state auction data by Reuters. At that auction, 83 percent of the more than 1,200 winning bids had competitive offers.

Five months later, at the October auction, the bidding and the results proved remarkably different and far less lucrative. It raised just \$9.7 million from the leasing of about 274,000 acres – more than twice the acreage sold in May but almost \$170 million less in revenue.

The average winning bid in October was \$46, the Reuters analysis shows. In May, it had been \$1,413. Most of the winning bids in October were for the minimum price set by the state: \$13 per acre.

One possible reason for the dreary auction results in October is that prices for

natural gas had fallen significantly, about 20 percent.

Another possible reason, according to documents reviewed by Reuters: Two of the largest buyers in October – Chesapeake and Encana – had been discussing how to avoid bidding against the other.

On October 14 – a dozen days before the state auction – Kurt S. Froistad, a land executive with Encana, emailed Gary Dunlap, Chesapeake's vice president of land. The subject line: "Michigan State Lease Sale."

Froistad told Dunlap he was "working on a draft agreement for the sale, but wanted to identify Encana's suggested contract lands and bidding responsibilities so you can take a look."

The suggested split shows Encana as the "bidder" at the auction for state land in Charlevoix, Cheboygan, Kalkaska and Crawford counties. Chesapeake would be the "bidder" in Emmet, Presque Isle, Roscommon, Missaukee and Grand Traverse counties, according to the email.

### CHIEFS IN THE LOOP

Over the next three days, Chesapeake executives designed maps outlining the proposed split of bidding at the state auction, according to emails.

McClendon and Wojahn, president of Encana's U.S. unit, were aware of the proposed auction bidding strategy. "Understand our teams are working on a cooperative approach to state leasing, that's good I think. Anything else out there encouraging to talk about?" McClendon wrote in an email to Wojahn on Oct. 17.

"We haven't arrived at a strategy yet but as we approach the sale we will be happy to have a fulsome technical discussion," Wojahn replied on Oct. 18.

A day later, Chesapeake drew up a particularly detailed map. It projected how the county split could allow each firm to end up with almost exactly 134,000 "oil acres" after the auction. Oil-rich shale is much more valuable, since crude trades at

# \$178m

The record amount raised by the state of Michigan in a May 2010 land auction

## "PEACE PIPE" ENERGY RIVALS PLOTTED TO SUPPRESS LAND PRICES



SEARCH FOR GAS: An Encana production well for oil and natural gas in Kalkaska, Michigan. **REUTERS/REBECCA COOK**

a massive premium to natural gas.

On Oct. 20, Wojahn sent McClendon an update: "From what I understand (Encana's) John Schopp has been leading the charge on working with your team on arranging a bidding strategy. I have a meeting with John planned on Friday and a review with Randy Monday." Randy is Randy Eresman, Encana's CEO.

McClendon appears to have decided to back away from the auction plan proposed by Froistad. A summary of Chesapeake's new ventures, sent in an email on Oct. 23, notes that, as a result of a meeting with McClendon, staff members should inform Encana that Chesapeake had lost interest in the "joint-bid strategy."

In the end, Chesapeake and Encana did not acquire state land in the exact counties outlined in the proposals and in the maps Reuters reviewed. But an analysis of the auction results shows that neither company bought any land in the same county as the other. Earlier, at the May auction, bidders for Chesa-

peake and Encana had competed fiercely for tracts in several of the same counties.

### BURDEN OF PROOF

Because the state does not keep a bid-by-bid record for parcels in which there was competition, it's unclear whether Chesapeake and Encana ever bid against each other in October.

But records do show that other companies bid against Chesapeake in just 10 percent of the 320 leases it purchased at the fall auction. That's in stark contrast to the Michigan state auction in May. Then, Chesapeake faced competing bids for every one of the more than 850 leases it secured.

Encana fared similarly in the fall auction. In October, only 27 percent of the 1,675 leases it purchased were contested. In the May auction, companies bid against Encana in each of its 70 successful offers.

Antitrust experts said that even though the plans discussed in the emails didn't play out exactly as envisioned, they nonetheless

may have had the desired effect.

"In a situation where there is some level of collusion going on, it's hard to get agreement on everything. It's not easy to form cartels," said law professor First. "The fact that a cartel isn't perfectly effective doesn't mean it isn't harmful."

*Reporting by Brian Grow and Joshua Schneyer in Gaylord, Michigan, and Janet Roberts in New York; editing by Blake Morrison and Michael Williams*

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JOB TWO



CEO Aubrey  
McClendon ran  
a \$200 million  
fund that invested in  
commodities produced  
by Chesapeake

MOONLIGHTING CEO: McClendon co-owned and was actively involved in a private hedge fund at the same time he ran Chesapeake Energy. "Strict codes" ban such dealing at most rivals, says one risk-management consultant. **REUTERS/SEAN GARDNER**

# The CEO'S secret hedge fund

BY JOSHUA SCHNEYER, JEANINE PREZIOSO AND DAVID SHEPPARD

NEW YORK, MAY 2, 2012

**A**s chairman and CEO of Chesapeake Energy Corp, Aubrey McClendon has been a powerhouse in the vast U.S. natural gas market, directing the company's multibillion dollar energy-trading operation and setting output targets for America's second-largest producer.

Behind the scenes, a Reuters investigation has

found, McClendon also ran a lucrative business on the side: a \$200 million hedge fund that traded in the same commodities Chesapeake produces.

On Tuesday, two weeks after Reuters reported that McClendon has taken up to \$1.1 billion in loans against his stakes in Chesapeake oil and gas wells, the company stripped McClendon of the chairmanship

## JOB TWO THE CEO'S SECRET HEDGE FUND

and reiterated that it's reviewing details of the loans. A statement quoted McClendon, who will stay on as CEO, saying that the move will enable him to focus his "full time and attention on execution of the company's strategy."

But for at least four years, from 2004 to 2008, McClendon's attention extended well beyond his job at Chesapeake.

During that time, said a veteran trader who helped run McClendon's private hedge fund, the Chesapeake executive engaged in "near daily" communications and "exhaustive" calls to help direct the fund's trading.

The fund, Heritage Management Company LLC, was started by McClendon and Chesapeake co-founder Tom Ward. The hedge fund listed Chesapeake's headquarters in Oklahoma City as its mailing address, documents show. Heritage's staff included an accountant who was simultaneously employed by Chesapeake. The fund also earned McClendon and Ward management fees and a cut of profits from outside investors.

There is no evidence that McClendon or Ward used inside knowledge gleaned from Chesapeake in their hedge fund trading. Neither the company nor McClendon would comment, and Ward said he saw nothing wrong with the arrangement.

But experts on energy trading, corporate governance and commodity-market regulation said they were stunned by the latest revelation.

"An executive's first responsibility is to shareholders and the betterment of their investment," said Carl Holland, who ran the trading-compliance department at former U.S. oil major Texaco. "Personal trading in the commodity around which the CEO's business is based would be a clear no. We would never have tolerated that, ever."

Thomas Mulholland, a risk-management consultant to oil and gas producers for Golden Energy Services in St Louis, said such matters are "taken very seriously by energy companies, and there are strict codes against it. Even if there is just a whiff of impropriety," he said, "it can be enough

to lead to a termination."

The commodities markets are less regulated than equity markets, where corporate executives are prohibited from trading stock in their own companies based on undisclosed financial information. In commodities markets, insider trading isn't illegal unless price manipulation can be proven.

Nonetheless, personal dealing in energy markets is typically forbidden by oil and gas companies for a variety of reasons.

In Chesapeake's case, McClendon would have been aware of major decisions that could affect natural gas prices before that information became public. Accounting for 5 percent of U.S. natural gas production, Chesapeake holds tremendous sway over markets. On Jan. 23, the company announced sharp output curbs in response to low prices. In response, U.S. natural gas futures surged by 8 percent the same day.

**“**A reasonable investor would want to know that the CEO could be in a situation where he's betting against the interests of the company personally. That, it seems to me, is a slam dunk.

**Elizabeth Nowicki**

Professor of securities law, Tulane University

"If the company needs to make an operating decision which might move the market against the CEO's positions, there's a risk that will influence the decision-making at the top of the company," said Jeff Harris, former chief economist at the market's U.S. regulator, the Commodity Futures Trading Commission, and now professor of finance at Syracuse University.

Another potential problem is known as "front-running." That's when a trader buys or sells a commodity in advance of a client's or his company's orders. In theory, McClendon's first-hand knowledge of Chesapeake's own plans to trade would enable him to

profit by trading ahead of Chesapeake - a move that could raise costs for the company.

"Advance knowledge of Chesapeake's activities could be perceived as having insight into the movement of commodities prices, which certainly raises conflict-of-interest issues as well as ethical issues about the ability to enrich himself on non-public information," said Tim Rezvan, oil and gas industry analyst at Sterne Agee in New York.

"If correct," Rezvan said, "these disclosures would be even more alarming than the personal loans."

A securities law professor said the very existence of the hedge fund could prompt a securities investigation.

"I would argue, and I think the SEC would argue, that the failure to disclose that you are engaging in this kind of conduct can constitute a securities fraud problem," said Elizabeth Nowicki, a professor at Tulane University. She said a failure by McClendon and Ward to disclose their fund to Chesapeake's shareholders may constitute a "material omission" that could draw SEC scrutiny.

"A reasonable investor would want to know that the CEO could be in a situation where he's betting against the interests of the company personally," Nowicki said. "That, it seems to me, is a slam dunk."

An SEC spokesman declined to comment.

### UNANSWERED QUESTIONS

It remains unclear whether McClendon received permission from Chesapeake's board to run a hedge fund and actively trade in the commodities markets for himself, or whether his trading continues. Chesapeake and McClendon's personal spokesman declined to comment.

Chesapeake also declined to say whether employees would be prohibited from operating such a hedge fund or trading their own cash in oil and gas markets. The issue isn't clearly addressed in a code of ethics published on Chesapeake's website.

Two Chesapeake board members contacted by Reuters declined to comment.

"Given litigation, we are constrained in what we can say," said Chesapeake spokesman Michael Kehs, who was referring to shareholder lawsuits filed in the wake of the Reuters report on McClendon's personal loans.

Oil and gas markets are secretive, and trading positions are almost never made public. McClendon's hedge fund partner Ward said the two were always careful not to let Chesapeake's decisions influence the hedge fund's endeavors.

Ward, who continues to trade his own personal cash in commodity markets and is now CEO of oil and natural gas driller SandRidge Energy, said he doesn't know whether Chesapeake's board knew of the hedge fund he ran with McClendon. But he said he sees "no conflict of interest."

"We did not use any proprietary knowledge of (Chesapeake) trades to make our own individual decisions," Ward said.

Peter Cirino, who helped trade natural gas for the hedge fund, also said he knew of no discussions about what Chesapeake was doing in energy markets: "They were much too smart as individuals," Cirino said of McClendon and Ward. "They would be able to manage that conflict there, if there was one."

Today, McClendon leads the three-man team that oversees Chesapeake's trading in oil and gas for the purposes of hedging, or offsetting the risk of unfavorable price swings. When Reuters asked McClendon last year whether he traded for himself in energy markets, McClendon said: "No, no, no. I'm part of Chesapeake's hedging committee."

That committee has helped Chesapeake "lock in" high prices for the gas it sells. This year, the company has not hedged. It told investors in a presentation that it doesn't expect natural gas prices - near 10-year lows - to continue falling.

The company's own trading has been a big success. "The bottom line is that Chesapeake has delivered \$8.4 billion in realized hedging gains to shareholders since 2006," said Kehs, the company spokesman. "That's

extraordinary shareholder value added through innovation and by far the best record in the oil and gas industry."

After Reuters disclosed McClendon's \$1.1 billion in loans, Standard & Poor's cut Chesapeake's debt rating, citing "shortcomings" in corporate governance. The SEC and the Internal Revenue Service have begun probes in the wake of the loans report.

Chesapeake shares rose more than 7 percent on Tuesday on the news that McClendon is being replaced as chairman. After the stock market closed, the company reported a first-quarter net loss of \$71 million. Its shares fell 5 percent in after-hours trading and are down almost 20 percent this year.

### BIRTH OF HERITAGE

A search of Chesapeake's public filings turned up no disclosure of McClendon's hedge fund, Heritage.

Reuters traced its roots to Delaware, where it was registered in 2004 by Corporation Trust Company, a firm that helps companies incorporate. Another filing in New York, where Heritage employees executed many of the fund's trades, lists its mailing address as Chesapeake headquarters in Oklahoma.

A Heritage telephone number listed in several business directories was answered "Chesapeake Energy" by a person who said she hadn't heard of the fund. The fund is also listed in a database compiled by the National Futures Association, which doesn't disclose its owners.

Heritage also shared at least one employee with Chesapeake: John D. Garrison. Garrison, an accountant listed as executive business manager for Chesapeake Energy in federal election campaign donation filings and as a Chesapeake employee since 2004, handled the hedge fund's bookkeeping, Cirino said. The arrangement is not illegal.

Business directories including Dun & Bradstreet also list Garrison as Heritage's chief financial officer. Garrison declined to comment when a reporter visited his home

## Big Player

The largest bets on rising natural gas prices on June 30, 2008

### OVER-THE-COUNTER NATURAL GAS SWAPS, NET LONG POSITIONS (Notional value, in billions)

Barclays	\$28.79
Texas Competitive Electric Holdings	4.58
Boone Pickens	4.03
Morgan Stanley	2.37
Tom L. Ward	2.30
Aubrey K. McClendon	2.25
Bank of Montreal	2.12
AIG	2.02
Goldman Sachs	1.80
Shell	1.76

Source: Commodity Futures Trading Commission via Sen. Bernie Sanders

near Oklahoma City.

Heritage was born when commodity trader Cirino and four other traders went searching for capital to start a hedge fund, Cirino said. Through industry contacts, they landed a coveted audience with McClendon and Ward, already famed Oklahoma drillers before becoming pioneers of the shale-gas boom.

The Chesapeake founders, Cirino recalled, agreed to seed the fund with a total of \$40 million of their own cash. But McClendon and Ward insisted on full ownership and involvement in the fund's trading strategy, Cirino said.

"They took a leap of faith to invest money in us, so we knew we were on the line," said Cirino, Heritage's former head trader and risk officer. "That they were in charge was made very clear."

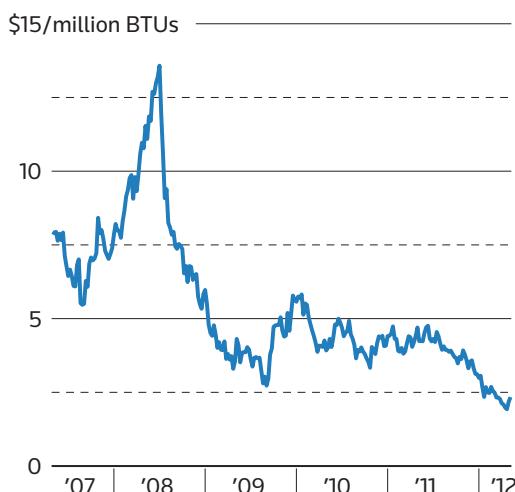
The fund's trading wasn't limited to energy markets. It bet on a variety of goods, from natural gas to cocoa and coffee. It even had a cattle trader in Oklahoma.

As Heritage racked up stellar returns of between 15 to 25 percent a year, McClen-

## Well of trouble

Chesapeake share performance closely tracked natural gas prices until an April 18 Reuters report that McClendon borrowed \$1.1 billion against his stakes in company wells.

**NATURAL GAS FUTURES,  
NYMEX continuous front month (Weekly)**



Source: Thomson Reuters

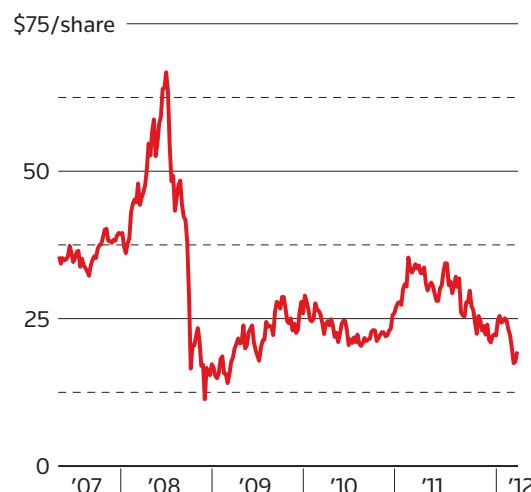
don and Ward decided to open the hedge fund to outside investors, including friends and associates, Cirino said. When Ward left Chesapeake in 2006, he retained his stake in the fund.

By 2007, Heritage was managing around \$200 million, Cirino said. That enabled Ward and McClendon to profit in another way: by charging outside investors a management fee equal to 2 percent of assets and pocketing 20 percent of the fund's profits. It's a typical structure in the hedge fund industry, known as "2 and 20."

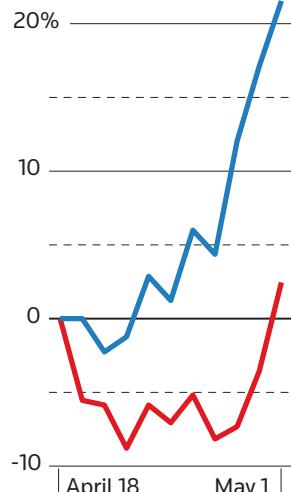
Cirino and Ward's recollections differ on at least one point. Ward said he didn't interact with the fund's outside investors. Cirino recalled that "every investor I was involved with either met with McClendon and Ward or at least spoke with them by phone before investing." The hedge fund's healthy gains were a lure, but "the cachet of those two individuals certainly also helped," Cirino said.

In addition to weekly Monday conference calls and regular emails, the two owners met frequently with traders in New York

**CHESAPEAKE ENERGY SHARES  
(Weekly)**



**PERFORMANCE  
(Percentage change)**



and occasionally in Oklahoma, Cirino said.

In 2007, as the price of natural resources surged on booming demand from China and other fast-developing countries, commodity traders with a successful track record were popular on Wall Street. After three years of double-digit returns, the fund's traders told McClendon and Ward they wanted an equity stake, Cirino said.

But the executives weren't ready to cede control, Cirino said, and the traders left to open their own shop, Perennial Capital LLC, a \$200 million fund that has no financial ties to McClendon or Ward. Cirino said the departure was amicable.

At Heritage, all of the money from external investors was returned by 2008, Cirino said. McClendon and Ward continued to operate the fund during that year, Ward said, but by 2009, Heritage traded no more.

What happened next to McClendon's commodity-trading ventures is unclear.

By June 2008 - as natural gas and oil prices were peaking, and just before the financial crisis - McClendon and Ward both

held huge positions in natural-gas derivatives, according to confidential trading data disclosed last year by U.S. Senator Bernie Sanders, an independent from Vermont.

The trading information was assembled as part of a CFTC inquiry into derivatives markets and their impact on real-world energy prices. McClendon and Ward were among only a handful of individual investors identified by the CFTC. Most of the other players were big corporations.

The data indicated McClendon and Ward were betting that the rally of 2008 would continue. By purchasing derivatives, they controlled nearly identical positions in natural gas worth around \$2.3 billion apiece, according to Reuters calculations based on closing futures prices as of June 30, 2008. McClendon held oil contracts worth another \$240 million, the CFTC data showed.

Of 300 banks, hedge funds, energy companies and other traders identified in the CFTC survey, only four held larger bullish bets in natural gas.

## JOB TWO THE CEO'S SECRET HEDGE FUND

Oil fell by more than 75 percent between July and December. Natural gas futures dropped almost 60 percent.

It isn't clear how McClendon and Ward's investments fared. McClendon would not discuss his trading. Ward said he could not recall the outcome of his own trades in 2008.

McClendon suffered a well-documented personal cash crunch later that year, however.

In early 2008 McClendon held a big position in Chesapeake stock purchased with borrowed money. Later that year, margin calls from his brokers forced McClendon to unload more than 90 percent of his Chesapeake shares and suffer a \$2 billion paper loss. His selling contributed to an 88 percent fall in Chesapeake's share price from its all-time high of \$74 that year. Chesapeake has since restricted "leveraged" trading in the company's shares by its executives.

Months later, McClendon became one of the highest paid CEOs in America for the year, receiving a total compensation package worth \$112 million. The payout included a one-time cash bonus of \$75 million to help him meet requirements for paying the costs of his personal stakes in Chesapeake-owned wells.

*Additional reporting by Sarah N. Lynch, Brian Grow, Anna Driver and Roberta Rampton.  
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DATA DISCLOSED : Vermont Senator Bernie Sanders released confidential trading data that showed that by June 2008, McClendon and Chesapeake co-founder Tom Ward held huge positions in natural gas derivatives. **REUTERS/BRIAN SNYDER**

## INSIDE CHESAPEAKE



1. In an annex at Chesapeake's corporate headquarters, a cadre of employees handles McClendon's personal business.
2. McClendon directed Chesapeake to spend \$10 million to help turn Oklahoma City into a rowing venue and put 10 Olympic hopefuls on the energy company payroll.
3. Duke University honored McClendon with a gargoyle likeness after he contributed \$15 million.
4. McClendon has taken more than \$1 million in personal trips on Chesapeake-leased jets.
5. McClendon has taken loans against profits in his stake in the NBA's Oklahoma City Thunder.
6. Chesapeake inked deals with the Thunder that included arena naming rights.



The CEO's personal and corporate interests are fused more extensively than shareholders may know, Reuters found

# The lavish and leveraged life of Aubrey McClendon

BY JOHN SHIFFMAN, ANNA DRIVER AND BRIAN GROW

# INSIDE CHESAPEAKE THE LAVISH AND LEVERAGED LIFE OF AUBREY MCCLENDON

OKLAHOMA CITY, JUNE 7, 2012

In an annex at the headquarters of Chesapeake Energy Corp, a unit informally known as AKM Operations manages a top company priority: the personal business of its namesake, Chief Executive Aubrey K. McClendon.

According to internal documents reviewed by Reuters, the unit's accountants, engineers and supervisors handled about \$3 million of personal work for McClendon in 2010 alone. Among other tasks, the unit's controller once helped coordinate the repair of a McClendon house that was damaged by hailstones.

Fourteen miles south, at Will Rogers World Airport, Chesapeake leases a fleet of planes that shuttle executives to oil and gas fields – and the McClendon family to holiday destinations. On one trip, the clan took flights to Amsterdam and Paris that cost \$108,000; McClendon counted the trip as a business expense. In another case, Chesapeake logs show, nine female friends of McClendon's wife flew to Bermuda in 2010 without any McClendons aboard. The cost: \$23,000.

Closer to home, McClendon pursues another of his passions: the Oklahoma City Thunder, the NBA franchise in which he owns a 19 percent stake. As with other assets, McClendon has melded his Thunder interest with Chesapeake business. The energy company signed a \$36 million sponsorship deal, and it pays up to \$4 million annually to brand the stadium Chesapeake Energy Arena.

What hasn't been previously disclosed is that McClendon mortgaged his future proceeds from the team to secure two bank loans.

The AKM unit, the jet flights and the Thunder relationship are part of the lavish but leveraged lifestyle that McClendon has built through Chesapeake, America's second-largest natural gas producer.

From the 111-acre corporate campus that he shaped with a meticulous eye for

detail, McClendon has intertwined his personal financial interests with those of the publicly traded corporation he runs to a far greater degree than shareholders may realize, according to interviews, public records and hundreds of pages of internal Chesapeake documents reviewed by Reuters.

McClendon, 52, has put longtime friends on the Chesapeake board and showered them with compensation. Restaurants he has co-owned occupy buildings owned by the energy company. A Chesapeake executive has handled the CEO's personal land and oil- and gas-well transactions.

Few outsiders are privy to the sophisticated universe of services that Chesapeake provides McClendon. The existence and scope of AKM Operations, for instance, hasn't been previously reported.

"I have to be wary when I see this type of pattern of disregarding shareholders' best interests," said David Dreman, chairman of Dreman Value Management LLP, which owns about 1 million Chesapeake shares. "I think McClendon should go."

Beyond the mixing of personal and professional, another theme emerges from in-

**“**I have to be wary when I see this type of pattern of disregarding shareholders' best interests. I think McClendon should go.

David Dreman

Chesapeake shareholder



terviews and records: McClendon's seemingly insatiable desire to own more and more – of everything.

Said a contemporary who knows McClendon well, "If you're competitive like Aubrey, you just always want to own more."

For Chesapeake, McClendon has overseen a spree of more than 100 real estate purchases in Oklahoma City in recent years worth more than \$240 million, property records show. On land steps from the corporate campus, he directed his natural gas company to develop a luxury shopping center. Now, he's planning to open a Chesapeake-owned grocery store.

For himself, McClendon bought his neighbor's house near Oklahoma City and then the one behind that. He acquired a mansion on "billionaire's row" in Bermuda and later added a larger estate. He bought properties in Minnesota and Maui and near Vail, Colorado. He filled cellars in three states with trophy wines, and purchased 16 antique boats valued at \$9 million.

Then McClendon mortgaged much of it – and bought more.

## 'MEDIA FIRESTORM'

Normally, McClendon loves publicity. When Forbes put his face on the cover last fall and declared him "America's Most Reckless Billionaire," Chesapeake posted the story on its website.

But these are not normal times for McClendon. In the wake of Reuters reports that raised questions about his mingling of personal and corporate interests, the board stripped him of his chairmanship. The company faces IRS and Securities and Exchange Commission inquiries, more than a dozen shareholder lawsuits, and demands for change from its largest investors. Meantime, the board is investigating ties between McClendon's personal financial transactions and Chesapeake's.

Bowing to the pressure, Chesapeake said this week that four current board members will be replaced with new directors chosen

by two top investors, activist Carl C. Icahn and Southeastern Asset Management. Along with a new independent chairman expected to be named later this month, the reconfigured board will effectively be controlled by shareholders – a shift expected to serve as a check on McClendon.

Citing the lawsuits, McClendon declined to be interviewed for this story. In mid-May, however, he spoke to several hundred Chesapeake employees about the crisis.

"I encourage everybody to inhale," McClendon said at one point, according to a partial recording of the meeting reviewed by Reuters. "I'm fine. You're fine. And we're in the middle of a pretty unprecedented media firestorm today. I don't exactly know the origins of it and I don't exactly know when it ends, but I know that it will end, and we will emerge stronger. We will emerge more focused, and we will change in some ways that we probably need to change in."

In recent weeks, Reuters has reported that McClendon used his stakes in company wells to arrange \$1.55 billion in financing from a major financier of Chesapeake and others; that a Chesapeake board member lent money to McClendon; that he sold his share of at least two large energy plays at the same time Chesapeake divested its interest; and that he operated a private \$200 million hedge fund from Chesapeake offices.

"You can pick up the paper every day and read something negative about me or about the company," McClendon told his employees during the May meeting. "I would not have wished the past month on my worst enemy."

## MCCLENDON

Chesapeake accountants and engineers handled about \$3 million worth of personal work for McClendon in 2010.

# 27

Number of times CEO McClendon used the word "bold" in the company's annual letter to shareholders

## 'MY WAY'

McClendon's fate will have implications well beyond Chesapeake. He has been one of the most influential CEOs of his generation, credited and sometimes cursed for championing the drilling technique known as hydraulic fracturing, or fracking. The controversial method has led to a vast boom in U.S. natural-gas production.

That boom has reduced American reliance on foreign energy and enriched his company and his hometown. Using his own cash and Chesapeake's, McClendon has helped rebrand Oklahoma City through philanthropy and real estate development. Once largely defined by a tragedy – the domestic terrorist bombing of the Alfred P. Murrah Federal Building in 1995 – the state capital is now emerging as a center of sports and culture.

In no small part, that revitalization was fueled by McClendon's vision and his commitment to the community and to Chesapeake. Subordinates say McClendon has four children – Will, Callie, Jack and Chesapeake. They are only partly joking.

McClendon routinely works through

weekends, and employees often wake to emails he has sent between midnight and dawn. He expects instant answers.

"He will ask me a question and push back when I hesitate," said McClendon's longtime architect, Rand Elliott. "He'll say, 'Rand, what if we paint it blue?' And I'll say, 'Let me think about it.' He'll insist, 'No, I want you to give me an answer right now.' I asked him once, 'Aubrey, why do you need to know now? How is it you can make decisions so quickly?' He said, 'I make hundreds of decisions every day. I've gotten pretty good at it. And I think I hit 90 percent of them right.'"

McClendon is often portrayed as a visionary – a Mellon or Rockefeller of his time: Chesapeake's geologists helped identify North American basins that may hold a hundred-year supply of natural gas. Yet those hefty reserves have pushed natural gas prices to among the lowest levels in a decade.

The CEO takes the long view, projecting optimism and self-confidence. In his most recent annual statement to shareholders, McClendon used the word "bold" 27 times to describe his stewardship of Chesapeake: "We made the bold decision..." "This is clearly a bold plan..." "We accelerated the next bold move..."

He's also a micro-manager – not necessarily meddlesome, employees and business associates say, but obsessed. No aspect of a project is too granular. He helped pick the kind of peanuts served at a restaurant he owns. He inserts commas into press releases and measures the distance between Redbud trees near his office.



## CHESAPEAKE

Chesapeake provides McClendon with unlimited complimentary secretarial services for his personal ventures.

"I'll say, 'I'd like all the tulips to be red,'" architect Rand recalled. "He'll say, 'No, no, they've got to be multicolored.'"

Chesapeake is now a Fortune 500 company with 13,400 employees. It has grown so big and McClendon has sold so much stock – dumping \$569 million during a personal financial crisis in 2008 – that he now owns less than 1 percent of the company.

Yet in many ways he still runs Chesapeake the way he did when he co-founded it with 10 employees in 1989. He meets every new Oklahoma City employee, in groups of 30 or 40, during an hours-long session. He takes out a large advertisement in the local paper that includes the pictures of the new hires.

McClendon also closely monitors their work, internal records show. Every six months he spends the bulk of a week in meetings to personally consider proposed bonus payments to hundreds of employees. The documents show the CEO gets briefed on matters as obscure as whether to discipline a mechanic in Texas who chronically complains to colleagues about his pay.

To McClendon, "every detail matters," said his minister, the Reverend Patrick Bright. Leaving church one Sunday, McClendon spotted a low-hanging tree branch that posed a traffic hazard. "Before I finished saying goodbye to everyone, I had an email from Aubrey," the minister recalled. "It was a picture of the branch sent from his phone."

Friends and colleagues say land is another preoccupation.

Under McClendon's direction, Chesapeake engaged in what the company described as a "land grab" to dominate shale plays around the country. According to internal emails and former executives, Chesapeake began paying above-market prices to squeeze out competitors. At times, former employees said, McClendon was too quick to approve deals.

"He is very easy to pitch because his general inclination is to say 'yes,'" said one



OWNER, FAN: Team owner McClendon and his wife, Katie, enjoy front-row seats at Thunder games. **REUTERS/STEVE SISNEY**

former employee. "It was really surprising. There weren't a lot of questions."

Last fall, McClendon held forth on his business philosophy during a forum on "creativity and conscious capitalism."

"I've always been comfortable thinking things through and doing it, more or less, my way," McClendon said. "You can be as creative as you want, but if you're ... unwilling to work on the details, to see those put into action, then creativity is just dreams, or worse, hallucinations."

The tycoon added a wry joke. "There are some areas in our business where creativity is not particularly welcome – for instance, if you're an accountant."

## TOM SAWYER

With his warm face, rimless glasses and distinctive white mane, the athletic McClendon is sometimes mistaken for former NFL quarterback Archie Manning, the father of football superstars Peyton and Eli Manning.

Like the Manning brothers, McClendon comes from a family of achievers. He is

**\$108,000**

Cost to fly family members to Europe for two-week "business trip" on a company-leased jet

a great nephew of former Oklahoma Governor Robert Kerr, co-founder of U.S. oil-and-gas pioneer Kerr-McGee Corp. His wife, Katie, is a Whirlpool heiress, and her relative, Kate Upton, is a Sports Illustrated swimsuit cover model.

"To say that he grew up with a silver spoon is wrong," said Chesapeake senior vice president Thomas S. Price Jr., a confidant. "The implication is that he pulled the lever on the slot machine in life and ding-dong, got lucky – and nothing could be further from the truth."

McClendon worked hard for everything he has accomplished, friends say, and his competitive drive emerged at an early age.

He received his first business lesson as a teenager, mowing neighborhood lawns in suburban Oklahoma City, the friends say. McClendon competed against a boy named Shannon Self, and one day noticed that Self's younger brother was cutting some of Self's lawns. McClendon discovered that his competitor had sub-contracted the work to his brother. Self was mowing more lawns and making more money than McClendon with less effort.

"He calls it his 'painting the fence' story, the scene where Tom Sawyer gets his friends to whitewash the fence," said a friend.

The episode served as an early example of McClendon's penchant for collecting smart and loyal friends and keeping them close. Self became a founding Chesapeake board member and remains a McClendon legal adviser.

A review of proxy statements shows that from 1995 through 2005, while Self served as both a Chesapeake board member and a partner shareholder in successive law firms, those firms billed Chesapeake for \$6.3 million in legal work. Self retired from the board in 2005 with 232,972 Chesapeake shares then worth \$4.8 million and another 288,750 stock options.

Self wasn't the only board member to profit handsomely while supervising McClendon. Until just a few weeks ago, when

## INSIDE CHESAPEAKE THE LAVISH AND LEVERAGED LIFE OF AUBREY MCCLENDON

pay and perks were curtailed in response to public scrutiny, the Chesapeake board was one of the most generously paid in the U.S. oil and gas industry, according to a review of proxy statements.

From 2009 through 2011, Chesapeake paid \$13.3 million in total compensation to 10 non-executive board members. By comparison, Exxon Mobil, the world's third-most-profitable company in 2011, paid 13 non-executive board members \$9.9 million during the same period.

Though Self left the board in 2005, McClendon's friend continued to exercise a perk bestowed on board members – flying on Chesapeake-leased aircraft. In 2009, logs show, Self flew with his family from Oklahoma City to the Grand Caymans. In total, Self and family members logged \$150,000 worth of personal flights on Chesapeake planes in 2010, records show.

Self did not respond to requests for comment.

Other Chesapeake board members were such frequent fliers in 2010 that some logged far more personal flights than business flights on company-leased jets, internal documents show.

Corporate plane use for business and personal flights is considered a prime perk for American executives and board members. It is legal if properly disclosed, though personal trips can be subject to income tax.

Chesapeake discloses such travel but only for board members and a few top executives. It does not detail how many flights each individual took, or where and with whom the individual traveled. Reuters

**“**I'll say, 'I'd like all the tulips to be red.' He'll say, 'No, no, they've got to be multicolored.'

**Rand Elliott**

McClendon's architect

reviewed internal company logs, which list specific flights and include dates, airports and passenger lists.

Board member Merrill "Pete" Miller, for example, the chief executive of National Oilwell Varco and Chesapeake's lead independent director, took \$160,000 in free personal flights – twice as much as he spent on business travel.

Former Oklahoma governor and current board member Frank Keating spent \$57,000 in business flights, mostly to shuttle between Oklahoma and Washington, and \$175,000 worth of personal flights. A round-trip flight with 10 friends to Alaska cost Chesapeake shareholders \$71,000.

Miller did not respond to requests for comment. Keating referred questions to Chesapeake, which did not respond.

### WEEKENDS IN BERMUDA

Even the board's most frequent fliers cannot rival McClendon's use of jets that the company leased. His contract permits him to take unlimited business or personal flights for free (though he must pay taxes for certain personal flights). Friends and family, the contract says, also fly for free.

On June 15, 2010, a Gulfstream 550 jet leased by Chesapeake departed Oklahoma City bound for Amsterdam with three pas-

sengers: McClendon and his two sons, Jack, now 26, and Will, 19.

McClendon gave a speech to a natural-gas conference shortly after arriving, then took the next two weeks off for a family vacation. According to logs reviewed by Reuters, the trio was joined by McClendon's wife, Katie, and together the four flew back from Paris. The charter flights cost \$108,000 and were billed as "business," the logs show.

The flights were among 155 business charters McClendon logged in 2010 at a cost of \$2.25 million. He brought family members along for at least 17 of those flights, billed as business expenses and valued at more than \$370,000.

Chesapeake executives, board members and their families also take what the company characterizes as "personal" flights. In 2010 the McClendons took at least 75 personal flights on Chesapeake-leased aircraft. The cost: an estimated \$830,000 to \$875,000. Although his contract affords him unlimited use of the jets for himself, his friends and his family, McClendon reimbursed the company \$375,000 for personal flights that year, according to a proxy.

The McClendons took personal trips to Mexico, the Cayman Islands and New York. Bermuda, where the McClendons own vacation properties, was also a favored destination. One Friday in fall 2010, McClendon, his wife and a son flew to the island and flew back to Oklahoma City by Monday. Total cost: \$34,000. The following weekend, his wife and daughter jetted there. Total cost: \$27,000.

### MCCLENDON

McClendon's contract allows him, his friends and his family to fly free on jets the company leases.



### CHESAPEAKE

Chesapeake leases a fleet of planes that shuttle executives to oil and gas fields—and the McClendon family to holiday destinations.

Personal use of corporate jets has abated since the SEC imposed stricter reporting rules in 2006. Travel by relatives in particular has declined, said Paul Hodgson, senior research associate at GMI Ratings, a corporate-governance ratings firm, "because the fierce light of disclosure is on them." Chesapeake's use of the perk appears relatively heavy, some experts said.

The jet travel is an indicator of wider troubles at the company, said John Liu, the comptroller for New York City, which holds 1.9 million shares of Chesapeake stock.

"It's becoming clear that the excessive perks and problematic related-party deals that the company discloses, which have long caused concerns among investors, are only the tip of the iceberg," Liu said. "But, at this point, it's no longer shocking given the company's pattern of behavior."

## AKM OPERATIONS

McClelland's personal business affairs are tracked in the low-slung building on the fringe of Chesapeake's corporate campus, where at least six company employees work.

This is AKM Operations.

Chesapeake regularly discloses that McClelland receives personal accounting and engineering support from company employees; his contract allows him to use company facilities for his "personal businesses, investments and activities." But the scope and sophistication of the support, including AKM Operations, is not broken out in public disclosures.

In 2010, Chesapeake employees spent more than 15,000 hours working on McClelland's personal projects, according to internal records reviewed by Reuters. The cost: about \$3 million.

In 2011 the documents projected that Chesapeake employees would do about \$3.2 million in work for McClelland.

The company keeps detailed records because McClelland's contract calls for him to provide "a partial reimbursement" of the salaries, benefits and indirect costs of the

## Flight pattern

Charges for Aubrey McClelland's flights in 2010, according to internal company documents

PERSONAL FLIGHTS  
Between  
**\$833,000 and  
\$875,000**

BUSINESS FLIGHTS  
**\$2.25 million**

FLIGHTS THAT INCLUDED FAMILY MEMBERS  
**\$502,000**

FLIGHTS THAT INCLUDED HIS ADULT CHILDREN: **\$298,000**

DATE	TRIP	COST
Feb. 18-20	Oklahoma City to Albany, Ga.	\$16,000
May 10	Bermuda to Washington DC	\$11,000
June 15	Oklahoma City to Amsterdam	\$51,000
June 28	Paris to Oklahoma City	\$57,000
July 14	Oklahoma City to Latrobe, Pa.	\$10,000
Aug. 5	Oklahoma City to Delhi	\$108,000
Aug. 9	Delhi to Mumbai	\$10,000
Dec. 12	Oklahoma City to San Diego (round trip)	\$35,000

Chesapeake employees who are "primarily designated to" work on his personal businesses. He does not reimburse the company for "secretarial or general administrative support," according to his contract.

The agreement also calls for Chesapeake to pay a portion of the accounting and engineering work as part of McClelland's annual compensation. In 2008 he received \$708,339 in both accounting and engineering support. In 2009 it totaled \$685,669, according to the proxies.

In 2010 the company covered \$250,000. Given that the accountants and engineers provided an estimated \$3 million worth of

personal work to the CEO, McClelland would have owed Chesapeake about \$2.7 million for services that year. One Chesapeake document reviewed by Reuters showed McClelland reimbursed the company for the difference.

People familiar with the process said the arrangement could amount to a 12-month loan because McClelland does not need to reimburse the company until the end of the year.

Most of the accounting work is performed by the special AKM unit. Consider the job held by Bryan Ott, an accountant who earned \$200,000 at Chesapeake last year. His job title is "Controller, AKM Business Operations," but Ott does much more than manage McClelland's money.

When McClelland put a vast Oklahoma ranch up for auction, he had Ott handle the matter. When hail damaged a local home



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McClendon was buying, Ott coordinated the repair so the sale could be completed. Ott also is the registered website administrator for several McClendon personal projects, including one for a massive Lake Michigan resort that has drawn the ire of many townsfolk, and another for a McClendon holding company, Arcadia Resources.

Arcadia Resources also acts as a Chesapeake contractor. An Arcadia consultant, Scott Mueller, supervises Ott and at least five other Chesapeake employees working full-time for AKM Operations. Mueller reports directly to McClendon.

Until last year, Chesapeake employee John Garrison was the highest-paid person working with AKM Operations. He earned \$800,000 in salary and bonuses, plus another \$1 million in equity compensation.

Garrison played a variety of roles. He served as treasurer of the McClendon Family Foundation, a 501c3 charity. He also helped McClendon run the \$200 million hedge fund from Chesapeake offices, a fund whose existence was disclosed by Reuters on May 2. Garrison retired late last year and is now a contractor for the AKM unit. His current compensation could not be learned.

The AKM unit is supplemented by scores of Chesapeake engineers who, among other duties, help calculate McClendon's reserve holdings in a special incentive program that gives him a chance to invest in every well the company drills. In 2010 at least 60 engineers spent on average six days each on McClendon-related projects, the records show. Some engineers spent mere hours; one logged more than 100 eight-hour days.

# \$390,000

The amount McClendon's Deep Fork catering company charged to handle Chesapeake events in 2007 and 2008

"Even if it's true that the executives are reimbursing for using company employees, having this kind of relationship with the company is treating it as a personal fiefdom," said Hodgson of GMI Ratings.

### WINE AND BURGERS

Separating McClendon's business interests in Oklahoma City from Chesapeake's isn't easy.

For example, McClendon holds an interest in a local restaurant, Metro Wine Bar & Bistro, which occupies space owned by a Chesapeake subsidiary.

Across the street from the corporate campus, McClendon co-owns Irma's Burger Shack, often filled with Chesapeake employees during the lunch hour. According to a proxy, another restaurant McClendon co-owns, Deep Fork, catered Chesapeake events in 2007 and 2008 at a cost of \$390,000.

As a co-owner of the Thunder basketball team, McClendon sits in the front row at games. As Chesapeake CEO he presides over a company that signed a \$36 million, 12-year sponsorship deal with the team. This year the company pledged to buy \$3 million worth of tickets, and many were distributed to employees and Chesapeake business associates.

Although McClendon's net worth is pegged by Forbes at \$1.1 billion, he has mortgaged much of what he owns: the restaurants, the wine, the boats, the homes, proceeds from three accounts at Goldman Sachs, his stake in private companies and his stake in thousands of Chesapeake wells. The well financing from one backer alone, EIG Global Energy Partners, totals \$1.3 billion, according to a person familiar with the deals.

McClendon has even mortgaged part of his stake in his beloved Thunder.

He holds 19 percent of a team valued at \$350 million. But twice, McClendon has pledged his share of future proceeds from the Thunder as collateral for loans, from Bank of America in 2009 and Wells Fargo in 2010, according to records reviewed by Reuters. Neither loan has been previously disclosed.

Further particulars of the Thunder loans – the amount McClendon borrowed, whether they have been repaid or whether the NBA or his Thunder partners were notified – could not be determined.

Neither of the banks, nor McClendon and his spokesman, would elaborate on the Thunder loans.

### THE MCCLENDON GARGOYLES

McClendon is generous with his money. He has donated roughly \$15 million to Duke University, his and his wife's alma mater, and \$12.5 million to the University of Oklahoma, his parents' alma mater. At Oklahoma, the McClendon Center for Intercollegiate Athletics is adjacent to the football stadium, and the McClendon Honors College is named after McClendon's parents.

#### MCCLENDON

McClendon owns a 19 percent stake in the Oklahoma City Thunder, an NBA franchise.



#### CHESAPEAKE

Chesapeake signed a \$36 million sponsorship deal and pays up to \$4 million annually to brand the stadium Chesapeake Energy Arena.

## INSIDE CHESAPEAKE THE LAVISH AND LEVERAGED LIFE OF AUBREY MCCLENDON

At Duke, attended by all three McClendon children, a prominent dorm and visitors' center carry the family name. The chapel organ is named in honor of Katie McClendon.

So prolific were McClendon donations to Duke that the university once honored the couple by commissioning gargoyles in their likenesses, hanging them above an arch on the dorm, McClendon Tower. According to the artist, Katie McClendon found them too ostentatious; they were later removed.

Beginning about six or seven years ago, McClendon, through Chesapeake, helped lead a concerted effort to remake Oklahoma City. The company started buying land around its campus, including half of the neighborhood across the street. Chesapeake kept mum about its plans. Many outsiders expected more office buildings; they were wrong.

In late 2008, McClendon strolled into Balliets, the closest thing in Oklahoma City to Neiman Marcus. He approached the co-owner, Bob Benham.

"Aubrey came in with a picture of a dress that he had torn out of 'The New York Times' magazine," Benham recalled, "and he wanted to see if he could get it for his wife."

Benham promised to try. "Then Aubrey spent the next 40 minutes asking me about my background and strategies for the store," the owner remembered. "It struck me as odd, because here's a guy running a huge energy company. Why would he be interested?"

Benham found the dress in Japan — a Salvatore Ferragamo — and had it shipped to Katie McClendon within 48 hours. Mc-

Clendon, it turns out, had been testing him, Benham said.

A few months later, a Chesapeake executive approached Benham and said, "Aubrey wants you to anchor Classen Curve," a shopping center that McClendon envisioned, located steps from the Chesapeake campus.

A chic and sleek shopping venue, Classen Curve is owned by Chesapeake. It now includes stores with names such as On a Whim, Green Goodies and Uptown Kids. The gastro sports pub Republic serves smoked-salmon sliders. Matthew Kenney OKC offers gourmet raw vegan meals. Even the dumpsters are classy, camouflaged by high-end brick and steel.

"Aubrey saw it as a quality of life issue," Benham said. "These things seem peripheral to Chesapeake but really aren't. You have to have the amenities to attract people."

McClendon calls the amenities "the jewels" — and on campus they include a 72,000-square-foot fitness center, Olympic-sized swimming pool and health center that offers teeth whitening and Botox injections.

The Classen Curve project is not disclosed in any shareholder filings. Business does not appear brisk; parking lots were largely empty on recent weekdays and many of the shops were vacant.

Benham said Chesapeake is choosy. "They could fill the place up tomorrow," he said, "but they want a certain type of tenant."

### LAND, LAND, LAND

Chesapeake's expansion in Oklahoma City stretches far beyond Classen Curve.

Since 2004 the company has purchased

at least 108 local properties for at least \$240 million, according to a Reuters analysis of Oklahoma land records. More than half were purchased at prices well above the assessed market value. The 108 tracts and buildings were valued by the Oklahoma County Assessor's Office at a total market value of \$146 million at the time of the purchases. In Oklahoma City, "market value" is based on recent sales data, said Larry Stein, the county's chief deputy assessor.

Chesapeake paid \$38 million for an office building valued at \$27 million and \$10 million for a church valued at \$1.4 million. In 2006 it paid \$16 million for Nichols Hills Plaza, a 50-year-old shopping center that was valued at \$6.3 million. The company plans a major renovation, said Nichols Hills Mayor Sody Clements.

"We don't have the money to do it and he does," the mayor said, interchanging, as many locals do, McClendon for Chesapeake. "He raises the bar on everything."

From fashion shops to food, McClendon's vision is reshaping the area near Chesapeake and Nichols Hills. When he became frustrated that Oklahoma City lacked a Whole Foods Market, he persuaded the popular organic chain to bring one to his hometown — and then leased it space on land owned by Chesapeake, across the street from his office.

At Nichols Hills Plaza, the energy company is planning to go into the grocery business itself, internal records show. Chesapeake plans to reopen the shuttered Nichols Hills Market and recently put two grocery store managers on its payroll.

### MCCLENDON

A McClendon boyhood friend served as a Chesapeake board member and a partner shareholder in law firms that served the company.



### CHESAPEAKE

Those firms billed Chesapeake for \$6.3 million in legal work.

Their combined salaries exceed \$200,000.

"I think in another life he would have been a city planner or architect," said the former employee, who worked closely with McClendon for years. "It's like playing with Legos for him, envisioning something in his mind, seeing it laid out. He wants to reshape things."

## MANY HOMES

Even at rest, McClendon remains competitive.

His wine collection, stored in cellars across three states and the Caribbean, exceeded 2,000 bottles, according to a 2009 inventory. It included a six-liter bottle of 1945 Mouton Rothschild, valued at about \$100,000.

"This is not a particularly connoisseur-y cellar," said Benjamin Wallace, the best-selling author of "The Billionaire's Vinegar," who reviewed McClendon's wine roster. "It's pretty much exclusively big-name trophy vintages. Just eye-balling it, it's got to be worth millions."

McClendon also owns a \$12 million collection of antique maps that fill the walls of Chesapeake buildings.

"His collection of Oklahoma maps and nearby states would be the envy of the Library of Congress," said Graham Arader, the broker who helped him acquire it. McClendon once angered some shareholders by selling the maps to Chesapeake to meet a margin call; he subsequently agreed to buy them back.

In 2005, McClendon set his sights on Bermuda's so-called billionaire's row, a neighborhood that included the vacation homes of Michael Bloomberg, Ross Perot and former Italian Prime Minister Silvio Berlusconi.

First, he bought an \$8.6 million home and spent \$12 million to renovate it. Next he bought the grandest property there for \$20.8 million: an 8-acre tract once owned by industrialist Henry Clay Frick's descendants. McClendon gave the Frick site a

makeover and sold it for a small profit. Last year his wife bought an \$11 million house there, perched over a spectacular cliff.

In his Oklahoma neighborhood, McClendon and his wife live in a \$4 million, 9,000-square-foot stone mansion in Nichols Hills, the tony enclave surrounded by Oklahoma City just a four-minute commute from the Chesapeake campus.

He also owns the house next door, purchased for \$2.3 million, and the one behind that, which cost \$700,000, records show. For a time, McClendon also owned yet another neighboring house.

## 'COMMIT TO THE LORD'

McClendon, an Episcopalian, sometimes invokes religious themes at work. Each day he helps select a quotation that is emailed to employees. Some are from the Bible.

A May 2 email quotes Proverbs 16:3: "Commit to the Lord whatever you do, and your plans will succeed."

Chesapeake also has three "corporate chaplains" on staff. According to a 2011 job posting, the chaplains provide confidential career, marriage, parenting and substance-abuse counseling as well as "spiritual consultation."

The chaplain positions are among Chesapeake jobs that reflect McClendon's passions. A keen student of history, he has a company historian on staff.

A proponent of good health for his employees, he also hired the 2006 winner of the World's Strongest Man contest, Phil Pfister, in part to promote exercise. On his website, Pfister says he's a man to whom "flipping cars, pulling two 18-wheelers or 'toting tonnage' comes naturally."

The historian and the World's Strongest Man, who each earn more than \$100,000, have other duties at Chesapeake. The strongman, for example, promotes Chesapeake's development efforts in important drilling regions.

McClendon has poured Chesapeake

resources into another love: rowing.

In a remarkable feat, Oklahoma City transformed its dry and weed-choked riverbed – "nothing more than a big ditch," says Mayor Mick Cornett – into an Olympic-class rowing venue.

Chesapeake built two of the venue's signature attractions, the sleek \$3 million Chesapeake Boathouse and glass-sheathed \$7 million Chesapeake Finish Line Tower.

McClendon also put 10 Olympic hopefuls on the Chesapeake payroll.

They earn modest salaries – \$30,000 to \$40,000, plus benefits – and are assigned to departments such as finance and community relations. Even so, according to Chesapeake documents, each of the 10 is officially classified the same way: "Rower."

Some of the rowers McClendon hired have also flown with him aboard a Chesapeake-leased jet.

On Dec. 12, 2010 – a Sunday – the CEO took five rowers on a one-day trip to San Diego, the flight logs show. McClendon brought a son along, too.

Total round-trip cost to shareholders: \$34,000.

*Additional reporting by Robin Respaut, Jennifer Abplan and Joshua Schneyer in New York and Alexander Cohen in Washington; editing by Blake Morrison, Michael Williams and Prudence Crowther*

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Chesapeake Energy has made amassing acreage central to its strategy – and its tough tactics are drawing fire

# Casualties of a ‘land grab’

BY BRIAN GROW,  
JOSHUA SCHNEYER  
AND ANNA DRIVER



REUTERS/MIKE STONE

*From Chesapeake's 2012 SEC filing:*

**“We believed that the winner of these land grabs would enjoy competitive advantages for decades to come...”**

## CHESAPEAKE CASUALTIES OF A "LAND GRAB"

OCTOBER 2, 2012

Ranjana Bhandari and her husband knew the natural gas beneath their ranch-style home in Arlington, Texas, could be worth a lot – especially when they got offer after offer from Chesapeake Energy Corp.

Chesapeake wanted to drill there, and the offers could have netted the couple thousands of dollars in a bonus and royalties. But Bhandari says they ultimately declined the deals because they oppose fracking in residential areas. Fracking, slang for hydraulic fracturing, is a controversial method used to extract gas and oil.

Their repeated refusals didn't stop Chesapeake, the second-largest natural gas producer in the United States. This June, after petitioning a Texas state agency for an exception to a 93-year-old statute, the company effectively secured the ability to drain the gas from beneath the Bhandari property anyway – without having to pay the couple a penny.

In fact, since January 2005, the Texas agency has rejected just five of Chesapeake's 1,628 requests for such exceptions, a Reuters review of agency data shows. Chesapeake has sought the most exceptions during that time – almost twice the number sought by a subsidiary of giant rival Exxon Mobil, Reuters found.

Chesapeake says it only seeks exceptions to the Texas statute – called Rule 37 – as a last-ditch effort, and often because it cannot locate the land owner. The law, company spokesman Michael Kehs said, "protects the rights of the majority of mineral owners."

Not so, say many local residents.

"The principle of it is insane," said Calvin Tillman, a former mayor of Dish, Texas, a small town north of Fort Worth where drilling has been heavy. "Not only can they take your property, but they don't have to pay you for it."

Chesapeake's use of the Texas law is among the latest examples of how the com-



TOO CLOSE FOR COMFORT: Kaushik De points to a map showing how close to his house Chesapeake plans to drill. He and his wife, Ranjana Bhandari (pictured front page), recently failed in an attempt to prevent Chesapeake from drilling there. **REUTERS/MIKE STONE**

**“**The principle of it is insane. Not only can they take your property, but they don't have to pay you for it.

**Calvin Tillman**

Former mayor of Dish, Texas

pany executes what it calls a "land grab" – an aggressive leasing strategy intended to lock up prospective drilling sites and lock out competitors.

Chesapeake has become the principal player in the largest land boom in America since the 1850s California Gold Rush, amassing drilling rights on more land than almost any U.S. energy company. After years of leasing tracts from New York to Wyoming, the company now controls the right to drill for oil and gas on about 15 million acres – roughly the size of West Virginia.

More than its rivals, Chesapeake has made land-leasing central to its business model. An analysis by investment research firm Morningstar Inc. shows that the company has spent \$31.2 billion to acquire drilling rights on unproven U.S. land in the last 15 years. Exxon – a company whose revenue was 35 times larger than Chesa-

peake's last year – spent \$27 billion during the same period.

Chesapeake's rationale is clearly spelled out in company filings with the U.S. Securities and Exchange Commission.

"We believed that the winner of these land grabs would enjoy competitive advantages for decades to come as other companies would be locked out of the best new unconventional resource plays in the U.S.," the company wrote in its 2012 filing.

It has been less forthcoming about the tactics used in implementing that strategy, however.

Reuters reviewed hundreds of internal Chesapeake emails and thousands of pages of documents, including in-house data that show how Chesapeake evaluates its land acquisitions.

Reporters also examined dozens of lawsuits by land owners in seven states, and interviewed contractors proffering deals for the company.

What emerged were approaches to leasing property that land brokers, land owners and lawyers say push ethical and legal limits. Chesapeake has unilaterally altered or backed out of leases. And in Texas and at least three other states, it has exploited little-

## CHESAPEAKE CASUALTIES OF A "LAND GRAB"

known laws to force owners to hand over drilling rights and sometimes forfeit profits.

Some of the company's own contractors have considered the tactics dubious.

"In my entire career, I have never been put in the position that (Chesapeake) has recently handed us," contractor David McGuire wrote to Chesapeake CEO Aubrey McClendon on Aug. 10, 2010. He had just been ordered by the company to reject hundreds of signed leases in Michigan – through means that McGuire said were "beyond anything I could ever have imagined."

He told McClendon that he regretted ever being part of Chesapeake's land grab. "I simply wish our deal would never have taken place," he wrote in the email.

Some of the methods that Chesapeake has used aren't unique to the company. Nor is the outcome necessarily one-sided. Many land owners have gotten rich on deals with Chesapeake.

"Chesapeake has been successful in our leasing because we strive to fairly compensate the more than one million Chesapeake mineral owners," said spokesman Kehs. "Chesapeake has paid nearly \$12 billion in lease bonus payments and nearly \$10 billion in royalty payments since 2005."

### CRITICAL JUNCTURE

How Chesapeake went about its land grab has become increasingly important in the past year, as the company weathers a governance crisis and liquidity crunch.

In April, Reuters reported that McClendon, 53, had arranged more than \$1.5 billion in financing by pledging his share of the company's wells as collateral for personal loans. Most of the borrowing came from a firm that also is an investor in Chesapeake, a potential conflict of interest. The report prompted Chesapeake's board of directors to strip McClendon of his chairmanship and hire an independent chairman. Disgruntled shareholders replaced four of its nine directors.

In June, Reuters documented Chesape-

# \$22 billion

The amount Chesapeake says it has paid to land owners in royalties and bonuses since 2005

Source: Chesapeake Energy Corp.

peake's efforts to team with Canadian rival Encana Corp. to avoid driving up land prices in Michigan. The U.S. Justice Department is investigating whether the companies violated antitrust laws.

Now, as Chesapeake fights to regain its footing, it is looking to execute the last stage in its land strategy: filling out its vast holdings, and then developing or selling them. Where Chesapeake doesn't intend to drill, it intends to sell, according to company presentations.

Much hinges on this next chapter. This year, the company aims to sell \$14 billion worth of assets to close a cash-flow deficit.

The real estate strategy has been honed by McClendon, who started his career as a land man, the term for brokers who acquire mineral rights for energy companies.

On April 28, 2010 – amid one of the biggest land grabs in Michigan history – McClendon received a flattering email that harkened to his beginnings. It came from contractor McGuire, manager at O.I.L. Niagaran, a local firm that Chesapeake hired to help handle its leasing efforts in northern Michigan.

"To the most successful Landman in the world," McGuire's email began.

McClendon adored the compliment. "That is the nicest title anyone has ever given me," he replied. "I really appreciate that, thanks David!"

McGuire had been hired to serve as Chesapeake's principal outside land man in Michigan, where the company sought acreage in the Collingwood shale formation, then one of the most promising new

oil and gas plays in the United States.

After Chesapeake identifies acreage that might hold significant gas or oil, it deploys armies of land men – some Chesapeake employees, others contractors such as McGuire and his employees. They knock on the doors of land owners to solicit leases. Few regulations govern what they can say or what language can be included in leases.

Chesapeake has, until recently, employed more than 4,000 land men. Often, they are ordered not to disclose that Chesapeake is their client, according to internal emails and interviews with land owners and land men.

"It is critical that we do everything in our power to keep our client's name secret!!!!" wrote Joe McFerron in a Nov. 10, 2010 email to his staff. McFerron was a contractor with RedSky Land, an Oklahoma brokerage hired by Chesapeake in North Dakota and Michigan. McFerron did not respond to requests for comment.

Broker McGuire pursued his task energetically and in secret: Within three months, O.I.L. Niagaran and other subcontractors for Chesapeake had leased about 450,000 acres in Michigan. Chesapeake spent some \$400 million there through McGuire and other brokers.

But internal Chesapeake emails show that by August – a few months after he had called McClendon the world's best land man – McGuire was troubled by the experience.

At the direction of McClendon and other Chesapeake executives, McGuire was ordered to reject or put on hold hundreds of leases after a Chesapeake test well performed poorly and a major Chesapeake competitor stopped new leasing.

A backlash ensued, and McGuire's company bore the brunt. O.I.L. Niagaran became a defendant in about 150 breach-of-contract lawsuits filed since late 2010 in Michigan state courts.

McGuire referred questions to an attorney, who declined to comment.

Extricating itself from land leases has

## Anatomy of Chesapeake's land grab

Here's how the second-largest natural gas producer in the U.S. goes about leasing land for drilling

### 3 LEASE TO PLEASE

**Chesapeake executives, including CEO Aubrey McClendon, control all aspects of leasing,** including how much land men can pay and the lease terms they should negotiate with land owners



### 1 IDENTIFY THE PLAY

**Before competitors, Chesapeake geologists** try to identify the hottest new shale plays across the United States



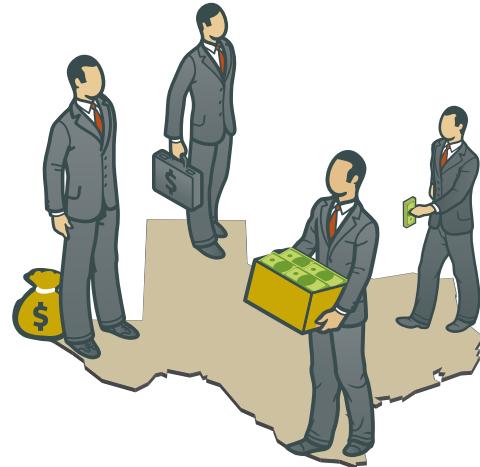
### 4 LEVERAGE THE STATE

**When Chesapeake can't find land owners** or persuade them to lease, it often leverages state laws allowing regulators to order land owners' properties be placed into drilling units



### 2 FLOOD THE ZONE

**Chesapeake sends in scores of company and contracted land men** to lease as much land as possible. Its goal: be one of the largest leaseholders in every play



### 5 DUMP THE CHAFF

**When Chesapeake decides it no longer wants land** secured by signed—but unpaid—leases, it frequently finds reasons to cancel the deals, often causing land owners to sue



SOURCE: Reuters research, Chesapeake investor presentations, SEC filings, court documents, state land records

## CHESAPEAKE CASUALTIES OF A "LAND GRAB"

sometimes proved as important to Chesapeake as obtaining them.

In lawsuits in Texas, Pennsylvania and North Dakota, land owners allege Chesapeake has treated signed leases as mere placeholders for deals that it may later choose not to honor.

Two state court judges in Michigan ruled early this year that Chesapeake had the right to reject leases at any time before title to the minerals was finalized.

But in the last three months, judges in Louisiana and Texas have awarded nearly \$120 million to two land owners – Peak Energy and Preston Exploration – after finding Chesapeake breached contracts by walking away from signed deals. Scores of similar cases in Michigan and Texas have been settled this year.

In late 2008, as the financial crisis sent natural gas prices tumbling, Chesapeake began to reevaluate deals it had cut.

One group of land owners caught in these retreats was the Witt family. They own a 33-acre tract above the Haynesville formation of rich gas fields in Harrison County, Texas.

In August 2008, the Witts were approached by land men working for Chesapeake. The offer: to lease mineral rights for the Witts' land for \$14,000 per acre, according to an amended complaint filed in May 2012. Instead of checks, Chesapeake issued bank drafts, which can be cashed after an owner's property title is reviewed – typically 30 to 90 days after a lease is signed.

When the Witts went to cash the Chesapeake bank draft, they were told by bank officials that the payment would not be honored. A hand-written note on one of the Witts' bank drafts rescinded by Chesapeake reads, "Cancelled for renegotiating price (per) acre," according to an exhibit submitted in the family's lawsuit.

The Witts alleged that McClendon told Chesapeake employees "to reduce the already agreed upon bonuses down to no more than \$5,000 per acre" and to

"take lawsuits" if necessary.

The family claimed they were "cold-drafted," a term used to describe an "unethical practice in the leasing industry" in which the land owner is provided a bank draft "in consideration for a valid, enforceable lease," even though the company's intent is "not to honor the payment obligation."

The practice allegedly enables Chesapeake to lock up property, block rivals, prevent owners from shopping for better offers, and then later decide if it wants to keep the acreage.

"It is unethical by anyone's standards in the energy industry if the intention was not to pay the draft at the time it was issued," said Richard Bate, an oil and gas attorney in Denver. "It is the essence of the land grab

One lawsuit against Chesapeake alleges that McClendon told employees to cut bonuses promised to land owners and to "take lawsuits" if necessary.

because it boxes out the competition without the intention to pay."

In response to the suit, Chesapeake said it "was simply under no contractual obligation to pay lease bonuses" to the Witts, according to court records. The company said the leases were "not signed by Chesapeake," though copies show they were taken in the name of a Chesapeake subsidiary, Chesapeake Exploration.

Terry Rhoads, an attorney for the Witt family, said their lawsuit was settled on Aug. 17. Terms were not disclosed.

### NO REFUSING

Some land owners oppose fracking, and New York, Vermont and Maryland have all refused to grant fracking licenses. The technique's effects on groundwater are still under review by the U.S. Environmental Protection Agency.

## For sale: "worthless" acreage



Selling land leases is as much part of Chesapeake's land grab as acquiring them. Some are proving hard to unload.

On Oct. 30, 2010, Chesapeake CEO Aubrey McClendon (pictured) told Jeff Wojahn, a top executive of Encana Corp., that he was ready to sell Michigan leases held by Chesapeake – "at reasonable terms if you were interested." Wojahn replied that he wanted to "trade well information first," according to emails reviewed by Reuters.

Encana and Chesapeake declined to comment on the emails.

Chesapeake executives knew that their test well in Michigan had performed poorly. But the emails indicate that McClendon wanted to provide Encana just enough information about Chesapeake's well to keep the sale talks going, without showing the well's full – and disappointing – results.

"But isn't our possible gain that they could want to buy our (now worthless) leases?" McClendon wrote to three top Chesapeake officials on Oct. 31, 2010. The words in parentheses – "now worthless" – were his. So was the suggestion to provide Encana barebones information.

"We need to know what is the data that we could release to Encana that makes us look like we have nothing to hide, yet won't show anything negative about the play?" he wrote in the same email.

Encana didn't bite, and Chesapeake is now marketing some 450,000 acres to other potential buyers.

Though McClendon once called the acreage "worthless," a prospectus for the sale touts it as containing "the strong possibility" of valuable oil and other liquids.

The sale was scheduled to close on Aug. 31. So far, there have been no takers.

## CHESAPEAKE CASUALTIES OF A "LAND GRAB"

But Chesapeake and other energy companies, which view fracking as safe, are now using state statutes to access the minerals under unleased land even if owners object to the drilling technique.

If property owners refuse deals, Chesapeake and its land men have made clear their plans to take the oil and gas from beneath the land by using little-known laws in Texas, Ohio and other states. The terminology varies from state to state – a Rule 37 exception in Texas, mandatory pooling or unitization in Ohio. But the result is often the same: getting state regulators to enable the company to drill, sometimes against the owner's will.

The economic argument for granting access to unleased land is logical. Difficulty in stitching together large plots leaves holes in drilling units that can make development less profitable. Large, contiguous plots enable drillers to pump more oil and gas. Allowing companies to access remaining land means that property owners who want to sell their mineral rights aren't shortchanged by a few holdouts.

"Under Ohio law, it's not legal for one or a few land owners to keep the vast majority of land owners from exercising their rights to develop their minerals and get the benefits," said Heidi Hetzel Evans, a spokeswoman

# \$71 million

What Chesapeake said would be lost in revenue if Ohio regulators didn't let it add the properties of holdout land owners to a drilling project.

with the state's Department of Natural Resources, which rules on such requests.

Chesapeake has based some of its petitions on just such a premise: that it is protecting the rights of people who want to drill, rather than succumbing to the will of holdout land owners.

That marks a turnaround in Texas. When the state passed the Rule 37 statute in 1919, it was meant to prevent excessive drilling of oil wells and to protect the mineral rights of small land owners, say legal experts. The rule prohibits companies from drilling too close to unleased properties.

Today, Rule 37 exceptions "seem to be a new creative use of the statute in a way that was not intended when it was designed," said Matthew Festa, an associate professor of law at South Texas College of Law. "It's possible that this amounts to the transfer of

private property from one private entity to another private entity."

Since Jan. 1, 2005, three of the largest oil and gas drillers in Texas have applied for 3,595 exceptions to Rule 37, according to a Reuters review of Texas Railroad Commission data. Chesapeake has been the most active. It has applied for 1,628 exceptions, compared with 1,073 for rival EOG Resources and 894 for XTO Energy, a unit of Exxon Mobil.

Chesapeake and its rivals almost always win. Energy companies only have to notify land owners that they intend to apply for a Rule 37 exception. If the owner doesn't protest, commission guidelines require the petition be granted.

Texas Railroad Commission spokeswoman Ramona Nye said the agency believes there is no evidence that fracking is unsafe. And evaluating the fairness of Rule 37 exceptions is not part of the commission's mandate, she said.

"We are charged by the legislature to make sure hydrocarbons don't stay underground and go to waste," she said. "It becomes a balancing act. Do we allow two or three landowners to prevent a majority from developing those minerals?"

Energy companies and their executives are the dominant contributors to the election campaigns of railroad commission members and candidates, according to a Reuters review of Texas Ethics Commission data. For example, Chesapeake was among the largest donors last year to the campaign of the commission's chairman, Barry Smitherman, who is seeking reelection this year. The company contributed \$25,000.

### "WHATEVER WE WANT"

In Texas, Arlington resident Bhandari is resigned to losing future income from the gas beneath the couple's land. "We decided not to sign because we didn't think it was safe," Bhandari said. But "the railroad commission doesn't seem to care about whose property is taken."

REUTERS TV

See the video <http://link.reuters.com/quk92t>



## CHESAPEAKE CASUALTIES OF A "LAND GRAB"

They aren't the only owners facing a similar scenario.

Ohio's Utica shale formation is a cornerstone of Chesapeake's plan to drill for more oil, which is fetching a premium at a time of rock-bottom gas prices. The company has already leased more than 1 million acres of land in the state. It wants more.

One result: Dozens of Ohio land owners interviewed by Reuters say Chesapeake land men are raising the prospect that their land will be "force pooled" – a term for using state law to mandate that unleased property be included in drilling units.

That contention is supported by a tape recording of land man Nate Laps, who worked for Chesapeake in Ohio through subcontractor Kenyon Energy. The recording was made by David Kennedy, a land owner in Stark County, Ohio. Kennedy later signed a lease with Chesapeake, receiving a bonus of \$9,900 for his 11-acre property. He said he feels that Laps gave him a "fair shake."

The recording indicates that not all land owners are as fortunate.

In a portion of the recorded conversation, Kennedy asked Chesapeake land man Laps: "Mandatory pooling – what is that?"

Laps responded: "We don't like to talk about this because we won't want to come across as it's our way or no way ... But since you mentioned it – if properties don't want to sign, if we have 90 percent secured of the well that we need, we have the power to put these people in the lease without their permission."

Kennedy: "Do you still have to pay 'em?"

Laps: "All you do is pay them the royalties. .... We can do whatever we want."

Laps did not respond to emails and phone calls seeking comment. But state records in Ohio show Chesapeake is doing precisely what Laps said, and with the blessing of regulators.

Unlike Rule 37 in Texas, Ohio statutes



TOUGH TACTICS: Ohio Rep. Mark Okey singles out Chesapeake's land men for their particularly forceful approach to dealing with property owners. **REUTERS/HANDOUT**

allow that land owners could receive royalties. Hetzel Evans said the DNR receives "a few dozen or more" forced-pooling applications per year. The DNR has approved most of them, she said, but only when a driller shows "there's no other option."

Asked about the comments by Laps to land owner Kennedy, she said: "It does concern us if we're being portrayed as allowing an operator to just come in and do what they will. A comment like that makes it sound like we don't have a framework in place."

State Rep. Mark Okey, a Democrat who represents nearby communities, has unsuccessfully sponsored legislation to govern the conduct of land men. He said his constituents have singled out Chesapeake's brokers as the most forceful. Their land men have even sought to lease his property, he said.

"They believe in intimidation tactics. They threaten you. They will yell at you.... It's all about getting you to sign," Okey said. "You don't sign? We'll go around you. You don't sign? You'll not get anything out of your mineral rights. You don't sign? Then you're going to pay the price because we're going to take those minerals from you."

Chesapeake declined to comment.

David and Catherine Conrad live just outside the town of Hartville, Ohio, near

Akron. They said they refused to sign a lease with Chesapeake last year because they, too, oppose fracking. But a Chesapeake well will soon snake beneath the Conrad home.

Chesapeake requested last November that the couple's land – and the land of 48 other property owners – be included in an area where Chesapeake plans to drill six wells. Chesapeake's application was reported by the Columbus Dispatch.

On July 10, officials with the DNR approved Chesapeake's request. "I don't think the state should be able to take a land owner's rights to generate a profit for a private company," Conrad said.

In its petition, Chesapeake told regulators its proposed drilling unit could produce 4.5 million barrels of oil and 3.5 billion cubic feet of natural gas – if the plots of the 49 land owners who didn't lease their property to Chesapeake were included.

If not, Chesapeake said, the unit would be 75 percent less productive and would miss out on an additional \$71 million in revenue, according to its application. That math carried the day.

*Reporting by Brian Grow, Joshua Schneyer and Anna Driver; additional reporting by Andrew Lampard; editing by Blake Morrison and Michael Williams*

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