



IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

In re Sanchez Energy Derivative Litigation	Consolidated C.A. No. 9132-VCG
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VERIFIED CONSOLIDATED STOCKHOLDER DERIVATIVE COMPLAINT

Plaintiffs, City of Roseville Employees' Retirement System ("Roseville"), Delaware County Employees Retirement Fund ("Delaware County") and Robert Friedman, by and through their undersigned counsel, assert this action derivatively on behalf of Sanchez Energy Corp. ("Sanchez Energy" or the "Company") against defendants A.R. Sanchez, Jr. ("Sanchez Jr."), Antonio R. Sanchez, III ("Sanchez III"), Gilbert A. Garcia, Greg Colvin, Alan G. Jackson (collectively, the "Individual Defendants" or the "Board"), Sanchez Resources, LLC ("Sanchez Resources"), Eduardo Sanchez, Altpoint Capital Partners LLC ("Altpoint Capital") and Altpoint Sanchez Holdings, LLC ("Altpoint Holdings") (together "Altpoint"). Plaintiffs make the following allegations upon knowledge as to themselves and upon information and belief (including the investigation of counsel and review of publicly available information) as to all other matters, and allege as follows.

SUMMARY OF THE ACTION

1. This stockholder derivative action arises out of an unlawful scheme by Sanchez Jr. and Sanchez III, the Chairman and CEO, respectively, and controlling stockholders of Sanchez Energy, to enrich themselves and their family at the expense of the Company's public stockholders.

2. Sanchez Energy is a shell company established by the Sanchez family in 2011 to take advantage of public funding. The Company has no employees and no directly managed operations. The Sanchez family maintains actual control over the Company's operations through a web of four privately held, affiliated companies – of which Sanchez Jr., Sanchez III, or another Sanchez family member act as CEO.

3. One of these privately held companies is Sanchez Resources. Eduardo Sanchez, the son of Sanchez Jr. and brother of Sanchez III, established and runs Sanchez Resources, while both Sanchez Jr. and Sanchez III maintain equity interests in it.

4. In August 2013, Sanchez Energy, with the Board's approval, agreed to purchase working interests in the Tuscaloosa Marine Shale¹ ("TMS") from Sanchez Resources (the "Transaction"). Sanchez Energy purchased these working interests at a price seventeen times higher than other oil and gas companies have paid for similar interests in the TMS. The beneficiaries of this over-priced purchase were the Sanchez family.

5. Sanchez Resources was originally seen as a way for the Sanchez family to profit exclusively from the development of this acreage. But when the Sanchezes could not finance the development costs themselves, they brought in a private equity investor – Altpoint Capital – to help foot those bills. The acreage was slow and costly to develop. When the Sanchez family asked Altpoint to provide additional cash to fund the business, Altpoint refused. The Sanchez family was unwilling to fund the development of the

¹ The Tuscaloosa Marine Shale is an area of oil and gas reserves stretching across Eastern Louisiana and Southwestern Mississippi. The TMS oil play holds both oil and natural gas that is obtained through hydraulic fracking operations.

acreage themselves, so they decided to force Sanchez Energy's public stockholders to do so.

6. The Transaction had some complex details, but its essence was the following: Sanchez Energy paid \$78 million for the working interest leases on 40,000 acres of undeveloped land in the TMS, which it then agreed to develop in a 50/50 joint venture with Sanchez Resources, which had retained the working interest leases on an additional 40,000 acres of land in the TMS. As a result, Sanchez Energy agreed to finance on its own the first six wells to be drilled on the undeveloped property, which is an additional commitment of approximately \$22 million. In exchange, Sanchez Resources was able to eliminate its private equity financier, Altpoint, at a substantial premium. In addition, Sanchez Resources received its own cash infusion of \$14 million directly from Sanchez Energy, plus a future royalty stream kickback. This kickback has never been disclosed to Sanchez Energy's stockholders, and it will help to finance Sanchez Resources' financial obligations in the joint venture. In sum, the Sanchez family and Altpoint come out ahead, and only Sanchez Energy comes out far, far behind. No independent third-party would have ever accepted this deal.

7. Although the Transaction requires Sanchez Energy to pay a price far higher than any disinterested party would pay for the undeveloped land, it is unsurprising that the Sanchez Energy Board "rubber-stamped" the deal. Sanchez Jr. and Sanchez III have stacked the Board with childhood friends and business associates who are beholden to the Sanchez family. Besides Sanchez Jr. and Sanchez III, the Board included Sanchez

Jr.'s childhood friend and business associate Alan G. Jackson, along with Sanchez Jr.'s other long-time business partner, Gilbert A. Garcia.

8. By agreeing to the Transaction, the Individual Defendants have breached their fiduciary duties to the Company, and Sanchez Resources and Eduardo Sanchez have aided and abetted such breaches.

JURISDICTION

9. This Court has jurisdiction over this action pursuant to 10 *Del. C.* § 341.

10. As directors of a Delaware corporation, the Individual Defendants have consented to the jurisdiction of this Court pursuant to 10 *Del. C.* § 3114.

11. This Court has jurisdiction over Sanchez Energy pursuant to 10 *Del. C.* § 3111.

12. As the manager of a Delaware Limited Liability Company, Eduardo Sanchez has consented to the jurisdiction of this Court pursuant to 6 *Del. C.* § 18-109.

13. This Court has jurisdiction over Sanchez Resources pursuant to 6 *Del. C.* § 18-105.

14. This Court has jurisdiction over Altpoint Capital pursuant to 6 *Del. C.* §18-105.

15. This Court has jurisdiction over Altpoint Holdings pursuant to 6 *Del. C.* §18-105.

THE PARTIES

16. Plaintiff Roseville is a retirement system for employees of the City of Roseville, Michigan. Roseville is administered by a Board of Trustees established

pursuant to the Roseville Code. Roseville is presently a stockholder of Sanchez Energy and has been a stockholder at all times relevant to the claims asserted herein.

17. Plaintiff Delaware County is a Pennsylvania-based retirement system that provides retirement allowances to employees of Delaware County. Delaware County Employees Retirement Fund owns shares of Sanchez Energy and has been a stockholder at all times relevant to the claims asserted herein.

18. Plaintiff Robert Friedman is presently a stockholder of Sanchez Energy and has been a stockholder at all times relevant to the claims asserted herein.

19. Nominal Defendant Sanchez Energy is an independent exploration and production company focused on the acquisition, exploration, and development of unconventional oil and natural gas resources onshore along the U.S. Gulf Coast, primarily in the Eagle Ford Shale in South Texas. Sanchez Energy is a Delaware corporation with its principal executive offices located at 1111 Bagby Street, Suite 1800, Houston, Texas 77002. The Company's common stock is listed and traded on the New York Stock Exchange under the symbol "SN."

20. Defendant A.R. Sanchez, Jr. has served as Executive Chairman of the Sanchez Energy Board since November 2012. Sanchez Jr. is also the co-founder, CEO, and Chairman of Sanchez Oil & Gas Corporation ("SOG"), a private oil and natural gas company engaged in the exploration and development of oil and natural gas primarily in Texas and the onshore Gulf Coast areas on behalf of its affiliates, which include the Company. Sanchez Jr. is the father of Defendant Antonio R. Sanchez, III and Eduardo Sanchez.

21. Defendant Antonio R. Sanchez, III has served as President and CEO of Sanchez Energy and as a member of the Board since the Company's formation in August 2011. Sanchez III is also the President or Managing Director of several privately-held affiliates of Sanchez Energy, including SOG, SEP Management I, LLC ("SEP Management"), and Sanchez Energy Partners I, LP ("SEP I"). In his capacities as an officer of these related affiliates, Sanchez III manages all aspects of their daily operations, including exploration, production, engineering and land management. Sanchez III is the son of Sanchez Jr. and the brother of Eduardo Sanchez.

22. Defendant Eduardo Sanchez is the founder and CEO of Sanchez Resources. Eduardo Sanchez is the son of Sanchez Jr. and brother of Sanchez III.

23. Defendant Alan G. Jackson ("Jackson") has been a member of the Sanchez Energy Board since November 2012. According to the Company's 2012 annual meeting proxy statement filed on Form 14A with the U.S. Securities and Exchange Commission on April 25, 2013 (the "Proxy"), Jackson is a "Senior Commercial Producer" at IBC Insurance Agency, Ltd. ("IBC"), a subsidiary of International Bancshares Corporation. Sanchez Jr. is a director and the largest stockholder of International Bancshares Corporation.

24. Defendant Gilbert A. Garcia ("Garcia") has been a member of the Sanchez Energy Board since December 2011. Garcia is a longtime business partner of Sanchez Jr. Garcia owns a 39% interest in Latin American Entertainment, LLC, and Sanchez, Jr. is an investor in Latin American Entertainment, LLC through his majority stake in an entity named Sandman Venture Investments, LLC. Garcia also owns a 48% interest in

Hacienda Records, L.P., and serves as President of the company, of which Sandman Ventures, LLC, is a Preferred Limited Partner.

25. Defendant Greg Colvin (“Colvin”) has been a member of the Sanchez Energy Board since March 2012.

26. Defendant Sanchez Resources, LLC is a Delaware limited liability company founded and run by Eduardo Sanchez. Sanchez Resources owns oil properties in Louisiana and Mississippi and has amassed an 80,000 net acre position in the core of the TMS. Sanchez Resources has its principal executive offices located at 1111 Bagby Street, Suite 1600, Houston, Texas 77002.

27. Defendant Altpoint Capital is a New York based private equity firm that makes substantial equity investments in established enterprises with the potential for significant growth and operating improvement.

28. Defendant Altpoint Holdings is a Delaware limited liability company created for purposes of Altpoint Capital’s investment in Sanchez Resources.

SUBSTANTIVE ALLEGATIONS

A. The Sanchez Family Takes The Company Public But Continues To Dominate And Control It

29. The Sanchez family began in the oil and gas business thirty-five years ago, when Sanchez Jr. and his father A.R. Sanchez, Sr. founded SOG in 1978. SOG has become the lynchpin in the Sanchez family's scheme to manage Sanchez Energy for the family's benefit. Since the Sanchez family founded SOG, they have built an empire of affiliated companies all focused on the oil and natural gas business in South Texas. These affiliated companies are SEP I, Sanchez Resources, Santerra Energy LLC ("Santerra"), and Sanchez Energy. SOG manages the actual drilling operations and oil and gas properties of all of the affiliated Sanchez companies.

30. SOG and its various affiliates have participated in and managed the drilling of over 900 wells, investing a substantial amount of capital in well costs, subterranean seismic land surveys to identify oil reserves, and mineral rights leaseholds on thousands of acres of land. SOG has remained both a private company and a family business since its inception. Sanchez Jr. is currently the CEO and Chairman of SOG. Sanchez III joined SOG in October 2001 and currently serves as its President.

31. Each of the Sanchez affiliated companies is an arm of SOG from which Sanchez Jr. and Sanchez III can exercise control over their oil and gas empire. These companies are so closely related they share the same offices. SOG is headquartered at 1111 Bagby St. Suite 1800, Houston, TX 77002, with a satellite office at 1920 Sandman St., Laredo, TX 78044. Three of the sister companies, SEP I, Sanchez Resources, and Sanchez Energy, are also headquartered at 1111 Bagby Street. A fourth company,

Santerra, is headquartered at SOG's 1920 Sandman Street office, which is also utilized as a satellite office for Sanchez Energy.

(a) **SEP I** was formed in Delaware on August 17, 2007, to manage oil and natural gas private equity investments for its limited partners, including members of the Sanchez family. Sanchez III is SEP I's Managing Director. SEP I focuses on the exploration and development of U.S. onshore oil and natural gas reserves. SEP I is privately held by the Sanchez family.

(b) **Santerra** was formed in Texas on May 11, 2010, to acquire mature conventional shallow oil fields in the Eagle Ford Shale of South Texas. Patricio Sanchez, who is the son of Sanchez Jr. and brother to Sanchez III and Eduardo Sanchez, is Santerra's CEO. Santerra is privately held by the Sanchez family.

(c) **Sanchez Resources** was founded in Delaware on September 16, 2010, by Eduardo Sanchez with investments from Sanchez Jr. and Sanchez III. Eduardo Sanchez is currently Sanchez Resources' CEO. Sanchez Resources owns conventional oil properties in Louisiana and Mississippi and amassed an 80,000 net acre position in the core of the TMS. Sanchez Resources is privately held by the Sanchez family.

(d) **Sanchez Energy** was formed in Delaware on August 22, 2011, to hold significant oil and gas assets in the Eagle Ford Shale² of South Texas that were previously controlled by SEP I. Sanchez Energy shares its office space with Sanchez Resources, SEP I, and SOG at 1111 Bagby Street in Houston, Texas. Sanchez Energy

² The Eagle Ford Shale is an oil and natural gas play that stretches across most of southern Texas.

was operated out of Suite 1600 with Sanchez Resources and SEP I until July 2012 when Sanchez Energy moved to Suite 1800, which it shares with SOG.

32. In order to raise the cash necessary to develop their Eagle Ford Shale properties, the Sanchez family took Sanchez Energy public. On December 19, 2011, the Company completed its initial public offering (“IPO”), issuing 10 million shares of common stock at \$22.00 per share, receiving net proceeds of approximately \$203.3 million in cash.

33. Despite ostensibly giving up voting control of the Company to the public, the Sanchez family retained an equity stake in the Company and firm control over the operations and the Board following the IPO. In fact, the Sanchez family never relinquished actual control over the Company’s operations despite its public company status.

34. Sanchez Jr. currently owns 5,542,138 shares – or approximately 16% – of Sanchez Energy’s issued and outstanding common stock. Sanchez III currently owns 1,876,308 shares – or approximately 5.5% – of the outstanding common stock.

35. As detailed below, the Sanchez family stacked the Company’s five-person Board with family members, friends, and business associates who would not impede the family’s control.

36. Additionally, the family structured Sanchez Energy to maintain direct control over its operations. The Company has no employees, other than its officers and directors. Instead, as the Company disclosed in an 8-K filed on December 23, 2011, the Sanchez family, through wholly-owned affiliates SOG, SEP I, Santerra, and Sanchez

Resources, provides all management, administrative and operational services to Sanchez Energy pursuant to a services agreement between the companies that was executed on the day of the IPO. Thus, all of Sanchez Energy's operations are controlled directly by the Sanchez family through their other privately owned entities.

37. Independent analysts have noted that despite Sanchez Energy's public listing, the Sanchez family still treats the Company like a family business. One analyst stated in a report entitled "Sanchez Energy: When An IPO Isn't" that:

[i]n my opinion, Sanchez Energy Corporation for all practical purposes appears to be a complex private financial arrangement by which A.R. Sanchez, Jr. is handing over the reins of Sanchez Oil & Gas to his son, A.R. Sanchez, III. I see no value to public shareholders at this time.

(Report available at: <http://seekingalpha.com/article/317985-sanchez-energy-when-an-ipo-isnt>).

38. As further evidence of the Sanchez family's control and domination over Sanchez Energy, the Company's Amended and Restated Certificate of Incorporation (the "Charter") purports to allow the Sanchez family to compete directly with the Company.

39. Section 9.2 of the Charter states that Sanchez family businesses – such as SOG and its affiliates – "have the right to engage (and shall have no duty to refrain from engaging) in the same or similar activities or lines of business as the Corporation."

Section 9.3 similarly provides that:

if the [Sanchez affiliates] acquire knowledge of a potential Business Opportunity that may be deemed a corporate opportunity of both the Corporation and any of the [Sanchez affiliates], then such [parties] shall have no duty to communicate or offer such Business to the Corporation.

40. The Company also entered into a licensing agreement with SOG wherein SOG granted Sanchez Energy a license to the unrestricted proprietary seismic, geological and geophysical information owned by SOG that is related to the Company's properties. In addition, in connection with the services agreement, SOG entered into an operating agreement with Sanchez Energy under which it agreed to develop, manage and operate the Company's properties or engage a responsible unaffiliated industry operator and joint owner for such development, management and operation.

B. The Sanchez Family, With Board Approval, Causes The Company To Purchase Working Interests From Sanchez Resources At An Unjustifiably High Price

41. Sanchez Resources was created on September 16, 2010 by Defendant Eduardo Sanchez, Sanchez Resources' current CEO, with investments from Sanchez, Jr. and Sanchez III. According to Sanchez III, Sanchez Resources was created for the purpose of acquiring assets in the TMS, particularly from Tridimension Energy LP ("Tridimension"), an oil and gas company that was going through bankruptcy. Sanchez Resources has also acquired TMS property directly from SOG.

42. The TMS is an area of oil and gas reserves stretching across Eastern Louisiana and Southwestern Mississippi. When the TMS began attracting the interest of oil companies in 2010 and 2011, SOG began buying up drilling rights on properties in the heart of the TMS. After Sanchez Resources was formed, it immediately began raising capital from private equity investors to purchase drilling rights in the TMS from SOG and other lease holders.

43. In order to purchase the TMS assets, Sanchez Resources needed additional capital investors. As Sanchez III explained during Sanchez Energy's August 8, 2013, Second Quarter Earnings call ("Earnings Call"), as part of the effort to raise capital for Sanchez Resources, Altpoint Capital invested "a lot of the capital at the start" through Altpoint Holdings. For its investment, Altpoint Capital not only received an ownership interest in Sanchez Resources, but it also received three director positions: (1) Guerman Aliev, the CEO and Chairman of Altpoint Capital, (2) Brett A. Pertuz, a managing director of Altpoint Capital, and (3) Yuki Narula, a managing director of Altpoint Capital.

44. With the help of Altpoint Capital's significant investment, in October 2010, Sanchez Resources, through its affiliate, SR Acquisition I, LLC ("SR Acquisition"), purchased substantially all of the oil and gas assets of Tridimension. Sanchez Resources paid only \$30.5 million for these assets at approximately \$184 per acre. In early April of 2012, Sanchez Resources purchased more TMS acreage in Pike County, Mississippi from SOG.

45. By 2013, Sanchez Resources held the working interest in 80,000 acres in the TMS – 40,000 acres of which is developed and 40,000 of which is undeveloped. Once the TMS reserves were proven in 2013, the Sanchezes sought to develop the undeveloped 40,000 acres. However, Altpoint did not want to finance the development costs and the Sanchezes sought a way to buy out Altpoint's stake in Sanchez Resources.

46. In an August 8, 2013 earnings call with investors and analysts, when discussing the Transaction and buying out Altpoint, Sanchez III stated:

There (sic) were a large equity owner in SR, I can't give you particulars as to who the name is, who they are or what there (sic) basis was or anything

like that that part of the agreement was that we would keep their name private. They made an equity investment over the course of several years and the original strategy was not to go to make it TMS play and as that changed they viewed, the real upside here really in taking some stock and participating with us through their shareholdings in the company and letting us kind of run with it. . . . [A]s this TMS really started to get hot a few months ago, we approached them and we said look guys you guys want to start writing some checks and lets go drill some wells and they said we'd rather take your stock lets figure out how to make this a transaction that could work....”

47. On that same day, Sanchez Energy announced that it had entered into an agreement with Altpoint³ and Sanchez Resources to acquire the 40,000 undeveloped acres, buying out all of Altpoint’s working interest⁴ and a portion of Sanchez Resources’ working interest in the acreage (the “Purchase Agreement”). Sanchez Energy’s 40,000 undeveloped acres were then combined with the 40,000 developed acres owned by Sanchez Resources to create an 80,000 acre Area of Mutual Interest (“AMI”), with Sanchez Energy and Sanchez Resources each owning a 50% undivided working interest across the AMI.

48. In connection with the Transaction, Sanchez Energy paid \$77.5 million in cash and stock.⁵ \$61 million was paid to Altpoint Holdings (consisting of \$53.5 million

³ The agreement was executed among Sanchez Energy, Sanchez Resources and Altpoint Holdings. Altpoint Holdings is a holding company created by Sanchez Resources and Altpoint Capital. Altpoint Holdings and Sanchez Resources transferred most of the 40,000 undeveloped acres to Altpoint Holdings prior to the Transaction.

⁴ A working interest is defined as “a form of investment in oil and gas drilling operations in which the investor is directly liable for a portion of the ongoing costs associated with exploration, drilling and production. In a similar fashion, working interest owners also fully participate in the profits of any successful wells.” See <http://www.investopedia.com/terms/w/working-interests.asp>.

⁵ See Sanchez Energy filing on Form 10-Q with the SEC on September 30, 2013 at n. 3

in cash and 342,760 shares of Sanchez Energy common stock valued at approximately \$7.5 million).⁶

49. In essence, the Board agreed to pay off Altpoint with Sanchez Energy's money by substantially overpaying for Altpoint's interests in the AMI. In the August 8, 2013 Earnings Call, Sanchez III acknowledged this, stating:

Of the \$78 million purchase price which was cash and stock 61 million of that went to an unaffiliated third party private equity group based out of New York. They are the ones that put up a lot of the capital at the start.... 61 million so well north of 50% of two-thirds of the purchase price amount was to buyout this private equity group that has absolutely no affiliation with us.

50. From the Transaction, Sanchez Resources received \$14.4 million in cash, and Sanchez Energy agreed to carry the costs of three oil wells to be drilled within the AMI for Sanchez Resources, with an obligation to carry an additional three wells if Sanchez Energy continues drilling in the AMI. During the August 8, 2013 Earnings Call, Sanchez III indicated that Sanchez Energy would, in fact, fund all six wells. According to a November 10, 2013 article published in *The Wall Street Journal* ("WSJ"), the value to Sanchez Resources of having Sanchez Energy carry the oil wells is roughly \$22 million.

51. During the August 8, 2013 earnings call, Sanchez III acknowledged that the commitment to cover the drilling costs increased the total cost of the Transaction to \$100 million. Including the drilling costs, Sanchez Energy paid nearly \$2,500 an acre for the TMS Assets.

⁶ \$14.4 million in cash was paid to Sanchez Resources, and the remaining \$2.1 million was paid to an undisclosed third party.

52. The price paid by Sanchez Energy for undeveloped acreage and its working interests in the AMI is particularly egregious when compared to comparable arms-length transactions in the TMS. In August 2013, Goodrich Petroleum Corp. (“Goodrich”), the largest acreage owner in the TMS, acquired a 172,000 acre working interest in the TMS from Devon Energy. According to the November 10, 2013, WSJ article, Goodrich paid only \$144 per acre for working interests in land virtually next door to the Sanchez Energy AMI. Thus, Sanchez Energy agreed to pay roughly 17 times more per similarly situated acre to Sanchez Resources than Goodrich did in a true third party deal.

53. Moreover, in its November 13, 2013 investor relations presentation, Goodrich stated that it has acquired all of its over 300,000 acre TMS interests for an average cost of \$185 per acre. There is simply no legitimate justification for Sanchez Energy to be paying \$2,500 per acre while its competitors in the TMS are paying a small fraction of that price.

54. According to the website www.tuscaloosatrend.blogspot.com, over the past three years, 1.7 million acres have been leased in the TMS at an average price of \$200 per acre. And Sanchez Resources only paid \$184 an acre to acquire the Tridimension assets, which it appears to have resold to Sanchez Energy, and that value includes the acquisition of wells and equipment.

55. When asked about the lofty price paid per acre by an analyst during the August 8, 2013 earnings call, Sanchez III stated:

The bulk of what ended up being the ultimate purchase price was negotiated between us and the private equity group that I have previously

mentioned. This was a process that took a couple of months as you can imagine we had different views and what it should transact at. We ultimately got to a purchase price of \$61 million with them so two-thirds of the answer which is two-third of the purchase price is a function of negotiated price that we agreed to, basically to take them out of this position.

56. This statement makes no sense. The fact that an existing investor in Sanchez Resources demands to be bought out by the Sanchez family at an astonishing premium to market is not a justification for Sanchez Energy – supposedly an independent third-party entering into an arm’s length transaction – paying such a king’s ransom.

57. The real reason Sanchez Energy is paying this extraordinarily high price is because Eduardo Sanchez is the CEO of Sanchez Resources, and Sanchez Jr. and Sanchez III have equity interests in Sanchez Resources. Through the Transaction, not only does Sanchez Resources end up free of managerial oversight pressures by Altpoint, it also leaves with \$14.4 million in cash, six operational oil wells free of cost, and a continued 50% interest in the AMI.⁷ The Sanchez family can now maximize the profits from their investments in Sanchez Resources while placing the development costs on Sanchez Energy and its stockholders.

C. The Transaction Further Enriches The Sanchez Family Through The Payment Of Royalty Fees To Sanchez Resources

58. As if paying off Altpoint’s equity stake in Sanchez Resources was not enough, the Sanchez family, with the assistance of Altpoint, decided to pay themselves a kickback in the form of an undisclosed royalty owed by Sanchez Energy to Sanchez Resources. Specifically, as a consequence of the Transaction, Sanchez Energy will also

⁷ See Sanchez Energy filing on Form 10-Q with the SEC on September 30, 2013 at n. 3

be required to pay Sanchez Resources royalty fees on any oil produced from the undeveloped 40,000 acres in the TMS.

59. The roots for these royalty payments were laid in 2011, when SOG began buying up oil and gas rights on properties in the TMS. SOG leased these rights from the property owners for industry standard royalty fee rates – typically, \$10 and a royalty fee of between 12% and 16% of anything produced from drilling operations on the land.

60. On April 10, 2012, after receiving significant capital investment from Altpoint, Sanchez Resources acquired through SR Acquisition all of SOG’s leases in the TMS.⁸ For these leases, Sanchez Resources paid \$10 and “other good and valuable consideration” – although the lease assignment does not specify what that additional consideration is.

61. On August 8, 2013, Sanchez Energy issued a press release announcing the terms of the TMS deal with Sanchez Resources.⁹ One week *later*, on August 15, 2013, Eduardo Sanchez, on behalf of SR Acquisition, executed an Assignment of Oil and Gas Leases (“Assignment”), which assigned 32.4% of its interest in the 40,000 undeveloped acres to Altpoint Holdings.¹⁰ Altpoint Holdings executed the Assignment on August 16, 2013. In the Assignment, Altpoint agreed to pay \$10, *plus* an overriding royalty to SR Acquisition of 25% of anything produced from drilling operations on the land, less the

⁸ SR Acquisition lists its address in the lease assignment from SR Acquisition to Altpoint Holdings as 1111 Bagby, Suite 1800, Houston, Texas 77002. This is the same address as Sanchez Energy.

⁹ On August 13, 2013, Sanchez Energy filed a Form 8-K with the SEC announcing the substance of the agreement, but conspicuously leaving out all of the exhibits to the Purchase Agreement providing the Transaction’s details.

¹⁰ *See e.g.*, Assignment Instrument # 252972 filed with the Pike County, Mississippi, Chancery Clerk, recorded September 6, 2013.

royalty payment owed to the land owner.¹¹ The same day, Altpoint Holdings executed the Assignment and sold its interest – for which it paid \$10 – to Sanchez Energy for \$61 million in cash and Company stock, and subject to all obligations in prior lease agreements, including the 25% overriding royalty to Sanchez Resources.

62. Under the terms of the Transaction, Sanchez Energy purchased all of Altpoint Holdings’ interests and various other interests from Sanchez Resources and other third parties, which gave Sanchez Energy ownership of the oil and gas contracts for the 40,000 undeveloped acres. As the holder of the leases on that acreage, Sanchez Energy is liable to the original property holders for all of the 12% to 16% royalties on any oil and gas produced from the land. And because Sanchez Energy acquired most of those leases through Altpoint Holdings, it is also liable to Sanchez Resources, through SR Acquisition, for the 25% overriding royalty added to the leases by Altpoint Holdings and Sanchez Resources.

63. These royalty payments – added to Sanchez Energy’s lease obligations by Altpoint Holdings and Sanchez Resources with the consent of Sanchez Energy’s Board *after* the substance of the Transaction was announced – have remained undisclosed in every subsequent filing discussing the Transaction. These royalty payments are simply another way for the Sanchez family to hoard a disproportionate amount of the profits

¹¹ The lease assignment states, in pertinent part, “[t]here is reserved unto [SR Acquisition] . . . an overriding royalty interest equal to the positive difference, if any, between all lease royalties, overriding royalties, and other similar type lease burdens of record and affecting [SR Acquisition]’s interest in the Leases as of the date of this Assignment. The overriding royalty interest herein reserved shall be reduced in proportion to the interest herein assigned, and shall be further proportionately reduced in the event any of the Leases cover less than 100% of the mineral estate.”

while pushing the weight of the development costs onto the stockholders of Sanchez Energy.

D. The Transaction Was The Result Of An Unfair Process

64. The Transaction was approved by the Board's audit committee comprised of purportedly independent directors Jackson, Garcia, and Colvin. The audit committee's review, however, was nothing more than a "rubber stamping" of the Transaction by cronies loyal to the Sanchez family. The Board and its audit committee were unable to adequately and fairly evaluate the Transaction because, as detailed below, a majority of the Board has conflicting interests and divided loyalties which prevent them from exercising independent business judgment. Of the five-member Board, at least four directors are conflicted. Sanchez Jr. and Sanchez III both have an equity stake in Sanchez Resources, placing them on both sides of the transaction. Jackson and Garcia are both life-long friends with the Sanchez family and are beholden to the Sanchez's interests through significant shared equity investment in outside companies.

65. It is irrelevant that the audit committee supposedly was advised by an outside investment advisor, which according to the WSJ was Scotiabank, because the financial data provided to such advisor undoubtedly came from members of the Sanchez family themselves. There is also no indication that this financial advisor was made aware of the undisclosed royalty kickback to Sanchez Resources.

DERIVATIVE ALLEGATIONS

66. Plaintiffs bring this action derivatively to redress injuries suffered by the Company as a direct result of the breaches of fiduciary duties by the Individual Defendants.

67. Plaintiffs have owned Sanchez stock continuously during the time of the wrongful course of conduct by the Individual Defendants alleged herein and continue to hold Sanchez Energy stock.

68. Plaintiffs will adequately and fairly represent the interests of Sanchez Energy and its stockholders in enforcing and prosecuting its rights and have retained counsel competent and experienced in stockholder derivative litigation.

DEMAND ON THE SANCHEZ BOARD IS EXCUSED AS FUTILE

69. Plaintiffs have not made a demand on the Sanchez Energy Board to bring suit asserting the claims set forth herein because pre-suit demand was excused as a matter of law.

70. *First*, the acquisition of the TMS interests by Sanchez Energy is plainly an interested transaction and, as alleged above, is not entirely fair to the Company – in terms of both price and process. Because the Transaction is not entirely fair to Sanchez Energy, it cannot be deemed a product of the valid exercise of business judgment and demand is excused as a matter of law.

71. *Second*, the Board's intentional decision to approve the purchase of the TMS interests from Sanchez Resources at a price *seventeen times* that of the nearest comparable transaction amounts to bad faith that is not subject to the business judgment

rule. Put simply, a decision that is inexplicable on grounds other than bad faith is not entitled to the protection of the rule.

72. *Third*, the process by which the Transaction was approved was not fair to the Company or its stockholders. A majority of the Sanchez Energy directors suffer from conflicts of interest and divided loyalties which preclude them from exercising independent business judgment. Because they are interested, their actions with respect to the facts alleged herein are subject to entire fairness review, and the business judgment rule is not applicable.

73. **A.R. Sanchez, Jr.** is the beneficiary of a trust that owns an equity interest in Sanchez Resources, which is run by his son Eduardo. Sanchez Jr. cannot possibly independently consider whether to aggressively prosecute claims that are against his personal financial interest in Sanchez Resources and which could potentially negatively impact his son's company. Sanchez Jr. benefitted personally from the Transaction through his interests in Sanchez Resources, making him directly interested in the Transaction and liable for the breach of his fiduciary duties as a Sanchez Energy director. Moreover, Sanchez Jr. is Sanchez III's father; he cannot possibly independently consider prosecuting claims against the Sanchez Energy Board without targeting his own son with whom he has a direct family relationship and close working ties in the other Sanchez affiliated companies.

74. **Antonio R. Sanchez, III** is the beneficiary of a trust that owns an equity interest in Sanchez Resources, which is run by his brother Eduardo. Sanchez III cannot possibly independently consider whether to aggressively prosecute claims that are against

his personal financial interest and which could potentially negatively impact his brother's company. Sanchez III benefitted personally from the Transaction through his interests in Sanchez Resources, making him directly interested in the Transaction and liable for the breach of his fiduciary duties as a Sanchez Energy director. Moreover, Sanchez III is Sanchez Jr.'s son; he cannot possibly independently consider prosecuting claims against the Sanchez Energy Board without targeting his own father with whom he has a direct family relationship and close working ties in the other Sanchez affiliated companies.

75. **Alan G. Jackson** is a close friend of Sanchez Jr. According to an October 26, 2002 article by Monica Wolfson titled "Education key in Sanchez race,"¹² Sanchez Jr. and Jackson have been close friends for more than five decades.

(a) In addition to having a personal relationship with the Sanchez family that has lasted for over 50 years, Jackson is beholden to Sanchez Jr. in his professional career. Jackson is an executive at IBC Insurance Agency, Ltd., which provides insurance brokerage services on a commission basis to the Company and its affiliates. Based upon information from salary.com concerning salary information for people holding positions similarly to Jackson's position at IBC in the San Antonio area, Jackson likely earned between \$200,000-\$250,000 in salary and approximately \$30,000-\$60,000 in bonus during 2012 as an IBC executive. Jackson's brother is also an employee of IBC. Sanchez, Jr. is a director of International Bancshares Corporation, the parent of IBC, and he and his family are the largest stockholders of International Bancshares Corporation's common stock. In 2012, both Jackson and his brother received

¹² Available at: <http://www.texnews.com/1998/2002/local/sanchez1026.html>.

a portion of the commissions paid to IBC by the Company and its affiliates. If Jackson, in his capacity as a director at Sanchez Energy, were to act against the interests of Sanchez Jr., he faces the threat of termination at IBC, the loss of promotion opportunities, and the loss or decrease of his salary – his very livelihood – because of Sanchez Jr.’s position on IBC’s board and significant influence through his substantial equity stake.¹³

(b) Jackson also donated \$12,500 to Sanchez Jr.’s unsuccessful Texas gubernatorial campaign in 2002. In 2012, Jackson earned \$165,329.04 in compensation for his service as a Sanchez Energy director. This six-figure salary is a major personal benefit to Jackson, which materially affects his ability to act independently of the Sanchez family. In fact, Jackson’s compensation for serving as Sanchez Energy director constitutes between 30-40% of Jackson’s total income for 2012. In this regard, Jackson is unable to act independently and disinterestedly consider a demand on Sanchez Energy because doing so would jeopardize (a) his close personal relationship with Sanchez Jr., (b) the ongoing business relationship between IBC and Sanchez Energy, (c) Jackson’s employment at both Sanchez Energy and IBC, and (d) the considerable compensation received for his service on the Sanchez Energy Board.

76. **Gilbert A. Garcia** owns a 39% interest in Latin American Entertainment, LLC. According to court filings in *Vela v. Hacienda Records and Recording Studio, Inc., et al.*, C.A. No. C-00-180 (S.D. Tex.), Sanchez, Jr. is an investor in Latin American Entertainment, LLC, through his stake in an entity named Sandman Venture Investments,

¹³ In its most recent Proxy Statement filed on April 19, 2013, IBC acknowledges Sanchez Jr.’s influence at IBC by listing him as a non-independent director under NASDAQ rules and other securities laws.

LLC. Sanchez Jr. directly owns a 17% stake in Sandman Ventures, LLC, while trusts for the benefit of Sanchez Jr. and his family own an additional 52% of Sandman Ventures, LLC. Sandman Ventures, LLC, owns a 20% stake in Latin American Entertainment, LLC. Garcia also owns a 48% interest in Hacienda Records, L.P., and serves as President of the company, of which Sandman Ventures, LLC, is a Preferred Limited Partner.

77. In 2012, Garcia earned \$238,006.11 in compensation for his service as a director. This six-figure salary is a major personal benefit to Garcia, which materially affects his ability to act independently of the Sanchez family. In this regard, Garcia is unable to independently and disinterestedly consider a demand on Sanchez Energy because doing so would jeopardize (a) his close, personal relationship with the Sanchez family, (b) the ongoing business relationship between Latin American Entertainment, LLC, Hacienda Records, L.P., and Sanchez Jr., and (c) the considerable compensation received for his service on the Sanchez Energy Board.

78. **Greg Colvin** earned \$272,780.11 in compensation in 2012 for his service as a Sanchez Energy director. This six-figure salary is a major personal benefit to Colvin, which materially affects his ability to act independently of the Sanchez family. In this regard, Colvin is unable to act independently and disinterestedly consider a demand on Sanchez Energy because doing so would jeopardize his personal relationship with the Sanchez family and the considerable compensation received for his service on the Sanchez Energy Board. Colvin donated \$5,000 to Sanchez Jr.'s campaign for governor.

79. The Board is also conflicted from bringing an action against Eduardo Sanchez and Sanchez Resources. Given that Sanchez Resources is the alter-ego of the Sanchez family and Eduardo Sanchez is a member of the Sanchez family, the Board could not be viewed as independent when considering a demand.

80. By approving the Transaction and entering into the Purchase Agreement, the Board has demonstrated its inability to independently consider a demand to bring an action against Altpoint. In fact, under Section 10.1 of the Purchase Agreement, the Board has agreed not to bring an action related to the Transaction against Altpoint. Moreover, the interests of the Sanchez family and Altpoint are intermingled in the Transaction.

81. Under these circumstances, the Sanchez Energy Board cannot be expected to bring the claims asserted herein, and the actions of the Board challenged herein are not protected from judicial scrutiny. Demand is therefore excused.

CAUSES OF ACTION

COUNT I

(Breach of Fiduciary Duty) (Derivatively Against Individual Defendants)

82. Plaintiffs repeat and reallege the preceding paragraphs as set forth above and incorporate them herein by reference.

83. The Individual Defendants, as directors of Sanchez Energy, are fiduciaries of the Company and its stockholders. As such, they owe the Company the highest duties of good faith, fair dealing, due care, and loyalty.

84. The Individual Defendants have breached their duty of loyalty by elevating and favoring the interests of the Sanchez family over the interests of Sanchez Energy and its public stockholders.

85. The Individual Defendants have also breached their fiduciary duties by failing to evaluate fairly the Transaction and permitting the purchase of the TMS working interest at an excessive and inequitable price.

86. Additionally, in contemplating, planning, and/or affecting the foregoing conduct, and consciously and deliberately serving the interests of the Sanchez family to the detriment of Sanchez Energy and its other stockholders, the Individual Defendants breached their duty of good faith toward, and acted in bad faith to, the Company.

87. As a result of these actions of the Individual Defendants, the Company has been and will be damaged.

88. Plaintiffs have no adequate remedy at law.

COUNT II

(Breach of Fiduciary Duty) (Derivatively Against Sanchez III)

89. Plaintiffs reallege the previous paragraphs set forth above and incorporate them herein by reference.

90. Sanchez III, as an executive officer of Sanchez Energy, is a fiduciary of the Company and its stockholders. As such, he owes the Company the highest duties of good faith, fair dealing, due care, and loyalty.

91. Sanchez III has breached his duty of loyalty by elevating and favoring his personal interests and his family's financial interests over the interests of Sanchez Energy and its stockholders.

92. Sanchez III, as an executive officer of Sanchez Energy, has also breached his fiduciary duties by failing to fairly evaluate the Transaction, permitting the payment of unnecessary and inequitable royalties to Sanchez Resources, and permitting the purchase of Altpoint's and Sanchez Resources' working interests in the AMI at an excessive and inequitable price.

93. Additionally, in contemplating, planning, and/or affecting the foregoing conduct, and consciously and deliberately serving his own personal interests and the interests of his family to the detriment of Sanchez Energy and its stockholders, Sanchez III has breached his duty of good faith as an executive officer toward, and acted in bad faith to, the Company.

94. As a result of the actions of Sanchez III, the Company has been and will be damaged.

95. Plaintiffs have no adequate remedy at law.

COUNT III

(Aiding and Abetting Breach of Fiduciary Duty) (Derivatively Against Sanchez Resources, Altpoint and Eduardo Sanchez)

96. Plaintiffs repeat and reallege the previous paragraphs set forth above and incorporate them herein by reference.

97. Defendants Sanchez Resources, Altpoint and Eduardo Sanchez were aware of the Individual Defendants' fiduciary duties to Sanchez Energy and its

stockholders to maximize the enterprise value of the Company for the benefit of the stockholders.

98. Defendants Sanchez Resources, Altpoint and Eduardo Sanchez aided and abetted the Individual Defendants' breaches of their fiduciary duty.

99. Defendants Sanchez Resources, Altpoint and Eduardo Sanchez had knowledge of this breach and knowingly participated in the breach by causing and accepting the Transaction and agreeing to the 25% overriding royalty after the Transaction was announced.

100. As a result of Sanchez Resources, Altpoint's and Eduardo Sanchez's conduct, the Company suffered harm.

101. Plaintiffs have no adequate remedy at law.

COUNT IV

(Unjust Enrichment) (Derivatively Against Sanchez Jr. & Sanchez III)

102. Plaintiffs reallege the preceding paragraphs as set forth above and incorporate them herein by reference.

103. Defendants Sanchez Jr. and Sanchez III were unjustly enriched as a result of the inflated and excessive consideration that was paid for the TMS working interest, at the expense of the Sanchez Energy stockholders.

104. As a result of the actions of Sanchez Jr. and Sanchez III, the Company has been and will be damaged.

105. Plaintiffs have no adequate remedy at law.

WHEREFORE, Plaintiffs pray for judgment as follows:

- (a) for an order declaring that the Individual Defendants breached their fiduciary duties to the Company;
- (b) for an order declaring that Sanchez Resources, Altpoint and Eduardo Sanchez aided and abetted the Individual Defendants' breaches;
- (c) for an order rescinding Sanchez Energy's purchase of the TMS working interests;
- (d) for an order awarding damages, together with pre- and post-judgment interest to the Company;
- (e) for an order disgorging all profits, benefits and other compensation obtained by Sanchez Jr. and Sanchez III as a result of their breaches of fiduciary duties;
- (f) for an award of Plaintiffs' costs and expenses incurred in this action, including, but not limited to, experts' and attorneys' fees and expenses; and
- (g) for such other and further relief as may be just and proper.

Dated: January 28, 2014

GRANT & EISENHOFER P.A.

Of Counsel:

Mark Lebovitch
Amy Miller
Evan Berkow
BERNSTEIN LITOWITZ BERGER
& GROSSMANN LLP
1285 Avenue of the Americas
New York, NY 10019
Tel: (212) 554-1400
Fax: (212) 554-1444

Co-Lead Counsel for Plaintiffs

/s/ Stuart M. Grant
Stuart M. Grant (Del. No. 2526)
Michael Barry (Del. No. 4368)
Nathan A. Cook (Del. I.D. No. 4841)
Bernard C. Devieux (Del. No. 5689)
Jacob R. Kirkham (Del. I.D. No. 5768)
GRANT & EISENHOFER P.A.
123 Justison Street
Wilmington, DE 19801
Tel: (302) 622-7000
Fax: (302) 622-7100

Co-Lead Counsel for Plaintiffs

– and –

CHIMICLES & TIKELLIS LLP

/s/ Pamela S. Tikellis

Pamela S. Tikellis (Del. #2172)

Scott M. Tucker (Del. #4925)

Vera G. Belger (Del. #5676)

222 Delaware Avenue, Suite 1100

P.O. Box 1035

Wilmington, DE 19899

Tel: (302) 656-2500

Fax: (302) 656-9053

Co-Lead Counsel for Plaintiffs