Beware of Leases that Require Arbitration and Prohibit Class Actions

Brian McMahon
NARO-CA

Royalty owners should give a lot of care and attention to royalty provisions before they sign a lease. After all, they want the largest royalty they can get. They should also give the same care and attention to other provisions in the lease to protect the royalties they bargained for. Royalty owners should be aware of signing leases that require disputes be submitted to arbitration and prohibit participation in class actions. Such provisions may make it very difficult to ensure that royalty owners receive the royalties they bargained for.

Mineral owners and energy producers form a partnership when they enter into leases with each other. After entering into leases, they usually work together for their mutual interests. But sometimes disputes between them arise over the value of the oil and gas production or over the costs that may be deducted from royalties. These disputes are almost always complex, require substantial discovery and are expensive to litigate.

Some disputes have arisen over the lessee's valuation of oil and gas where the lessee has sold the production to its affiliate, the affiliate has sold the production to a third party at a higher price, and the lessee has paid royalties based on the price paid by its affiliate. Other disputes have arisen where the lessee processed the oil production in its own refinery and used prices of dissimilar crude oil to calculate royalties. More complicated disputes concern situations where the royalty owner has accused the lessee of artificially manipulating the prices of oil or gas.

Disputes have also arisen over the costs deducted by the lessee. Among them are disputes over whether some post-production costs are deductible, which costs have been incurred to place the oil or gas in a marketable condition, and if costs incurred to transport oil or gas over the pipeline owned by a lessee's affiliate have been artificially inflated.

Royalty owners would be severely disadvantaged in these disputes over the valuation of production and deductable costs if they are required to submit them to arbitration and/or if they are prohibited from participating in class actions.

Arbitration is cheaper and faster than litigation. So what's wrong with submitting all disputes to arbitration? Submitting a dispute to arbitration is preferable when the dispute is simple and straightforward. But arbitration poses a number of disadvantages when a dispute between a royalty owner and lessee involves complicated issues over royalties. Arbitration allows far less discovery than lawsuits making it more difficult, for example, for royalty owners to uncover sophisticated schemes to underpay royalties. Another disadvantage is that the arbitrator's decisions are usually not subject to review by a court even if the arbitrator applies or relies on incorrect the facts and law. In contrast, a trial court's mistakes of facts and the law are reviewable by an appellate court. Finally, the results of arbitration are confidential and cannot be cited in subsequent arbitrations or lawsuits. This feature of arbitrations enables a lessee to litigate the same issue again and again against many different royalty owners, without fear that its defeat by one royalty owner will impact disputes against other royalty owners.

Provisions that prohibit royalty owners from participating in class actions may similarly prevent royalty owners from obtaining the royalties they bargained for. Disputes over royalties often require large financial resources. Class actions can perform a critical function for royalty owners in disputes over royalties for two related reasons. First, litigation is expensive. It is costly for royalty owners to prove that they were underpaid and to prove what the correct amount of the royalty should be. Second, royalty owners often have small royalty interests. Small royalty interests and large litigation costs often combine to prevent individual royalty owners from litigating their rights. Class actions provide royalty owners lessors with a solution, even if an imperfect one, to the royalty owners' dilemma. Multiple royalty owners can aggregate their similar claims, while litigation costs are borne by the attorneys who file the class actions. By giving up their right to participate in class actions, royalty owners are extremely disadvantaged in disputes with See Beware on page 7

NARO-AP from page 3

The Cumnock Shale in the Triassic Strata Deep River Basin of Lee and Chatham counties is drawing *much* attention by geologists and mineral owners alike. Some leasing activity has already begun and 28 wells have been drilled–six of which have reported natural gas and oil. This may be the next "Marcellus/Utica" type play in the Eastern U.S., although much smaller geographically than either of those in the Northeast.

Standardized Royalty/Accounting Legislative Initiative

NARO Appalachia chapter member and West Virginia Royalty Owners President, Ron Hayhurst, has started work on an initiative to educate West Virginia legislative leaders on the need for new statutes that simplify royalty payment information. This would require a standard royalty reporting format and simplification of terminology. NARO Appalachia will be assisting Ron in this effort. Currently, most operating companies use their own format and terminology which is complex and difficult to understand by most royalty recipients. We believe that all states should require simplified and standardized royalty reporting by operators which can be easily understood by mineral owners and/or their mineral managers. Many states already require such simplified formats that we have provided to key state regulators for consideration.

Beware from page 5

lessees over royalties.

Royalty owners cannot expect that courts will find that agreements to arbitrate and to prohibit class actions are

unconscionable and thus unenforceable. The recent United States Supreme Court decision in AT&T Mobility v. Concepcion has swept aside all previous court decisions that invalidated arbitration provisions prohibiting class actions on the ground that they were unconscionable. The Supreme Court held that courts must enforce agreements to arbitrate and to prohibit participation in class actions. If leases require that disputes be submitted to arbitration and forbid participation in class actions, those requirements will be enforced. Royalty owners may well find that they effectively cannot enforce their royalty rights. So, the best practice is to refuse to accept such agreements when entering into a lease.