

Oil & Gas Exploration and Production

What does this have to do with residential mortgages?

The State of North Carolina has recently evaluated potential issues associated with oil and gas exploration and production in the State. In anticipation of the State allowing certain technology to recover natural gas from shale formations, oil and gas companies have begun to enter into gas leases with residential property owners and at least one developer has severed the subsurface rights from the surface rights. The relationships of subsurface rights and residential mortgages are complex and are an emerging issue for lenders in North Carolina.

[Oil and Gas in North Carolina](#)

The North Carolina Geological Survey has concluded that a commercially viable reserve

of natural gas may underlie parts of the Triassic basins in North Carolina, including portions of the Deep River Basin (particularly in Chatham, Lee and Moore counties) and possibly the Dan River Basin (including Stokes and Rockingham counties).

Although oil and gas are not currently produced in North Carolina, technology exists that allows “shale gas” to be recovered from shale formations such as those found in North Carolina. Modern exploration and gas production technology, such as horizontal drilling and hydraulic fracturing (commonly known as “fracking”), has enabled the extraction of shale gas in similar formations in other states, including New York and Pennsylvania. Fracking is a process used to enhance production

of natural gas from shale or other impermeable rock formations and involves: (i) drilling a well into rock that contains natural gas; (ii) injecting fluids under pressure to fracture the rock; and (iii) extracting the natural gas from the fractures that are created. In North Carolina, current regulations prohibit fracking and horizontal drilling.

Pursuant to Session Law 2011-276, the North Carolina General Assembly directed the Department of Environment and Natural Resources (“DENR”), the Department of Commerce, and the Department of Justice to study the issue of oil and gas exploration in the State, including the use of horizontal drilling and fracking for natural gas production. In its final report issued on May 1, 2012, DENR identified several environmental risks associated with shale gas drilling and associated activities (e.g., surface disturbances, drinking water contamination, air quality, accidental spills, and well blowouts and explosions), but determined that subject to certain limitations and recommendations, fracking and horizontal drilling can be done safely in North Carolina.

Acquiring Oil and Gas Rights

Although fracking and horizontal drilling are currently prohibited, oil and gas companies and developers have begun to secure oil and gas rights in North Carolina in anticipation of these practices becoming lawful. Companies acquire the rights to subsurface oil and gas through deeds and lease agreements. Since 2010, several oil and gas companies have entered into lease agreements with property owners, primarily in Lee County. Leases are private contracts between the gas company and the individual mineral rights holder granting the gas company the right to explore, develop, produce and extract the natural gas in exchange for payments to the mineral right holder, typically in the form of a signing bonus and royalties. In addition, at least one developer has recorded deeds in several counties granting rights to all

subsurface oil and natural gas to its affiliate. Unlike a lease, a deed to subsurface or mineral rights splits the fee estate between the surface property and the subsurface property, with separate deeds for each estate.

Considerations for Lenders

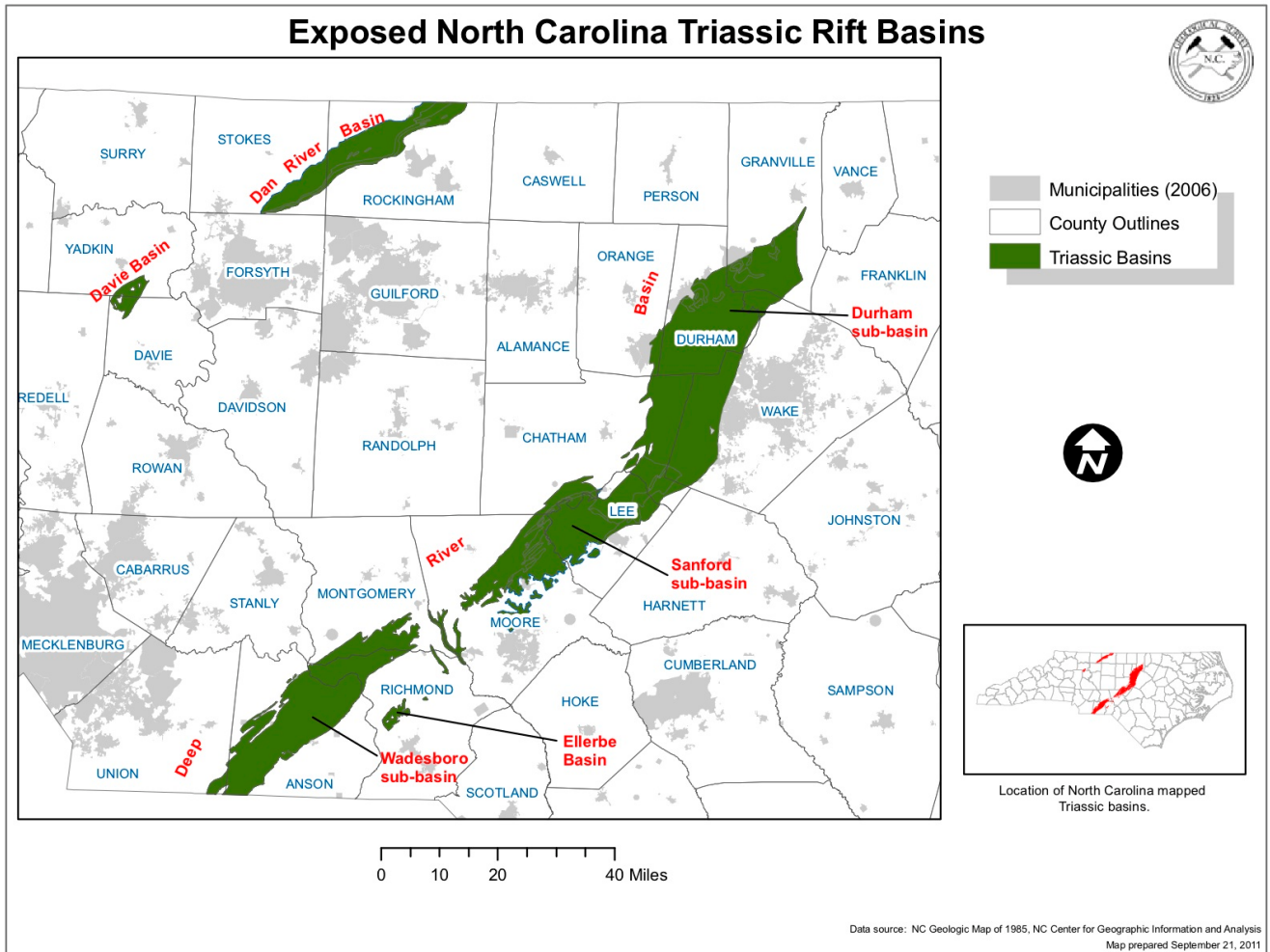
The potential for oil and gas exploration and production in North Carolina raises several issues that lenders should consider.

1. **Potential Violations of Mortgage.** Residential mortgages are typically secured by surface and subsurface property rights. Most mortgages, including the Deed of Trust approved by Fannie Mae (Federal National Mortgage Association) and Fred-

Because the Fannie Mae and Freddie Mac uniform mortgage documents prohibit a borrower from selling any portion of the mortgaged property without prior approval of the lender, it will be difficult for a lender to warrant that the loan meets all investor requirements if an oil and gas lease exists on the property.

die Mac (Federal Home Loan Mortgage Corporation) for use in North Carolina, contain a clause (commonly known as a “due-on-sale clause”) prohibiting the borrower from selling or transferring any portion of the mortgaged property or any interest in the property without prior approval of the lender. Entering into a lease for subsurface oil and gas rights without prior approval of the lender would be in violation of this clause and could be considered a default under the mortgage.

In addition to the due-on-sale clause, most residential mortgages contain a clause prohibiting the borrower from permitting: (i) the use, storage or presence of hazardous substances on or in the property; or (ii) activities that affect the property that (a) are in violation of an environmental law, (b) may trigger an environmental cleanup, or (c) due to the presence, use or release of a hazardous substance create a condition that adversely affects the property’s value.



Drilling and other activities associated with shale gas extraction and production may be in violation of this clause.

2. **Secondary Mortgage Market.** A potential breach of the mortgage may not be limited to the borrower. The vast majority of residential mortgage loans are sold into the secondary mortgage market. Congress chartered Fannie Mae and Freddie Mac to help maintain a secondary mortgage market. To sell conforming mortgages to either Fannie Mae or Freddie Mac, institutions must meet certain eligibility requirements and represent and warrant to Fannie Mae or Freddie Mac that, among other things, they will comply with extensive seller guidelines established by the two companies. Because the Fannie Mae and Freddie Mac uniform mortgage documents prohibit a borrower from selling any portion of the mortgaged property without prior approval of the lender, it will be

difficult for a lender to warrant that the loan meets all investor requirements if an oil and gas lease exists on the property.

Fannie Mae provides guidance regarding the procedures that borrowers should follow to make a request to enter into a gas lease and standards that lenders should apply to determine whether or not to approve such a request. The Fannie Mae guidance provides that lenders may approve such a request if such a lease “is customary in the area and exercise of the lease will not have a material effect on the value of the property, prevent use of the property as a residence, or expose the residents to serious health or safety hazards.” Because fracking is currently prohibited in North Carolina and there have been relatively few gas leases entered into in North Carolina, it may be difficult to establish that such leases are “customary” in the area.

Fannie Mae and Freddie Mac guidelines

also provide that existing homes must be at least 200 feet from any surface or subsurface entry. Leases commonly have adequate setbacks from structures for drilling, but allow other activities (pumping stations, roads, pipelines, etc.) within the 200-foot setback area.

3. **Loan Underwriting.** All mortgage loans require a property appraisal, title insurance covering the lender or its assignees, and homeowner's insurance.

Reliable appraisals of properties subject to gas leases are difficult to obtain and may be expensive. North Carolina law does not require that gas leases be recorded; rather, memoranda of the leases are recorded, which do not include the terms of the lease and may make it difficult to properly evaluate risks. Moreover, comparable sales, historical data, and impact (either positive or negative) on value or marketability are unable to be documented reliably. As a result, if appraisers cannot properly determine the value of the property, the loan may be considered non-conforming.

A lender's title policy insures the mortgage as of the date of the policy against loss or damage if title is vested in someone other than the borrower. Gas leases signed after the policy date are not covered by the policy. Gas leases in effect when the policy is issued may be listed as a title exception; if so, coverage will not include the gas lease or any claims arising from it. Thus, this can lead to additional exposure to primary and secondary lenders.

Residential mortgages require that the borrowers hold homeowner's insurance. Homeowner's insurance typically excludes the types of risk associated with gas drilling and production.

4. **Property Value.** Environmental impacts associated with the drilling and production process may affect the value of the surface property as a security interest or in foreclosure.

Recommendations

As a result of the potential risks and uncertainty associated with gas exploration, drilling and production, some lenders will not purchase

or issue mortgage loans on residential properties where the borrower does not own the mineral rights or has entered into a gas lease. There are steps, however, that prudent lenders should take when evaluating whether to purchase, issue or maintain a mortgage on such a residential property.

With respect to mortgage applications, lenders should revise their underwriting requirements to evaluate whether there is any oil and gas activity on the property or the neighboring property and, if so, the potential risks associated with such activity. The lender should also consider whether to request that the oil and gas company release the lease or a certain amount of land around a residence before issuing a mortgage. In addition, the lender should request that the oil and gas company enter into a deed of subordination and an indemnification agreement indemnifying the lender and borrower with respect to any environmental damage caused by the oil and gas activities.

With respect to existing mortgages, if lenders become aware that a borrower has granted gas rights without prior approval, lenders should immediately send the borrower a reservation of rights letter and notify Fannie Mae or Freddie Mac, if applicable. The lender or Frannie Mae or Freddie Mac will then need to decide whether to approve the lease or declare the mortgage in default. In addition, lenders should consider requesting that the oil and gas company release the lease and seek an indemnification agreement as described above.

In addition to the steps discussed above, the Department of Justice has made several recommendations in its final report, including (i) requiring that property owners be given written notice that entering into a gas lease may cause them to be in violation of their mortgage; (ii) requiring oil and gas companies to notify any mortgage lender holding an existing mortgage on the property that an oil and gas lease has been offered to the property owner, and to obtain the lender's approval prior to finalizing the lease; and (iii) requiring that oil and gas leases be recorded, in full, in the appropriate office of the register of deeds. These recommendations will likely be considered by the General Assembly during upcoming sessions. §



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