



STATE OF IDAHO
OFFICE OF THE ATTORNEY GENERAL
LAWRENCE G. WASDEN

January 25, 2016

Honorable Michelle Stennett
Minority Leader
Idaho State Senate
STATEHOUSE MAIL
mstennett@senate.idaho.gov

Via electronic mail and statehouse mail

Re: Impact of Oil and Gas Leases on Mortgages ~ Title 47, Chapter 3, Idaho Code

Dear Senator Stennett:

In your January 12, 2016, email to Assistant Chief Deputy Brian Kane you ask how oil and gas leases may affect residential mortgages. This letter summarizes the relevant sections of Idaho's oil and gas laws, identifies the two applicable provisions found in standard Idaho mortgages, discusses the interplay between oil and gas leases and those provisions, and outlines recommendations for mitigating potential problems.

OIL AND GAS LEASES

Title 47, chapter 3, Idaho Code, and IDAPA 20.07.02 govern the development of oil and gas wells in the state of Idaho. Management of Idaho's oil and gas industry falls within the purview of a number of state agencies, but the Idaho Oil and Gas Conservation Commission ("Commission") enforces title 47, chapter 3, Idaho Code.

In a typical leasing transaction, a "landman" from an oil and gas development company approaches a property owner about leasing the property owner's mineral rights. A mineral lease is a contract that allows a person—other than the property owner—to extract and exploit the minerals located beneath the property. The lease also specifies, among other terms, the third-party's surface access rights.

In some instances, a pool of oil or gas or both exists beneath multiple properties. The Commission establishes spacing units for each subsurface oil or gas pool and issues orders setting the well numbers and position within each spacing unit. Subject to Idaho Code § 47-322(a), persons holding subsurface rights to an oil or gas pool may enter into an integration

agreement to integrate their “tracts or interests” and lease their interests within the spacing unit to an oil or gas developer. In instances where voluntary integration is not possible, any interested person may apply to the Commission for an integration order, which, if issued, integrates the opposing landowner(s) tract(s). See IDAHO CODE § 47-323(1)-(4).

MORTGAGE LOANS

The Federal National Mortgage Association (Fannie Mae) and the Federal Home Mortgage Corporation (Freddie Mac)¹ dominate the secondary mortgage market where residential mortgages are bought and sold. Because of Fannie Mae and Freddie Mac’s overwhelming presence in the secondary market, primary—or originating—mortgage lenders must conform their mortgages to Fannie Mae and Freddie Mac’s guidelines to ensure they purchase the originating lenders’ mortgages. For that reason, this letter focuses on Fannie Mae and Freddie Mac “conforming mortgages” and how these entities handle issues involving oil and gas leases.

When Fannie Mae or Freddie Mac purchases a mortgage, it acquires all of the rights that the originating lender had under the mortgage, including the right to foreclose on the property if the borrower defaults on the mortgage.

A mortgage typically is secured by the surface and subsurface portions of a plot of land, along with all existing and future buildings and fixtures on the land. A common provision in most mortgages, including a Fannie Mae or Freddie Mac conforming mortgage, prohibits a borrower from transferring any portion of the mortgaged property without the prior approval of the lender. The purpose of this restriction is to protect the security holder’s interests in the mortgaged property. Leasing the rights to a property’s subsurface minerals without the security holder’s pre-approval violates this provision and triggers the due-on-sale clause. That clause authorizes the security holder to demand full and immediate payment of the amount the borrower owes on the mortgage. The security holder may foreclose on the mortgage if the borrower cannot pay the full amount.

Most residential mortgages also prohibit borrowers from (1) using or storing hazardous materials on the property; or (2) engaging in activities that (a) violate environmental laws; (b) may require an environmental cleanup; or (c) decrease the property’s value because of the presence or release of hazardous substances. Extracting oil and gas from a property may violate one or both of these prohibitions.

Under certain circumstances, Fannie Mae or Freddie Mac may release its property interests and allow the execution of a gas and oil lease on the mortgage property. A borrower needs to work with his mortgage servicer—the company that services the loan on behalf of Fannie Mae or Freddie Mac—to obtain and submit the required form and documents. On behalf of

¹ Fannie Mae and Freddie Mac are government sponsored entities (GSEs) that are congressionally chartered to help maintain the secondary mortgage market.

Fannie Mae or Freddie Mac, the mortgage servicer reviews the borrower's information and decides whether to approve or deny the borrower's request.

The Fannie Mae Servicer Guide provides mortgage servicers with substantial guidance on how to review and judge a request for a security interest release when it involves mineral leases.² The servicer may approve the request on behalf of Fannie Mae if "the leasing of oil, gas, or mineral rights meets the following conditions:"

- granting of oil, gas, or mineral leases is customary in the area;
- exercise of the lease does not have a material impact on the value of the property securing a mortgage loan;
- exercise of the lease does not prevent use of the property as a residence; and
- exercise of the lease does not expose the residents to health or safety hazards.³

If the mortgage servicer finds the lease meets at least one, but not all of the conditions, the servicer must refer the lease request to Fannie Mae for its review. The mortgage servicer must deny the lease request if it fails to meet any of the above conditions.

Fannie Mae will not purchase or securitize a mortgage if the property has a title impediment. However, it allows existing oil, water, or mineral rights that are "customarily waived by other lenders" and that "do not materially alter the contour of the property or impair its value or usefulness for its intended purposes."

Under certain conditions, Freddie Mac allows title exceptions for existing oil, gas, or mineral rights.⁴ The rights must be those that lenders "commonly grant" in the area and must not damage the property or impair its use or marketability as a residence. The guidelines do not allow surface or subsurface entry within 200 feet of a residence, and require a title policy endorsement to protect the lender.

² Fannie Mae 2015 Single-Family Servicing Guide, § D1-1-01: Evaluating a Request for the Release, or Partial Release, of Property Securing a Mortgage Loan (11/12/2014) (pub. Dec. 16, 2015).

³ Fannie Mae 2015 Single Family Servicing Guide, § D1-1-01: Evaluating a Request for the Lease of Oil, Gas, or Mineral Rights (pub. Dec. 16, 2015). The borrower must submit a copy of the lease, along with Fannie Mae Form 236, to the mortgage servicer.

⁴ Freddie Mac Single-Family Seller/Servicer Guide, Acceptable exceptions to title insurance or to attorney's opinion of title - Oil, gas, water and mineral rights, § 39.4(i) (10/06/06) (pub. Mar. 17, 2015).

SOLVING POTENTIAL PROBLEMS

Homeowners are not always aware of the restrictions contained in their mortgages and may sign an oil and gas lease without obtaining pre-approval from their lender. Other homeowners may ignore the restrictions and execute a lease without the lender's approval. Another scenario involves nonparticipating owners who are subject to an integration order. The following summarizes actions the state, developers, mortgage lenders, and consumers can take to mitigate potential problems:

Notice

- Require the developer to give written notice to the property owner that entering into an oil and gas lease may violate an existing mortgage. The notice needs to be in a standard, easy to read and understand format and signed by the property owner.
- Require the developer to give to the property owner, along with the written notice, the state's written educational material (see below).
- Require the developer, before finalizing an oil and gas lease, to notify the property owner's mortgage lender and to obtain its written approval.
- Require the developer to record the complete oil and gas lease with the county recorder's office where the property is located.

Education

- Develop a dedicated consumer education website where Idahoans can go to find objective, nonpartisan information and news about Idaho's oil and gas laws, leases, and related issues.
- Develop a consumer education campaign with printed, electronic, and video materials to help homeowners and homebuyers better understand their rights and responsibilities when considering an oil and gas lease.
- Provide a link on the website to Fannie Mae Form 236, as well as contact information for mortgage servicers, state banks, and Idaho credit unions.

Mortgage Lenders

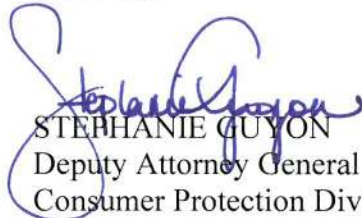
- If a mortgage lender learns a borrower entered into an oil and gas lease without the lender's approval, the mortgage lender has options, including issuing a reservation of rights letter, declaring the mortgage in default, requesting the developer's release of the lease, and obtaining an indemnification agreement.

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- When considering a mortgage application with an existing oil and gas lease, a mortgage lender may request release of the lease or a portion of land around the property, enter into a deed of subordination, and seek an indemnification agreement indemnifying the lender and the borrower against potential environmental damage.

I hope this information is helpful to you. Please contact me if you have questions.

Sincerely,



STEPHANIE GUYON
Deputy Attorney General
Consumer Protection Division

SNG/tt