

Gas and Oil Leases

Impact on residential mortgage lending

Presented by Greg May, Senior VP , Residential Mortgage Lending, Tompkins Trust Company

- **Please note: No opinion is being expressed or implied by the author on the practice of leasing mineral rights surrounding gas and/or oil leases (referred to as gas leases, leases or fracking hereafter) by these comments.**
- **The comments provided are summarized to highlight potential conflicts for residential mortgage lending in an effort to facilitate education about and consideration of these issues for home owners and potential home buyers.**
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- There are several critical issues associated with traditional mortgage lending that are in direct conflict with the Proposed SGEIS and the Revised Express Terms 6 NYCRR Parts 550 through 556 and 560 (the revised regulations).
- The lending standards followed by the vast majority of lenders are those of the secondary market agencies, specifically Fannie Mae, Freddie Mac, FHA and VA and in NYS, SONYMA.
- These conflicts with commonly accepted lending standards would prohibit any residential property with a gas lease or drilling activity from securing traditional mortgage financing.

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1) Fee simple ownership and property value:

- Residential real estate ownership is most commonly transferred in “fee simple” ownership, which by definition represents all rights to both the surface and sub-surface real estate and property.
- Property value is established by a NYS licensed Appraiser that compares similar property sales that traditionally transfer ownership with all these “fee simple” rights as a bundle.
- Should some of those rights not be transferred or have an encumbrance attached, then the NYS licensed Appraiser cannot provide a reliable and accurate estimate of value (an Appraisal) that would meet traditional mortgage lending or secondary market (Fannie Mae, Freddie Mac, FHA, VA, USDA and SONYMA) requirements.
- To accurately determine if some of those “fee simple” rights were transferred or encumbered, would require a legal title search, which is costly and outside the responsibility and skills of a NYS licensed Appraiser.
- Without an acceptable Appraisal, the property is not eligible for traditional secondary market mortgage financing.

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2) Compulsory Integration:

- HVHF allows horizontal drill bores to radiate out from the vertical bore up to one mile in each direction which could potentially impact other owners “fee simple” real estate ownership.
- In effect, Compulsory Integration binds a home owner to participate in lease or drilling activity even if they did not willingly execute a gas lease.
- Compulsory Integration may impact “fee simple” ownership.
- It may render property unable to secure traditional residential mortgage financing if sub-surface rights are compromised as is a potential with HVHF.

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3) Secondary market standards:

- Fannie Mae and Freddie Mac (as well as SONYMA which adopted these standards) have long standing requirements regarding both surface and sub-surface set back distances.
- For example, the Freddie Mac requirements in section 39.4 (i) states “...and there is no surface or sub-surface entry within 200 feet of the residential structure...”.
- The recent DEC revised regulations provide for a setback of 500 feet from an occupied dwelling, but with horizontal drilling proposed by HVHF the sub-surface activity is not addressed.
- Any DEC regulation regarding setback must also protect “fee simple” ownership of sub-surface rights.

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4) FHA and VA financing:

- FHA/VA also have specific restrictions regarding gas leases and wells.
- Section 4150.2d of the HUD Minimum Property Standards states:
“Operating and abandoned oil and gas wells pose potential hazards to housing, including potential fire, explosion, spray and other pollution.
 1. Existing Construction: No existing dwelling may be located closer than 300 feet from an active or planned drilling site. Note that this applies to the site boundary, not to the actual well site.”
- Any DEC regulation regarding setback must also protect “fee simple” ownership for an adequate distance surrounding any well site.

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5) NYS standard mortgage document:

- The standard NYS mortgage document (Fannie Mae/Freddie Mac form 3033) has been in use since the last revision in 2001.
- It has been adopted by virtually all lenders in NYS.
- Section #18 of that document states:
 - “Lender may require Immediate Payment in Full of all Sums Secured by this Security Instrument if all or any part of the Property, or if any right in the Property, is sold or transferred without Lender’s prior written permission.”
- Most gas leases executed have been done by home owners without prior written consent of the lender and are now in technical default under the terms of their mortgage loan.

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NEW YORK--Single Family--Fannie Mae/Freddie Mac UNIFORM INSTRUMENT

Form 3033

1/01

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18. Agreements about Lender's Rights If the Property Is Sold or Transferred.

Lender may require Immediate Payment in Full of all Sums Secured by this Security Instrument if all or any part of the Property, or if any right in the Property, is sold or transferred without Lender's prior written permission. If Borrower is not a natural Person and a beneficial interest in Borrower is sold or transferred without Lender's prior written permission, Lender also may require Immediate Payment in Full. However, this option shall not be exercised by Lender if such exercise is prohibited by Applicable Law.

If Lender requires Immediate Payment in Full under this Section 18, Lender will give me a notice which states this requirement. The notice will give me at least 30 days to make the required payment. The 30-day period will begin on the date the notice is given to me in the manner required by Section 15 of this Security Instrument. If I do not make the required payment during that period, Lender may act to enforce its rights under this Security Instrument without giving me any further notice or demand for payment.

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6) NYS standard mortgage document:

- Section #21 of the standard NYS mortgage document states:
 - “...There are other substances that are considered hazardous for purposes of this Section 21.” It continues: “...These substances are gasoline, kerosene, other flammable or toxic petroleum products, toxic pesticides and herbicides, volatile solvents, materials containing asbestos or formaldehyde, and radioactive materials.”
- It further states:
 - “I will not cause or permit Hazardous Substances to be present on the Property. I will not use or store Hazardous Substances on the Property. I also will not dispose of Hazardous Substances on the Property, or release any Hazardous Substance on the Property, and I will not allow anyone else to do so.”
- A gas lease grants all these and many other rights that are specifically not authorized or allowed under the terms of a standard residential mortgage. Again, most leases that have been executed are in technical default under the terms of their mortgage.

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NEW YORK--Single Family--Fannie Mae/Freddie Mac UNIFORM INSTRUMENT

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21. Continuation of Borrower's Obligations to Maintain and Protect the Property. The federal laws and the laws of New York State that relate to health, safety or environmental protection are called "Environmental Law." Environmental Law classifies certain substances as toxic or hazardous. There are other substances that are considered hazardous for purposes of this Section 21. These substances are gasoline, kerosene, other flammable or toxic petroleum products, toxic pesticides and herbicides, volatile solvents, materials containing asbestos or formaldehyde, and radioactive materials. The substances defined as toxic or hazardous by Environmental Law and the substances considered hazardous for purposes of this Section 21 are called "Hazardous Substances." "Environmental Cleanup" includes any response action, remedial action, or removal action, as defined in Environmental Law. An "Environmental Condition" means a condition that can cause, contribute to, or otherwise trigger an Environmental Cleanup.

I will not do anything affecting the Property that violates Environmental Law, and I will not allow anyone else to do so. I will not cause or permit Hazardous Substances to be present on the Property. I will not use or store Hazardous Substances on the Property. I also will not dispose of Hazardous Substances on the Property, or release any Hazardous Substance on the Property, and I will not allow anyone else to do so. I also will not do, nor allow anyone else to do, anything affecting the Property that: (a) is in violation of any Environmental Law; (b) creates an Environmental Condition; or (c) which, due to the presence, use, or release of a Hazardous Substance, creates a condition that adversely affects the value of the Property. The promises in this paragraph do not apply to the presence, use, or storage on the Property of small quantities of Hazardous Substances that are generally recognized as appropriate for normal residential use and maintenance of the Property (including, but not limited to, Hazardous Substances in consumer products). I may use or store these small quantities on the Property. In addition, unless Environmental Law requires removal or other action, the buildings, the improvements and the fixtures on the Property are permitted to contain asbestos and asbestos-containing materials if the asbestos and asbestos-containing materials are undisturbed and "non-friable" (that is, not easily crumbled by hand pressure). (section continues)

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7) Hazard - Homeowners insurance:

- Hazard Insurance for residential homes (commonly referred to as homeowners insurance) has specific prohibitions for activities granted and undertaken by a gas lease.
- In a July 2012 press release from Nationwide Insurance, (considered a top 3 in policies written in the US) the company clearly stated that they do not provide coverage for any losses associated with gas leases or drilling.
- In dialog with many other Insurance companies, they are unanimous in the response that they will not insure losses as a result of gas leases or drilling and most stated that if they became aware that a lease or drilling was in effect, they would not renew insurance coverage.
- This leaves the home owner and the lender without adequate protection and would result in a default under the terms of a standard mortgage.

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US insurer won't cover gas drill fracking exposure

Written by MARY ESCH, Associated Press

Friday, 13 July 2012 08:33 (parts of news article)

ALBANY, N.Y. (AP) — Nationwide Mutual Insurance Co. has become the first major insurance company to say it won't cover damage related to a gas drilling process that blasts chemical-laden water deep into the ground.

The Columbus, Ohio-based company's personal and commercial policies "were not designed to cover" risk from the drilling process, called hydraulic fracturing, or fracking, Nationwide spokeswoman Nancy Smeltzer said Thursday.

The memo reads: "After months of research and discussion, we have determined that the exposures presented by hydraulic fracturing are too great to ignore.

Risks involved with hydraulic fracturing are now prohibited for General Liability, Commercial Auto, Motor Truck Cargo, Auto Physical Damage and Public Auto (insurance) coverage."

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Insurers: Fracking-related damages not covered by standard policies

By Patti Conley pconley@timesonline.com | Posted: Wednesday, February 27, 2013 12:00 am

Homeowners, be aware! That fine print in your homeowner's insurance policy could really matter if hydraulic fracturing damages your home sweet home.

Fracking-related damage, insurance industry insiders say, is not covered under a standard homeowner's insurance policy. Neither is damage caused by floods, earthquakes or earth movement, which insurers call exclusions.

“(Fracking is) deemed an exclusion in the same way earthquake or earth movement is,” said Mike Barry, vice president of media relations at the Insurance Information Institute, a nonprofit institute funded by the insurance industry.

So how do homeowners try to make sure that cracks won't be discovered in their homeowner's policy if fracking-related incidents should occur? Some homeowners may be considering leasing land to an energy company. Others aren't leasing land but live near property where fracking is taking place. Both should begin by asking their insurance agent to review what's covered in their homeowner's policy before fracking operations begin.

“We would recommend that the homeowners check their homeowner's or farm insurance before signing any leases,” said Roseanne Placey, spokeswoman for the Pennsylvania Insurance Department. “Check to see if they (the homeowners or farmers) would be at risk. These are commercial wells. You may need a commercial liability policy.

“As a landowner, do you want to bear the liability risk? And if you do, do you have the proper coverage?”

Homeowners who are leasing land to an energy company should work out with the company who would be liable if there is fracking-related damage, Barry said. The homeowner also may want to involve an attorney in such discussions.

Once the policy's inclusions and exclusions are determined, insurance agents may advise homeowners living in fracking areas to buy earthquake or earth-movement insurance by adding a rider to their existing standard policy or buying a freestanding earthquake policy, Barry said.

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“Unless you have either earthquake insurance coverage or a rider to your standard homeowner’s policy, you are not going to be covered,” Barry said.

The earthquake or earth-movement rider, also called an endorsement, could add a few hundred dollars to the policy’s annual premium, but the actual cost depends on the home’s value, said Dave Phillips, a spokesman for State Farm Insurance Co.

State Farm has set specific guidelines regarding hydro-fracking operations. The company does not write commercial insurance for businesses conducting hydro-fracking operations or for commercial properties where fracking is taking place.

State Farm does not have a fracking endorsement for private residences, but does have earthquake, earth-movement and sinkhole endorsements available in most areas, Phillips said.

“But there needs to be a conversation as to whether fracking would be covered under that, if at all,” Phillips said.

The endorsements don’t guarantee that fracking-related damage will always be covered.

So it’s important, Phillips said, that homeowners living near property where fracking operations are under consideration talk to their insurance agents before the operations begin on nearby property. There could be a waiting period before the endorsement coverage goes into effect, he said.

“Do it before fracking begins, not when (the contractor is) actually operating,” he said.

“When it comes to hydro-fracking there needs to be a dialogue, because there’s a third party involved, which is the hydro-fracking contractor,” Phillips said. The coverage depends on what the contractor is liable for, he said.

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In a statement released in July, Nationwide Insurance said fracking-related losses have never been a covered loss under personal or commercial line policies, which were not designed to provide for any fracking-related risks.

“Our longstanding underwriting guideline is that we do not insure the oil and gas business,” Nancy Smeltzer, a Nationwide spokeswoman, said.

Nationwide’s statement was prompted after a leaked memorandum that appeared on several anti-fracking groups’ websites indicated that the company will not underwrite fracturing exposures.

“From an underwriting standpoint, we do not have a comfort level with the unique risks associated with the fracking process to provide coverage at a reasonable price,” the statement read.

However, Smeltzer said Nationwide will investigate all claims submitted by customers who believe they are a result of damage from fracking.

“Every Nationwide claim is reviewed on a case-by-case basis,” she said.

Insurers and customers will continue to seek answers.

“(Fracking) is a new risk, and all insurers are taking a look at it. It is an issue in evolution,” Phillips said.

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- In dialog with the Federal Housing Finance Agency (FHFA) during December 2012, the FHFA confirmed that the secondary market agencies they oversee (Fannie Mae and Freddie Mac) will enforce long standing published regulations and hold lenders responsible to meet the published regulations.
- As noted in the prior summaries, secondary market regulations state they prohibit activities that are commonly granted in gas leases and drilling.
- Based on these conflicts, residential mortgages with gas leases or drilling activity or invasion of the “fee simple” ownership via Compulsory Integration, would be ineligible for sale to these agencies.
- Based on recent reports, as much as 90% of the nation’s loans are sold in the secondary market to agencies that have adopted the regulations of Fannie Mae, Freddie Mac, FHA or VA.
- QUESTIONS?