

Compulsory Pooling & Mortgage and Insurance Issues

Presentation to Compulsory Pooling Study Group
of the North Caroling Mining & Energy Commission

Central Carolina Community College
Pittsboro, NC
February 8, 2013

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Mortgage Loans & Insurance

- At the January 11, 2013, Meeting of the Compulsory Pooling Study Group, members of the public raised questions about the potential impact of compulsory pooling laws on existing mortgages, new mortgages, and property insurance.
- This presentation was prepared in response to those questions to provide the Study Group and public with additional information on these issues and lay the groundwork for further research.

Mortgage Risks

- NC DOJ Consumer Protection Report to the General Assembly of May 1, 2012, on Impacts on Landowners and Consumer Protection Issues discusses several potential impacts of natural gas leasing on home mortgages:
 - Existing mortgages
 - Ability to refinance
 - Ability to obtain new credit
- http://portal.ncdenr.org/c/document_library/get_file?uuid=bdd3a76c-a23c-4930-9b82-66d673a6d116&groupId=8198095

Mandated Warning to Surface Owners

“Surface owners are advised to secure written approval from any lender who holds a mortgage or deed of trust on any portion of the surface property involved in the lease prior to execution of the lease and obtain written confirmation that execution of the lease will not violate any provision associated with any applicable mortgage or deed of trust, which could potentially result in foreclosure.”

- *N.C.G.S. § 113-423(i)*

Standard NC Deed of Trust

Fannie Mae/Freddie Mac Uniform Deed of Trust Instrument Form 3034 is standard deed of trust in NC

- (<http://www.freddiemac.com/uniform/unifsecurity.html>)

Due-on-Sale Clause

“Residential mortgages are secured by surface and subsurface features of land and any buildings and fixtures on the land.”

- Letter from David Carpenter, Congressional Research Service Legislative Attorney to Rep. Carolyn Maloney, dated Sept. 15, 2011 (<http://maloney.house.gov/issue/hydraulic-fracturing-fracking>) (cited in NC DOJ 5/1/12)

Due-on-Sale Clause

“If all or any part of the Property or any Interest in the Property is sold or transferred ... without Lender’s prior written consent, Lender may require immediate payment in full of all sums secured by this Security Instrument.”

- *Fannie Mae/Freddie Mac Uniform Deed of Trust Form 3034*,
¶ 18 (<http://www.freddiemac.com/uniform/unifsecurity.html>)

Due-on-Sale Clause

- Fannie Mae advises loan servicers to approve requests to release security interest in mineral rights on behalf of Fannie Mae if the lease “is customary in the area and the 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.”

- *Fannie Mae Single Family 2011 Servicing Guide, p. 307-6*
(<https://www.fanniemae.com/content/guide/svc061011.pdf>)

Due-on-Sale Clause

- In considering approving an release of mineral rights, a Fannie Mae servicer should take into consideration:

“The extent to which the rights granted by the lease infringe on the property owner’s rights. For example, if the lease permits removal of deposits by directional exploration from an area outside of the property, there may be little or no adverse effect, depending on the location of the exploration area and the attitude of the community. On the other hand, if the lease allows for complete ingress and egress to explore any part of the property or to store or install equipment on it, the property may no longer have any real value as a residential property.”

- *Fannie Mae Single Family 2011 Servicing Guide, p. 307-5*
(<https://www.fanniemae.com/content/guide/svc061011.pdf>)

Form 3034 Hazardous Materials Clause

“Borrower shall not cause or permit the presence, use, disposal, storage, or release of any Hazardous Substances ... on or in the Property.”

- *Fannie Mae/Freddie Mac Uniform Deed of Trust Form 3034,*
¶ 21 (<http://www.freddiemac.com/uniform/unifsecurity.html>)

Form 3034 Hazardous Materials Clause

“Borrower shall not do, nor allow anyone else to do, anything affecting the Property ... (c) which, due to the presence, use, or release of a Hazardous Substance, creates a condition that adversely affects the value of the Property.”

- *Fannie Mae/Freddie Mac Uniform Deed of Trust Form 3034*,
¶ 21 (<http://www.freddiemac.com/uniform/unifsecurity.html>)

Form 3034 Hazardous Materials Clause

- *Hazardous Substances* – substances defined as toxic or hazardous substances, pollutants, or wastes by state or federal law and gasoline, kerosene, other flammable or toxic petroleum products, toxic pesticides and herbicides, volatile solvents, materials containing asbestos or formaldehyde, and radioactive materials

- *Fannie Mae/Freddie Mac Uniform Deed of Trust Form 3034*,
¶ 21 (<http://www.freddiemac.com/uniform/unifsecurity.html>)

Form 3034 Hazardous Materials Clause

- “Borrower shall not do, nor allow anyone else to do, anything affecting the Property ... (b) which creates an Environmental Condition.”
- *Environmental Condition* – a condition that triggers an environmental cleanup action under federal or state law.

- *Fannie Mae/Freddie Mac Uniform Deed of Trust Form 3034*,
¶ 21 (<http://www.freddiemac.com/uniform/unifsecurity.html>)

Waste Clause

“Borrower shall not destroy, damage or impair the Property, allow the Property to deteriorate or commit waste on the Property. Whether or not Borrower is residing in the Property, Borrower shall maintain the Property in order to prevent the Property from deteriorating or decreasing in value due to its condition.”

- *Fannie Mae/Freddie Mac Uniform Deed of Trust Form 3034*,
¶ 7 (<http://www.freddiemac.com/uniform/unifsecurity.html>)

Waste Clause

- “Do not commit waste” clause provides that if landowner does something to the detriment of the property, such as dispose of hazardous waste on it, the lender could declare the loan in default and foreclose.
- Whether this would occur would depend on reassessment of loan balance, remaining property value, and changes to income from activity.

USDA-Backed Mortgages

- The National Environmental Policy Act (NEPA) requires federal agencies to identify federally funded programs with a significant impact on the environment and review that impact.
- In March 2012, a staff person in the USDA Congressional Relations Office raised a question about whether NEPA required USDA to conduct an environmental review of its programs backing home mortgages or individual mortgages.

USDA-Backed Mortgages

- After outcry from members of Congress, Secretary Vilsack issued a policy directive that USDA would continue to apply the long-standing categorical exclusion from NEPA to all USDA-backed mortgages – which pre-dated concerns regarding shale gas – so that no environmental review of individual mortgages or of the program as a whole would be required.

- *USDA Administrative Notice 4632, March 21, 2012.*

- *Bleiweiss & Davidson, Fracking and NEPA's Categorical Exclusions, ABA Section on Environmental Litigation*

<http://apps.americanbar.org/litigation/committees/environmental/email/fall2012/fall2012-1212-fracking-nepas-categorical-exclusions.html>

USDA-Backed Mortgages

RD AN No. 4632 (1940-G)
March 21, 2012

TO: State Directors
Rural Development

ATTN: Program Directors, Area Directors, and State Environmental Coordinators

FROM: Tammye Treviño *(Signed by Tammye Treviño)*
Administrator
Housing and Community Facilities Programs

SUBJECT: NEPA Compliance for Rural Development Single Family Housing Loan
Programs

PURPOSE/INTENDED OUTCOME:

The purpose of this Administrative Notice (AN) is to provide clarification and guidance on the application of the National Environmental Policy Act of 1969 (NEPA) process under Rural Development (RD) Instruction 1940-G to the Rural Development Single Family Housing Loan Programs.

BACKGROUND:

The nature of existing leases for gas and oil exploration varies but most allow development activities on a landowner's property. Such development activities determined by the producer to be necessary to oil and/or gas well exploration and production could include site preparation and site access work.

IMPLEMENTATION RESPONSIBILITIES

This Administrative Notice reaffirms the use of a Categorical Exclusion (CE) under RD Instruction 1940.310(b) to provide financial assistance for the purchase of a single family dwelling on these properties. The presence of gas leases on a property alone does not constitute any of the special circumstances listed in that instruction or the policy considerations contained in RD Instruction 1940.303 through 1940.305. Normal security and appraisal requirements under RD Instruction 1980-D and RD Handbook 3550 continue to apply for these properties.

EXPIRATION DATE:
April 30, 2013

FILING INSTRUCTIONS:
RD Instruction 1940-G

USDA-Backed Mortgages

- The Housing and Community Facilities Program has stated in a telephone interview on January 25, 2013, that USDA intends to continue the policy of exempting mortgages from NEPA and renew the Secretary's directive when it expires in April 2013.

Lender Mortgage Issues

Portfolio Protection

- In a market without experience with natural gas development, lenders lack information to be confident gas production would not drive down property values and cause loan balances to exceed collateral values. *(NC DOJ 5/1/12, at 7.)*
- Basis of current State Employees Credit Union and NC Housing Finance Agency policy to refuse mortgages on severed estates and properties with gas leases. Concern for other lenders also.

Lender Mortgage Issues

- Lenders are also wary of mortgage defaults that would leave lenders with properties having significant environmental liabilities, especially after bad experiences with foreclosing on significant numbers of properties with environmental liabilities during housing crisis.
- Even if no actual environmental hazard, the possibility of potential environmental problems creates risk of significant litigation costs.

Lender Mortgage Issues

- Many lenders need more experience in a NC real estate market during period of natural gas development and want more regulatory certainty about how issues of liability and risk will be addressed before they will be prepared to write mortgages in areas where natural gas development is occurring.
- State Employees Credit Union specifically has stated that it will continue to review its policy as it gains more experience in the market.

Lender Mortgage Issues

- In some instances lenders have negotiated with gas companies to maintain lenders' priority of lease, obtain title insurance, and be indemnified by gas companies in the event of environmental damages. Such negotiations have extended mortgage process for several months and have not always resulted in agreements. *(NC DOJ 5/1/12, at 8.)*

Lender Mortgage Issues

Secondary Market

- To sell mortgages on secondary market, lenders must make warranties and representations to purchaser about the condition of the mortgages sold along lines of Form 3034.
- If property later must be foreclosed on, originating banks are concerned that they could be held liable for corresponding damages if property undervalued or damaged by hazardous waste.

Lender Mortgage Issues

Compulsory Pooling Process

- Mortgage lenders would be necessary parties in any process pooling mortgaged properties.
- Under terms of standard mortgages, lenders as lienholders have right to determine how much of proceeds from sale of a property interest go to lender to pay down loan balance and ensure it does not exceed value of property securing loan and how much go to mortgagee/landowner.

Landowner Mortgage Issues

Mortgage Defaults

- Compelling landowners with mortgages into pools may cause them to default on mortgages.
- However, NC DOJ Consumer Protection Division is unaware of any instance in NC or elsewhere where signing of a gas lease has caused a lender to declare the loan in default and request immediate repayment.
- Nonetheless, such defaults do pose real financial risks to landowners.

Landowner Mortgage Issues

Asset Value and Liquidity

- Removal of mineral assets or construction of wells on the surface can cause value of property acting as collateral to decline below loan amount, which creates foreclosure risk, reduces chances for refinancing, and complicates sale of land. If these results occur, landowner assets will become less liquid and available for other purposes.
- Buyers may have fewer mortgage options, which decreases demand and resale value.

Landowner Mortgage Issues

Restrictions on Mineral Leasing

- Since granting of mineral leases is not customary in North Carolina, and effects of lease and mineral extraction on property prices is uncertain, Fannie Mae servicing guidelines may not allow servicer to act on Fannie Mae's behalf to release Fannie Mae's security interest in the property to enable leases to be signed.

Landowner Mortgage Issues

Severed Estates

- Surface owners of severed estates will be in worse position because they will suffer financial constraints without benefit of compensation from leasing or developing mineral rights.

Landowner Liability

- Hazardous Waste term can be used by lenders to hold landowners liable for environmental damages by operators in case of loan default.

Insurance

- In July 2012, Nationwide Insurance announced that its personal and commercial insurance lines would not cover damages caused by hydraulic fracturing and other aspects of natural gas development.

- <http://www.nationwide.com/newsroom/071312-FrackingStatement.jsp>

Insurance

“Nationwide has not changed our policies or guidelines, nor are we cancelling policies. Fracking-related losses have never been a covered loss under personal or commercial lines policies.”

- <http://www.nationwide.com/newsroom/071312-FrackingStatement.jsp>

Insurance

- Nationwide's coverage position is public, but its coverage is likely not different from the position of most homeowner and commercial carriers.
- Landowners will need to look to other strategies, such as indemnification from gas operators, if they enter into gas leases or are near gas development activity that may affect their property.

Landowner Insurance Issues

- Landowners who are compelled to join a pool will not be covered by their homeowners or commercial insurance and will not have access to another party to which they can shift risks.
- If landowners are compelled to join a pool, State action will be required to protect landowners by shifting the uninvited risk away to the State, gas operators, or other parties.

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