Phillips Lytle LLP

The Commercial Paper

JUNE 2013

A BANKING & FINANCIAL SERVICES REPORT FROM PHILLIPS LYTLE

Hydraulic Fracturing Leases and the Mortgage Loan Market

Hydraulic fracturing or "fracking," which was first implemented in 1949, is the process of fracturing layers of rock beneath the earth's surface with highly pressurized liquid resulting in the release of fossil fuels such as petroleum and natural gas. The process involves the mixing of millions of gallons of water with sand and chemicals and injecting it into horizontal wellbores under pressure in order to fracture the surrounding shale formation, thus releasing the trapped oil and gas.

Proponents believe that the process is safe and is an efficient method of accessing valuable oil and gas, which carries the benefit of generating significant revenues and otherwise supports the economy through job creation. Some opponents, however, believe the fracking process may have negative environmental consequences.

Irrespective of where one may stand on this issue, for mortgagees, hydraulic fracturing presents a number of challenges. Also, the oil and gas leases which allow the energy companies on a lessor's property that is, or may become, encumbered by a mortgage loan, may create issues for mortgagees.

This article will discuss some of the salient issues that mortgagees face and how, together with counsel, careful diligence and documentation, and title company negotiation, such challenges can be hurdled.

MORTGAGEE'S DUE DILIGENCE

In conducting due diligence, typically mortgagees, among other things, ascertain the owner of the real property, assess the value of the property, determine whether there are any encumbrances or other third party rights that may affect the property, examine environmental risk and, of course, review the financial wherewithal of the mortgagor.

Recently, mortgagees have started examining whether oil and gas leases might affect their collateral and whether such leases contravene secondary mortgage market requirements. For instance, the act of leasing mineral rights to a third party encumbers real property and, under some circumstances, may devalue the real property. Alternatively, oil and gas leases may allow for certain onsite activities associated with hydraulic fracturing, such as storing waste water recovered after a well bore is fracked on the mortgaged property. This could trigger a breach

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of the terms and conditions of the mortgage, and violate rules set by the secondary mortgage market. To address this problem, mortgagees and institutions, like Fannie Mae and Freddie Mac, are reviewing how they might implement more flexible mortgage provisions and/or regulations that standardize the bank's and secondary market's policies and balance the interests of the mortgagee, mortgagor/lessor and lessee.

Standardized rules and mortgage terms, which clarify under what circumstances such a lease is permitted and what procedures and/or consents are required prior to entering into such a lease, can offer a solution to these problems. For instance, mortgage provisions that require all, or a portion of, signing bonuses, royalties and/or lease payments given to the lessor to be paid directly to the mortgagee as a principal reduction payment, will not only help protect the mortgagee's interest by limiting its exposure, but will also continue to benefit the mortgagor/lessor by paying down its debt. Mortgagees and the secondary market are also developing and implementing other solutions such as requiring more advanced appraisals, seeking indemnifications from property owners and/or lessees, negotiating subordination, non-disturbance and attornment agreements ('SNDA") with the lessees, mandating more advanced environmental reviews, and/or seeking affirmative coverage from title insurance companies with respect to the associated risks.

PROPERTY VALUES

Real estate professionals, landowners, potential buyers and mortgagees know that mortgaging encumbered property is an uphill battle. Oil and gas leases create an encumbrance on real property. Some mortgagees may be concerned that oil and gas activities, particularly those onsite activities associated with well development, including access roads and well pads, could negatively impact property values. For mortgagees, such decreases in real property value would have a negative impact on the loan to value ratio, thereby increasing risk and ultimately making it more difficult for landowners or prospective buyers to finance a purchase of real property or to refinance an existing loan.

To address these potential risks, some mortgagees are requiring indemnification agreements in which the lessee and/or landowner will reimburse the bank for any losses attributable to the lease. Mortgagees are also implementing more stringent appraisal requirements and thorough environmental reviews that take into account any impact a lease may have on the subject real property.

On the other hand, oil and gas leases can, and often do, increase the value of the mortgaged property, as well as the surrounding areas. For instance, in addition to initial signing bonuses, landowners typically receive royalties from the oil and gas that is extracted from the land. These leases also have the ability to (i) generate significant fee and tax revenues for the State and local economy and (ii) create significant job opportunities in areas in need of an economic boost. As an example, with respect to tax revenues, an ad valorem tax, or a tax based on the assessment of the real property, can be collected from landowners with productive wells on their property. Recently, it has become more common for such taxes to be paid by the oil and gas companies. This results in higher tax revenues for the local economy at no additional expense to homeowners. Further, it has been estimated that one well has the capability, over a thirty-year period, of generating $1.2 million in tax revenue for its local economy.

OIL AND GAS LEASES MAY TRIGGER DEFAULT UNDER A MORTGAGE

While there can be significant economic benefits for a mortgagor entering into an oil and gas lease, a little caution is warranted. The execution of an oil and gas lease, without the consent of the mortgagee, may trigger a mortgage default if the mortgage, as most do, contains restrictions on encumbering the real property. Additionally, these leases often allow for oil and gas companies to conduct certain activities, like storing waste water on the property, that are strictly prohibited by the covenants in the mortgage and are non-compliant with secondary mortgage market regulations. If secondary mortgage market requirements are not met, government sponsored entities, like Freddie Mac and Fannie Mae, will not purchase such mortgages from the mortgagees and may default mortgages they currently hold.

Again, the standardization of mortgage terms and conditions that accommodate all parties and the pursuit toward uniformity with secondary mortgage market's regulations is currently being discussed and developed. Standardized policies regarding the type of appraisals and environmental reviews, together with more practical and flexible mortgage provisions, are being stressed by the mortgage industry as solutions to the problem. It is inevitable that oil and gas leases will continue to be executed by property owners and it is becoming clear that blanket provisions prohibiting all oil and gas leases, together with the activities essential to these leases, are no longer reasonable.

PRIORITY MATTERS; ENCUMBRANCES

If an oil and gas lease is executed prior to the execution of a mortgage, the lease could have priority over any mortgage placed on the property after such lease is executed. Often times, mortgagees need and require a first lien position so that in the event of a foreclosure, they have the option of selling the property free and clear of third party rights. To address this issue, mortgagees have implemented the SNDA, which provide that the lessee subordinates the lease to the mortgage, thereby allowing the mortgagee to obtain a first lien position. Further, the non-disturbance component provides that in the event of a foreclosure, the mortgagee will not disturb the lessee's rights so long as the lessee is not violating the terms of its lease, thus restoring the lessee, for practical purposes, to the same position it would have enjoyed had the lease continued to have priority. The attornment component operates as a promise by the lessee to recognize the bank as its lessor in the event of a foreclosure.

TITLE INSURANCE REQUIREMENTS

Mortgagees require title insurance when entering into a mortgage loan to guard against losses that may arise from title defects. Further, as a condition to selling mortgage loans on the secondary markets to Fannie Mae and Freddie Mac, who bundle these mortgages and sell them to investors as mortgage-backed securities, mortgagees are required to obtain a title insurance policy covering the loan. These policies insure the mortgage lien against loss or damage if any interests exist in the land other than that of the landowner. Due to the rights granted to lessees under an oil and gas lease to use the property, their potential long-term nature and the inability to terminate such leases, they are likely to be shown as an exception on the title insurance policy.

Since oil and gas leases are often listed as an exception, mortgagees will, at a minimum, require some form of affirmative coverage from the title company. For instance, Freddie Mac requires affirmative coverage stating "the exercise of such rights will not result in damage to the mortgaged premises or impairment of the use or marketability of the mortgaged premises for residential purposes and there is no right of surface or subsurface entry within 200 feet of the residential structure." The good news for mortgagees is that most title insurance companies are willing to provide such affirmative coverage at no additional expense, but several agents have suggested that they may hesitate to provide such coverage with regard to oil and gas leases until regulations for hydraulic fracturing are implemented. Having knowledgeable legal representation that can properly negotiate and obtain this affirmative coverage is

becoming increasingly important to mortgagees in regions that have a significant amount of oil and gas leases.

CONCLUSION

Fracking has shown great promise in connection with satisfying the demand for oil and gas, and there has been a substantial uptick in the number of oil and gas leases nationwide. Right now, New York State has placed a moratorium on high-volume hydraulic fracturing ("HVHF") (using 300,000 gallons of water or more) in order to study the process and how to effectively regulate it. Nonetheless, it is anticipated that HVHF will eventually occur in New York and that the process will predominantly take place in the Marcellus Shale region located across New York's Southern Tier and, to a lesser extent, the Utica Shale region located across Central New York. Although no permits have been issued in New York, oil and gas companies have leases in place with landowners while they patiently await the end of the moratorium and final regulations.

In the meantime, mortgagees can learn how fracking and the associated oil and gas leases pose new challenges, which can be effectively addressed by conducting careful due diligence, negotiating an SNDA with the lessee and obtaining affirmative coverage in the title insurance policy. Banks should be cognizant that leases might raise concerns with respect to lien priority, title insurance requirements and due diligence, all of which can be addressed with the assistance of knowledgeable and experienced legal representation.

Phillips Lytle Banking & Financial Services attorneys are available to answer questions pertaining to mortgage loans in relation to hydraulic fracturing, or any other banking or financial matter. ■

Lender Concerns When Combining Low-Income Housing Tax Credits and New Markets Tax Credits

The respective purposes of the New Markets Tax Credit Program (NMTC) and the Low-Income Housing Tax Credit Program (LIHTC) are entirely complementary. NMTCs attract private investment into low-income community businesses by providing a 39% tax credit based on the amount of an investor's qualified equity investment (QEI) into a community development entity (CDE), which makes a qualified low-income community investment (QLICI) in or to a qualified active low-income community business (QALICB) located in a low-income community. LIHTCs encourage the construction and development of affordable rental housing. Together, they can transform a community by creating thriving businesses and safe and affordable housing. However, on a regulatory level, LIHTCs and NMTCs are virtually incompatible.

LIHTC AND NMTC INCOMPATIBILITY

LIHTC and NMTC incompatibility is the direct result of two conditions. First, the requirement that an NMTC project receive at least 20% of its income from commercial activity prevents the project from benefiting from the Internal Revenue Service's (IRS) favorable depreciation rules for residential property thereby essentially eliminating one of the most important incentives in housing development. Second, and more significantly, Treasury Regulation §1.45D-1(g)(3)(C)(ii) specifically prohibits any loan or investment from being categorized as a QLICI if a building's eligible basis for the LIHTC is financed from that loan or investment. Simply speaking, NMTCs are not made available to a project when NMTC funds are used as the basis for LIHTCs. Despite these issues, it is still possible for developers to use both tax credits to finance one project.

DUAL OWNERSHIP CONDOMINIUM STRUCTURE

The depreciation and basis limitations are considerable, but they do not completely prevent LIHTCs and NMTCs from being used to finance the development of the same project. The most common method for combining the credits is to divide the project into two condominium units whereby the QALICB owns the commercial condominium unit generating the NMTCs and a single purpose entity created specifically for the project owns the residential condominium unit generating the LIHTCs. The advantages to this structure are obvious. The developer is afforded the opportunity to maximize tax credit equity to fund construction, and city planners and prospective tenants benefit from the mixed-use amenities. From a lender perspective, however, the dual ownership condominium structure can create additional complications. Issues including Intercreditor Issues, Property Management and Condemnation & Insurance Proceeds are highlighted below.

INTERCREDITOR ISSUES

Generally, developers will use the same lender for both the commercial and residential condominium units. As such, the lender becomes familiar with both sides of the project and can develop a comfort level with the prospects of both condominium units. Yet, due to the considerable differences between the units and their respective sources of operating income, it is not unusual for different lenders to finance each unit. Naturally, this creates a host of complications.

The project will only succeed, and the lenders will only benefit, if both units are successful. Each lender must be assured that the terms provided by its counterpart are feasible and suitable for the project. If one unit is thrown into financial distress, the turmoil will undoubtedly create a drag on the other unit. This could be particularly damaging during construction. Depending on the building's layout and condominium plan, the inability to finish construction on one unit could irreparably harm the development of the other unit. The residential unit in particular needs to be constructed in accordance with a strict timeline to meet its placed-in-service deadline to qualify for the LIHTCs and to avoid certain repurchase dates imposed by the LIHTC investor. Failure to meet these deadlines could severely jeopardize the residential unit's receipt of the LIHTCs.

In a similar vein, the developer will need to decide whether each unit should have a separate construction contract or whether both unit owners should be a party to a single construction contract. If the former option is chosen, the developer must ensure that the lenders are aware of how delays or disputes under one contract will affect the other. In the case of the latter option, the single contract will need to be very specific about how costs are allocated between the two units so as not to jeopardize each unit's respective basis calculation.

The condominium plan is also of utmost importance. A lender must be comfortable that if it foreclosed on its unit, the unit could

be operated or sold as a stand-alone project. Accordingly, the lender and its advisors need to scrutinize the condominium plan to determine if the common elements are sufficient to service both units and whether the foreclosure of one unit might affect the access or services provided to the other.

PROPERTY MANAGEMENT

Most developers that attempt to combine LIHTCs and NMTCs through the dual ownership condominium structure are savvy enough to choose experienced property managers familiar with both the LIHTC and NMTC regulatory regimes. Nonetheless, lenders should still thoroughly evaluate the property manager. Property managers serve on the front line with respect to a project's tax credit compliance. For example, property managers are essential for screening and selecting tenants. Selecting the wrong tenants, such as an excluded business (e.g., massage parlors and credit unions) for the NMTC unit or non-qualifying persons for the residential LIHTC unit, could seriously jeopardize the tax credits for one or both of the units. Lenders should always reserve approval rights for the property manager in their loan documents and scrutinize the property manager's experience in managing tax credit supported projects.

CONDEMNATION & INSURANCE PROCEEDS

Lenders should be particularly aware of how condemnation and insurance proceeds might be shared among the various parties, including the unit owners and the lenders themselves. It is possible, depending on when a condemnation or casualty event occurs during the NMTC and LIHTC compliance periods, that the NMTC parties and the LIHTC parties will have competing interests with respect to how proceeds should be applied across the condominium. Moreover, the condominium plan must be precise in its demarcation of the units. The plan must be such that the parties involved can quickly determine which unit the condemnation or casualty affects. Without such clarity, the two owners, the tax credit investors and the lenders could easily get bogged down in otherwise avoidable disputes which could delay and adversely impact the viability of the entire project.

To learn more about tax credit benefits, or any other banking or financial matter, please contact any Phillips Lytle Banking & Financial Services attorney. ■

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Today, more than ever, financial institutions are the driving force of the economy. And for those institutions to lend wisely, realize on their loans, and enforce their remedies, they need the help of experienced attorneys who understand the intricacies of both law and finance.

As a premier banking and commercial law firm, Phillips Lytle's Banking & Financial Services attorneys enjoy an excellent reputation built on decades of successful representation of major commercial, savings, and foreign banks; trust companies; finance companies; credit unions; and various other types of financial institutions. Phillips Lytle has been practicing law in New York for more than 175 years. We have built a substantial practice to meet the financing needs of our FORTUNE 500, midsized and closely held business clients, and are experienced in structuring, negotiating, and closing complex transactions on behalf of borrowers and lenders.

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