Gas Leases Conflict with Mortgage Rules

NY State Bar Association Journal article examines conflicts
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The continuing rush to grab up shale gas rights has some people asking whether gas leases comply with mortgage rules. Last spring and summer attorney Elisabeth Radow studied gas leases. Now she has a long list of concerns. That's because hydraulic fracturing for shale gas carries heavy industrialized risks, she says. And those risks can spread with a ripple effect through residential communities.

Homeowners can end up with uninsurable property damage for activities they cannot control, she notes in this month's NY State Bar Association Journal magazine. Furthermore … "a growing number of banks won't give new mortgage loans on homes with gas leases because they don't meet secondary mortgage market guidelines."

In addition to the federal guidelines, mortgages themselves prohibit the storage, use, disposal or release of hazardous substances (including gas) on the mortgaged property. They also prohibit landowners from transferring an interest in the property, such as mineral or gas rights, without the written consent of the mortgage lender.

As the lenders see it, homeowners pledge their house and land as collateral for a mortgage loan. For the duration of the loan the homeowner is responsible for keeping his property safe from harm.

A standard, pre-printed gas lease potentially conflicts with that right, says Radow. "For example, the expansive, undesignated, reserved surface (and subsurface) rights given the gas company in a lease can result in acres going to support the drilling operation even after the lease term ends." With no provision for funds to continue upkeep or remediate impacts, she notes. That "potentially perpetual right", Radow says, jeopardizes the homeowner's ability to use and enjoy the property to the fullest. It also robs them of the ability to control the heavy industrial activity on their residential property.

During a recent phone conversation, Radow delved into the messy conflicts between gas leases and mortgage rules. When a person applies for a mortgage, she explained, the lender needs to understand how that property is encumbered and who controls its use. Too often they don't see the gas leases because DEC doesn't require the full lease to be recorded. Instead, gas companies can record a short document called a "memorandum of lease" which omits the key terms lenders care about. Or they record nothing at all.

The main problem that Radow sees is that gas leases redistribute traditional rights of homeownership to gas companies. "But not the responsibilities," she says.

One of the responsibilities that falls on the landowner is liability. That's because the industry has not fully insured their operations, says Radow. And it's not clear whether the companies have funds reserved to self-insure to make up for a shortfall in insurance coverage.

In disclosure statements filed with the SEC, both Chesapeake Energy and Range Resources state that drilling is inherently risky; drilling operations can result in injury, loss of life, damage or destruction to property, and environmental clean-up. But, they caution, their insurance may not cover all those risks.

In the Form 10-K included with its 2010 Annual Report, Chesapeake admits, "… our insurance may not be adequate to cover casualty losses or liabilities, and our insurance does not cover penalties or fines that may be assessed by a governmental authority. Also, in the future we may not be able to obtain insurance at premium levels that justify its purchase."

In that same 10-K, Chesapeake reported that it has $400 million in general liability insurance, Radow said. While they have interests in 45,800 productive wells, they control drilling on 25,700 of those wells – that's about $15,500 in liability coverage for each well they're drilling.

On top of that they carry $75 million for sudden risks, such as blow-outs and $130 million for pollution liability insurance, she points out. "From what appears to be the current practice, the amount of liability insurance gas companies carry may be potentially inadequate for even one catastrophic event," Radow said. "Consider the costs associated with BP and the recent upstate flooding, as examples."

What does this have to do with mortgages? We have a $6.7 trillion secondary mortgage market, Radow said. As shale gas extraction takes hold nationwide, if the gas company passes the liability from drilling accidents onto the homeowner and the homeowner defaults on his loan, and pension plans and others investment vehicles have invested in the secondary mortgage market …. "I see potential for another serious secondary mortgage market impact," Radow said.

Bubble or no, there are other potential financial problems with gas leases on residential properties. Recent data show that the value of homes and property near wells is declining. If the assessed value of a property goes down, that property's taxes could follow suit. On a municipal-wise basis, decreases in the assessed value of homes near drill sites could affect the rest of the town by increasing what they pay to make up for that loss in tax revenue. Even people who don't lease to gas companies could find their finances adversely affected by drilling on their neighbor's property, Radow said.

"We are all in this together," says Radow, noting that tens of thousands of New Yorkers have signed gas leases. "While New Yorkers hope to reap royalties from their underground shale gas, on the expense side we haven't an inkling of how it will all shake out."

For a more detailed study of this issue read Radow's article, "Homeowners and Gas Drilling Leases: Boon or Bust" in the Nov/Dec 2011 issue of NYSBA Journal.