

Gas and Oil Leases

Impact on Residential Lending

by Greg May

VP – Residential Mortgage Lending Tompkins Trust Company

NOTICE

The information in this presentation is general in nature and is to be used only for informational purposes.

Consult with a Real Estate Attorney to address specific issues as they relate to a specific property or lease.

No opinion is being expressed or implied on the practice of leasing mineral rights, environmental impact or regulations surrounding gas and oil leases.

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Past

- Property values considered a “guarantee” to hold or increase
- Out of town buyers, property flippers & speculative buying
- Pushed values up and created somewhat of a false market
- Lending became very liberal as economy was good

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Present

- Economic slow down has had an impact on local real estate markets
- Includes residential properties...especially with “excess” acreage
- Lending has become more strict by legislation and regulation – more “prudent” guidelines

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Future?

(...where did I put that crystal ball?)

- Are we in “uncharted territory”?
- What will replace manufacturing in this area?
- Will lending remain strict or become liberal again?
- Can leasing property mineral rights offer options?
- Will leasing mineral rights impact the way property is viewed/valued by a potential buyer or lender?

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Answers

(Again...where did I put that crystal ball?)

- We are likely in “uncharted territory”
- Service industry, high tech, gas or ??????
- Lending will likely not be as liberal as it was
- Leasing mineral rights may work in some cases but caution is needed
- Leasing mineral rights will very likely impact the way a potential buyer or lender views your property

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Appraised Value Determination

- Appraised value methods
 - Sales: comparable sales within reasonable time and distance
 - Income: value determined based on income produced
 - Cost: value based on cost to construct
- Residential value is typically established based on the Sales method

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Legal Issues

- Lease: a contract where owner transfers right to possess and use the real estate typically for a specific time period
- Leaseholds: a tenant's right to real estate during the lease
- Easements: right to use land of another for a specific purpose and usually passes with title when transferred

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Legal Issues

- BEFORE signing any lease or easement agreement consult legal counsel familiar with REAL ESTATE LAW
- Each lease or easement can be and often is unique
- Executing a lease or easement may have the potential to restrict the property from selling, building or gas drilling

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Legal Issues

- BEFORE signing any lease or easement agreement consult legal counsel familiar with REAL ESTATE LAW
- Each lease or easement can and often is unique
 - Terms may be negotiated
 - obligation to restore
 - surface rights
 - location of drilling or geo-physical testing
 - other restrictions
- Executing a lease or easement may have the potential to restrict the property from being sold, building or gas drilling

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Legal Issues

- Termination of lease
 - Date expiration
 - Company may file an affidavit contesting expiration
 - Company claims “force majeure”
 - Lease grants automatic renewal upon certain conditions
 - “...so long as gas/oil may be produced or operations are being conducted...”
- Breach of lease terms
 - Non-payment of royalties
 - Other breach

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Is property value impacted with a gas lease?

- Commercial
 - Commercial value may diminish, stay the same or increase depending on the nature and highest and best use of the property
 - Commercial value is frequently established based on the income approach...by the amount of income generated by the use of the property

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Is property value impacted with a gas lease?

- Residential
 - Residential property is purchased as a bundle of rights to allow the “quiet enjoyment” of the parcel
 - Value is supported based on comparable sales of similar properties within a short time and distance
 - Illustration – Pen and refill

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Gas/Oil Lease Issues

- Leases commonly give up some of the bundle of rights to quiet enjoyment
- Leases commonly place restrictions on use of the property
 - Restricts building outbuildings, sheds, pools, plantings,
- Leases commonly have automatic renewals or extensions of the lease terms even with just geophysical activity
- Leases commonly have set backs from structures for drilling but allow for pumping stations, roads, lighting, pipelines, etc. within the 200 foot setback area
- Current & proposed NYS set back is 100 - 150 foot

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Residential Lending Issues

- Secondary Market Requirements:
 - No surface or subsurface entry within 200 feet of residential structure for Freddie Mac
 - No surface or subsurface entry within 300 feet of residential structure for FHA and not within 300 feet of boundary line
 - Must not interfere with the use and enjoyment of any present or proposed improvements or the balance of the mortgaged premises
 - Must not affect property marketability
 - Must have no or very limited impact on value
 - Must be commonly acceptable to private institutional lenders (it is NOT commonly acceptable in CNY)

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Residential Lending Issues

- Secondary Market Requirement:
 - Title insurance endorsements required to affirmatively insure the lender against damage or loss due to exercise of drilling rights
 - NYS title insurance comprehensive endorsement contains the following restrictions that would likely void coverage if they exist:
 - No structures over 35 feet tall on premises
 - No storage of any material, machinery, equipment or supplies on premises
 - Premises shall not be used for any commercial purposes
 - All allowed in typical gas lease - coverage likely void

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Residential Lending Issues

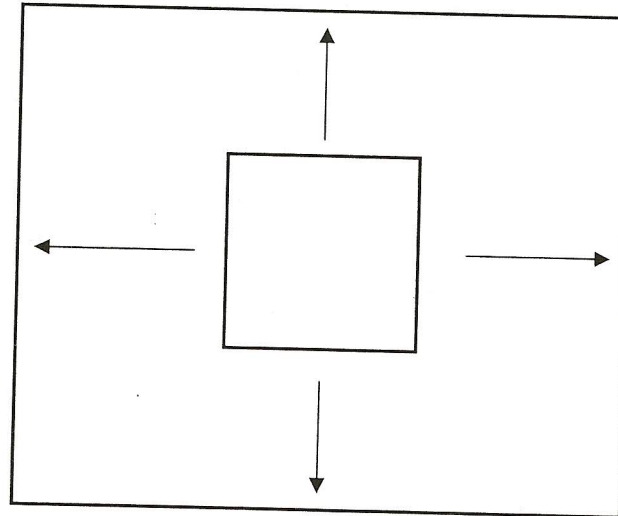
- Secondary Market Requirement:
 - If underground mines exist, the Appraiser must consider the effect on value and marketability and support that by comparable sales
 - Expensive and/or impossible to research without:
 - central data collection and report access point
 - practice of recording lease memorandums rather than lease

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- At least 200 foot setback from any improvements (FHA is 300 ft)
- At least 400 foot plus house, etc. of say 40 x 40 (FHA is 600 ft)
- An acre is approx. 43,560 sf
- So at 440' X 440' = 193,600 sf or approx 4.5 acres before well septic, outbuildings (FHA: 640' X 640' = 409,600 sf or 9.4 acres)



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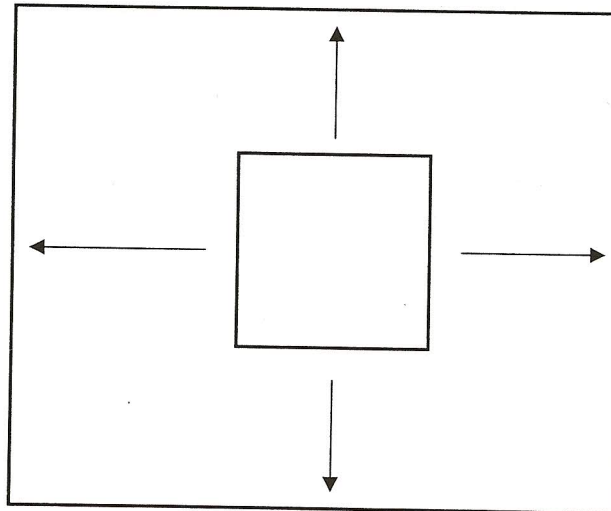
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Conclusion – Conventional Financing:

- Must have at least 5 acres surrounding the improvements released from the lease to finance as a Residential property

Approximately 5 Acres



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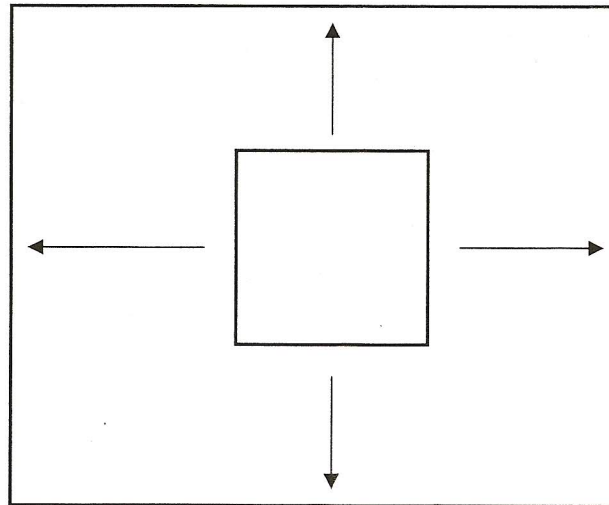
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Conclusion – FHA Financing:

- Must have at least 10 acres surrounding the improvements released from the lease to finance as a Residential property

Approximately 10 Acres



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- If property sits closer to road or property boundary and neighbor has signed a gas lease, it may create an issue in securing financing
- Many lenders are taking some calculated risk at this time that neighboring properties do NOT have leases that would restrict financing – that may not last into the future
- Expect that most if not all lenders will need you to get a release of the lease on at least a 5 acre area surrounding the improvements or at least 10 acres for FHA loans
- Always discuss a lease with a Real Estate Attorney before execution
- Talk to your lender and attorney early about leases - it takes weeks and sometimes longer to secure releases
- Thank you. Questions?