Banking & Finance Law Report

Blog series:
Energy Financing

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Porter Wright Resources

Porter Wright's Banking & Finance and Bankruptcy, Workout & Creditors' Rights practice groups include more than 30 attorneys with extensive experience in energy sector financing. These attorneys include:

Tim Grady chairs Porter Wright's Banking & Finance practice group. His puts his depth of financing experience to work for a diverse group of industries and owners. He also advises clients on letters of credit and swap transactions, and conducts seminars on secured transactions under Article 9 of the UCC. (Columbus, OH)

Jim Botti, who chairs the firm's Bankruptcy & Reorganization practice group, has spent his 30-year career representing banks and other financial institutions in negotiating and documenting complex commercial loan transactions, and in handling troubled "workout" situations both inside and outside of bankruptcy. (Columbus, OH)

Andy Bojko advises lenders and borrowers in commercial lending, asset-based financing, mezzanine debt and leveraged buyouts. He also handles a variety of real estate matters, with an emphasis on construction and permanent loans, leasing and acquisitions/divestitures. (Columbus, OH)

Don Fisher has substantial experience in the areas of secured transactions, particularly in connection with documentation of loans and workouts, and representing financial institutions in matters involving lender liability claims, letters of credit, bankruptcy, creditor rights and foreclosure and collection litigation. (Cleveland, OH)

Polly Harris counsels financial institutions in commercial transactions and litigation. She represents lenders in commercial loan documentation, workouts, collections, foreclosures and bankruptcies as well as in lender liability, lending discrimination, contract and commercial paper actions. (Columbus, OH)

Tami Hart Kirby practices in the areas of creditor's rights, real estate, and commercial and business transactions. She represents financial institutions and businesses in all aspects of creditor's rights, including the rights and remedies available under UCC, the Bankruptcy Code and applicable state law. (Dayton and Cincinnati, OH)

Phil Langer represents banks and financial institutions on lender liability issues, loan work out, commercial litigation, loan restructuring and documentation. He has also been involved in more than 200 acquisitions of bankrupt companies or their assets, and was lead counsel in several debtor cases. (Cleveland, OH)

Walter Reynolds has developed an excellent reputation representing brokerage firms, banks, insurance companies, savings and loan associations and other financial institutions. He has handled many construction disputes representing owners, contractors, subcontractors, and material suppliers. (Dayton, OH)

Grant Stephenson has vast experience in the law and regulation of financial institutions. He represents clients regarding business acquisitions, financial institution mergers and acquisitions, issuing public and private securities, corporate reorganization and bankruptcy, and technology matters. (Columbus, OH)

Bill Weir represents a variety of financial institutions in the areas of real estate lending. He regularly represents lending institutions as lead counsel in multi-million dollar construction loans on projects located throughout the United States. He also represents financial institutions in real estate loan workouts and restructurings. (Cleveland, OH)

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Due Diligence in Lending to the Oil and Gas Industry

March 29, 2013 | Christopher Baronzzi

Although Ohio lenders that finance companies in the oil and gas industry will encounter some of the same due diligence issues found in other industries, the oil and gas business is a world of its own. We advise our lending clients to conduct diligence in the oil and gas industry in the same manner as if they were buying the company, perhaps just not to the same degree, because lenders typically have some collateral to help them recover a portion of their investments from oil and gas customers that stumble. Nevertheless, lenders need to understand the world of oil and gas if they wish to avoid mistakes and prosper.

First, lenders must understand that the shale oil and gas revolution has inspired a new generation of entrepreneurs, some of whom are making their first foray into the oil patch. This entry will be difficult for companies with little or no experience or existing relationships. Even well-established oil and gas companies may know very little about the laws, regulations, and geology of Ohio. To properly evaluate risk, the lender's first task is to learn about its prospective borrower. Does the prospective borrower have experience in the industry, with this particular play, in this state, or with a given technology, such as drilling horizontal wells? Do they understand the regulations applicable to their businesses? These are just a few of the critical questions lenders should ask.

A lender should also consider the economic and business climate to determine whether the borrower's budget and estimated time to complete a project are reasonable. Regulatory bottlenecks and shortages of supply should be expected as the shale revolution sweeps across the country. For example, in 2012 unusual demand for guar gum, used as a thickening agent in drilling mud, sent prices to more than ten times their usual level and cut into the bottom line of operators. Likewise, insufficient pipelines and refining capacity in northeast Ohio have forced oil and gas operators to shut in dozens of wells that would otherwise be producing. These kinds of issues should be anticipated by an experienced borrower and a savvy lender.

Next, lenders need to understand the language of oil and gas and what is meant by a farmout agreement, assignment of interests, joint operating agreement, area of mutual interest, overriding royalty, working interest, net revenue interest, held by production, and deep rights. These are just a few terms that are commonly used to define the rights and obligations of parties to an oil and gas transaction. Like any language, one learns the language of oil and gas through education and experience.

Lenders must also understand the assets unique to the oil and gas industry. For example, the primary assets of many oil and gas companies are leases, wells, royalties, reserves, and contractual arrangements. Under applicable law, these assets may be treated as real estate, mineral rights, as-extracted collateral, general intangibles, accounts, equipment, fixtures, production payments, net-profits interests, partnership interests, royalties or a combination of the foregoing. The value and nature of these types of assets is more difficult to measure than typical equipment, inventory, and real estate. The value of oil and gas assets can fluctuate significantly depending on commodity prices, contract law, regulations, and the solvency or experience of the operator. A lender should understand the various categories of reserves, including "unproved possible reserves" on one end of the spectrum, and "proved developed reserves" on the other, how these reserves can change, and how such a change can affect an oil and gas company's balance sheet.

It is essential for lenders to engage experienced counsel to ensure that the due diligence is properly conducted before extending credit secured by oil and gas assets. Federal and state agencies, judges and legislators have been scrambling to keep pace with the advance of technology. The result has been many new laws, decisions and proposals within the last few years that have serious consequences for the oil and gas industry. For example, within the last year judges have ruled on such critical issues as whether a local government has the authority to regulate oil and gas drilling, whether drilling permits can be appealed, and whether payment of a delay rental effectively maintains a lease. Likewise, the Ohio legislature has passed sweeping changes to Ohio oil and gas statutes in each of the last three years, and a new round of legislation is pending. State and federal agencies have been just as busy.

Experienced counsel can also advise a lender about specific kinds of due diligence and whether other consultants, such as a petroleum geologist or environmental consultant, should be engaged. For example, in many oil and gas transactions, leases and existing wells are the primary asset being transferred or they are the lynchpin to all further activities and development. Experienced oil and gas counsel will know how to search and interpret agency records for existing wells, what problematic lease provisions to look for, and other common pitfalls that should be detected and avoided.

Lenders often employ unique lending concepts for the oil and gas industry, such as reserve-based financing, project financing, or mezzanine financing with an equity kicker (often in the form of an overriding royalty interest), or volumetric production payment financing. All of these arrangements have been developed to account for special attributes of the oil and gas industry and oil and gas assets. Lenders need to develop a working knowledge of these tools.

Overall, the key to successfully lending to the oil and gas industry is being part of the industry by learning to speak the language, knowing the business climate, understanding the regulatory and legal structure and, of course, doing the proper due diligence on your prospective borrower.

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The Mystery of Mineral Rights: A Lesson for Lenders

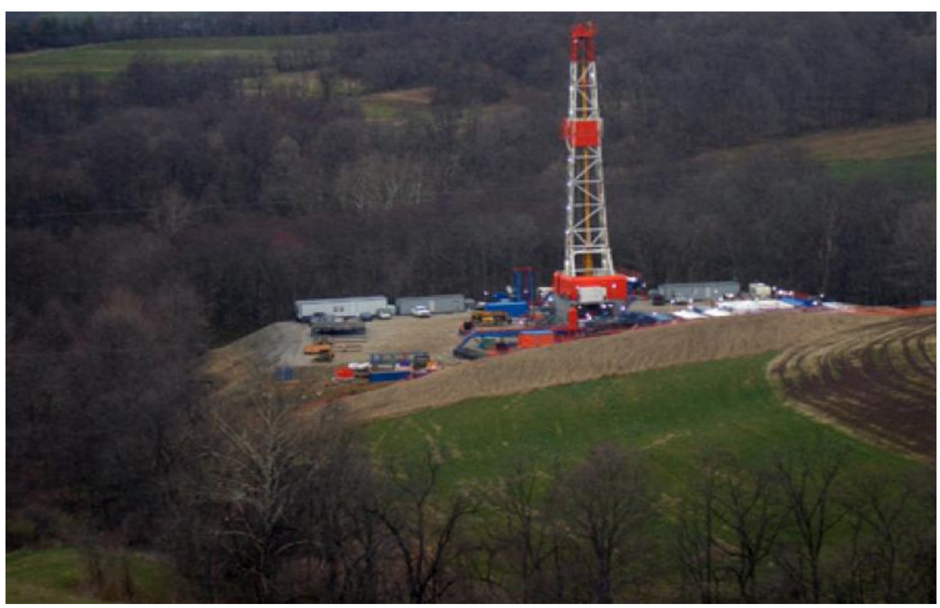
March 15, 2013 | Matt Moberg

By now, you have probably heard about some of the changes in title policies and title searches caused by the recent oil and gas activity in Ohio. Title insurers also recently added to their policies a standard exception for any "lease, grant, exception or reservation of minerals or mineral rights."

Essentially, this language means that any separate mineral interest created at any point in time by any party is now an exception to the title insurance policy, regardless of whether it is expressly disclosed. In other words, there will be no coverage offered whatsoever if one of those interests negatively impacts the property in the future, even if it was not specifically disclosed in the policy. And because title insurers will not insure against oil and gas interests, there isn't much incentive for them to include such interests as exceptions in their title searches, especially when the cost of obtaining such information can be staggering.

Today's topic focuses on what these changes mean for lenders. The existence of a severed mineral interest or an oil and gas lease is of consequence to lenders because those interests have the potential to significantly decrease the value of the mortgaged property. A severed subsurface mineral interest is the dominant estate when compared to the surface, and impliedly includes the right to use as much of the surface area as is reasonably necessary to enjoy the subsurface rights. Subsurface leases (most often oil and gas leases) will often expressly convey similar rights to the lessee, and could contain terms and conditions rather unfriendly to the surface owner. In practice, this means that the owner of valid subsurface rights on a particular parcel could theoretically build roads, install pipelines or construct a drilling pad on the mortgaged property. Although often the potential for royalties might offset some of this devaluation or risk, the ultimate surface rights claimed by the owner of the mineral estate do have the

Even if a title insurer could be persuaded to remove the aforementioned exceptions, many mineral interests were granted in the first half of the 20th century, which is farther back than the average title search extends. These topics are discussed in-depth in a two-part post published previously on the Oil & Gas Law Report blog. Read part one and part two.



potential to significantly decrease the value of the mortgaged property.

How this type of operation could devalue a property should be fairly obvious. And some leases prohibit the landowner from building on, digging in and even landscaping over a certain portion of the land. The discovery that such a prohibition exists over a critical portion of the property could severely limit the uses that can be made of the property as well as the number of potential buyers and, in turn, the value of the collateral.

Given the state of affairs in the realm of title insurance, what can lenders do to protect themselves short of refusing to extend credit in resource-rich regions? Most obviously, lenders can no longer rely on standard title insurance to protect against devaluations in mortgaged land caused by unknown mineral interests, or even to reveal the existence of those interests. Ideally a lender would find a way to persuade a title company to remove the standard mineral exceptions mentioned above; but, unfortunately, that result is exceedingly unlikely and may well be impossible under today's underwriting standards.

Assuming there is no title insurance to be had, lenders should obtain as much information as possible about the mineral interests applicable to the collateral property. This information can help lenders assess their risk levels with respect to any given property. For example, lenders should search for a title insurer who will include mineral interests in the title search, even if it refuses to insure against those interests. And the lender should request that the title search extend back at least 100 years rather than the standard 40 or 60 years. But both of these additional services will be accompanied by additional fees.

Another option is to retain a company specializing in searches designed to turn up severed interests and oil and gas leases. However, this option is typically recommended for large-scale projects so it may not be a viable option for lenders who do not issue a large volume of mortgages. Finally, lenders can search oil well records with the Ohio Department of Natural Resources and/or conduct physical due diligence (i.e., a site walk) to determine whether there are any active wells on the property.

All these options are less than satisfying, and lenders will need to get creative to protect themselves from the hidden perils of undisclosed mineral interests.

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Perfecting Security Interests in Assets of Ohio Gas and Pipeline Companies

March 22, 2013 | Amy Strang and Andrew Bojko

With the recent boom in Ohio's oil and gas industry, secured creditors in Ohio should be sensitive to special statutory requirements for perfecting security interests granted in assets of gas and pipeline companies.

Although security interests in personal property and fixtures are most frequently perfected by filing financing statements under the UCC, there are several types of security interests which require perfection through other channels. In Ohio, pursuant to Section 1701.66 of the Revised Code, security interests in property of "public utilities" are among the interests that must be perfected by other means. "Public utility" is defined by the Ohio Revised Code Sections 4905.02 and 4905.03 to include, among others and with certain exceptions, (i) gas companies and natural gas companies, when engaged in the business of supplying artificial or natural gas, as applicable, for lighting, power, or heating purposes to consumers within Ohio and (ii) pipe-line companies, "when engaged in the business of transporting natural gas, oil or coal or its derivatives through pipes or tubing, either wholly or partly within [Ohio], ***but not*** when engaged in the business of the transport associated with gathering lines, raw natural gas liquids, or finished product natural gas liquids." (Emphasis added). Additional discussion about this distinction among pipeline companies follows.

Revised Code Section 1701.66, titled "Recording of Railroad or Public Utility Mortgages," provides for a special method for perfecting security interests in the assets of a public utility or a corporation organized for the purpose of constructing, acquiring, owning, or operating a public utility. This section requires mortgages of "property of any description, or any interest in the property" made by public utilities to be recorded in the office of the county recorder of *each county* in which any of that property is situated or employed. A mortgage by a public utility including rolling stock or movable equipment may be filed in the secretary of state's office, and will have the same effect as if filed in the county recorder's office. Any public utility mortgage that is filed as provided in Section 1701.66(A) is a lien on the property described from the respective times of filing the mortgage with the recorders of the appropriate counties (or secretary of state, as to rolling stock or movable equipment). A public utility mortgage encumbering after-acquired property becomes a lien on such after-acquired property from the date of its acquisition by the public utility debtor, so long as the public utility mortgage was recorded as provided above.

(*Note*: As used in Section 1701.66, the term "mortgage" is most likely used in its older sense to include security interests in personal property. Section 1701.66 refers to public utility mortgages including specific personal property (rolling stock and movable equipment), and provides for perfection of security interests in after-acquired property, which is generally impermissible in mortgages of real estate.)

Section 1701.66(E) provides that public utility mortgages do not need to be otherwise filed or refiled as is required for other security interests under Article 9 of the UCC. Additionally, Revised Code Section 1309.109, which defines the scope of UCC Article 9 in Ohio (with respect to both personal property and fixtures), states that it does not apply to liens created under any provision of Section 1701.66 (except with respect to a provision regarding priority of possessory liens).

Under the statutory framework, it appears that security interests in assets of pipeline companies that are not public utilities are perfected using the same method as other interests under UCC Article 9. Pipeline companies engaged in the business of transport associated with "gathering lines, raw natural gas liquids, or finished product natural gas liquids" are not public utilities. "Gathering lines" is given the same definition as in the Natural Gas Pipeline Safety Act (49 U.S.C. Chapter 601), meaning a pipeline that transports gas from a current production facility to a transmission line or main. "Raw natural gas liquids" generally include mixtures of ethane, propane, butanes, and natural gasoline, and "finished product natural gas liquids" include ethane, propane, iso-butane, normal butane, and natural gasoline.

Secured creditors lending to oil and gas companies should consult experienced legal counsel to ensure they use the proper methods to effectively perfect their security interests in collateral owed by gas and pipeline companies.

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What Goes Up … A Quick Glance at Ohio Oil and Gas Leases in Bankruptcy

March 4, 2013 | Andy Nicoll

As Ohio enjoys its latest boom in oil and gas exploration, it is important to understand how oil and gas leases are treated in bankruptcy. Unsettled Ohio law regarding whether a debtor owns unextracted oil and gas as part of the debtor's real property can make this a difficult issue.

In *In re Loveday*, No. 10-64110, 2012 WL 1565479 (Bankr. N.D. Ohio May 2, 2012), the Northern District of Ohio examined whether a Chapter 13 debtor had properly included in his bankruptcy schedules his interest in unextracted oil and gas relating to the debtor's real property. Whether the debtor's oil and gas rights were properly scheduled was a significant factor in determining whether the debtor could retain the proceeds of the sale of his oil and gas rights. But more importantly, for the companies who sought to purchase the debtor's oil and gas rights, knowing whether such rights were properly scheduled was necessary to determine whether the debtor had unfettered authority to sell his oil and gas rights without court approval.

The *Loveday* debtor argued that his oil and gas rights were properly scheduled because these rights were part of his real property, which real property he had listed in his bankruptcy schedules. By operation of law and the debtor's Chapter 13 plan, all the debtor's interest in his properly scheduled assets were vested with the debtor on confirmation of his Chapter 13 plan. Thus, as the debtor argued, because his oil and gas rights were inherently part of his properly scheduled real property, such oil and gas rights were scheduled and the debtor was empowered to sell such rights and entitled to retain the proceeds from the sale.

In testing the debtor's argument, the bankruptcy court outlined two prevailing theories on oil and gas rights — one holding that an owner of real property holds a fee right in unextracted oil and gas that may be severed, and the other holding that rights to oil and gas require actual possession to establish ownership in such oil and gas, and a landowner has the right to reduce the oil and gas to possession or to sever this right for economic consideration. The court found that the "[c]ourts in Ohio are split regarding the treatment of oil and gas rights to an owner," but determined that "the nonownership theory is the more sensible approach to the ownership of oil and gas rights for purposes of valuation in bankruptcy." The court further explained that, "[g]iven the migratory nature of oil and gas, it is premature to give value to the oil and gas before they are extracted from the Land," and held that:

> In instances where a debtor retains the oil and gas rights to his property, he has a duty to disclose the retention of these rights on his schedules. … [T]the debtor cannot assert that the oil and gas rights are included in the value given to the real property on his schedules. When a debtor schedules real property, the court assumes that the debtor refers only to the top surface rights associated with the real property unless the debtor specifically schedules the retention of other rights associated with the real property. Given how many different rights can be associated with real property, e.g. easements, oil and gas rights, and countless other rights, a debtor need only indicate whether any of these rights have been conveyed, specifically listing which have been conveyed, or indicate that all rights associated with the real property are still retained.

Because the debtor had failed to expressly indicate that his scheduled real property included oil and gas rights, he was required to obtain court approval to sell such rights and retain the proceeds of the sale.

In practice, it would be unusual to find oil and gas rights separately scheduled or expressly noted on a Chapter 13 debtor's bankruptcy schedules. Thus, purchasers of such rights would be wise to condition their acquisition of oil and gas rights on approval by the Chapter 13 debtor's bankruptcy court unless the oil and gas rights are explicitly and unambiguously scheduled.

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