Don't Sleep on Your Golden Goose: Mineral Rights and DIP Financing

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The recent slump in fossil fuel prices that allowed me to fill up my tank for $2.19 per gallon on the way into the office has understandably cooled some of the enthusiasm for continued natural gas exploration and development in the Marcellus and Utica shale formations throughout southeastern Ohio.

However, those with property rights to the minerals are well advised to also acquire and maintain the permits necessary to extract the minerals, even if they do not intend to actually extract them in the immediate future. Maintaining the proper permits, even if you do not intend to use them, can still increase the value of the person's or enterprise's assets, and can enable emergency borrowing against those assets that might not be possible if the person or enterprise owns them but cannot legally extract them.

Under normal circumstances, an owner facing a cash flow crunch would look to borrow against those assets from his regular secured lender. The extra value of legally extractable resources, over merely legally owned resources, should be helpful in such discussions. But the difference could be even more significant in a bankruptcy proceeding, if one is forced to consider such an option.

First, if the bank already has a lien on the property, the difference in value between owned and accessible resources could mean the difference in the lienholder being able to almost immediately foreclose on its lien—obtaining relief from stay, in bankruptcy-speak—and being forced to hold off on any foreclosure until completion of the bankruptcy case. A bankruptcy filing automatically stays, or pauses, all acts to obtain or control the debtor's property or enforce liens against such property. But creditors can obtain relief from that stay if they can show they are not "adequately protected."

One way of showing that a creditor is adequately protected and thus should be forced to wait for the bankruptcy case to run its course is to show that there is an equity cushion in the property. In a close case, the extra value of having the subsurface minerals be legally extractable could make the difference in finding there is an equity cushion.

Second, however, the Bankruptcy Code has a much-less-commonly invoked provision that allows for a bankruptcy court to authorize priming liens. Priming liens are rare because they violate one of the otherwise-fundamental rules of secured transactions: the first lien perfected is the first lien paid. The Bankruptcy Code provides, however, that the court "may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien," but only if the trustee is unable to obtain such credit otherwise and there is "adequate protection" of the interest of the holder of the already-existing lien(s). The burden will be on the trustee (usually the debtor-in-possession) to show that the existing creditor will still be adequately protected after the imposition of a priming lien.

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The existing secured creditor is extremely likely to litigate that issue fiercely, because they often sincerely believe there is no equity remaining in the property, which is a primary reason that the trustee is unable to obtain additional credit from that existing lender. The existing lender also knows that if the court allows the priming lien but the valuation turns out to be erroneous, it is the existing lender that will suffer the loss from being inadequately protected.

The litigation is also likely to be compressed into a tight window very soon after the filing of the bankruptcy case, because the debtor will often be extremely starved of cash absent permission to obtain super priority financing, since the lender threatened with the prospect of being primed is also unlikely to be cooperative with requests for the consensual use of cash collateral.

An example of this dynamic arose in the 2010 bankruptcy of Schwab Industries (Ohio Case No. 10-60702). The case was filed on February 28, 2010, a Sunday. One of the debtors-in-possession's initial motions was to obtain up to $18.3 million in super priority secured financing from a lender other than the debtors' existing secured lender, which held a secured claim in the range of $50-60 million. One needs only glance briefly at the docket to see the motion was intensely contentious and litigated within a very short timeframe: interim relief allowing a small priming lien ($3.5 million) was granted on Wednesday, March 3, 2010, and the remainder of the super priority financing requested was denied on Monday, March 22.

One significant factual issue raised by the motion was the valuation of a large parcel of real property in Florida with substantial subsurface limestone deposits—but without permits in place allowing extraction of those minerals. The property was still, by a considerable margin, the debtors' most valuable fixed asset, and the permitting issue was one topic raised at the evidentiary hearing under the broader subject of whether the debtors had an equity cushion that would adequately protect their existing lender.

Yes, the shale market has cooled off for now. But owners of mineral rights should still have their legal house in order.

It is impossible to know whether having those permits in place would have changed the outcome, as there were many issues raised in the multiple briefs and depositions submitted supporting and opposing the motion, and the court did not issue a full written opinion. However, it would at least have removed one legal uncertainty that worked against the debtors in the adequate-protection analysis.

Therefore, owners of subsurface mineral rights should consider laying all of the legal groundwork for future extraction of those resources, even if they actually do not currently plan to extract them until market conditions for sellers improve. The mere fact that an owner has made such preparations could prove to have tangible value in an emergency cash crunch.