Can a Lease Survive Foreclosure?

Two Foreclosure Cases and a New Statute

Two recent federal foreclosure cases applied Texas law and one highlighted a fact situation that may involve a new (2015) statute.

In *Arbuckle v. Chesapeake*, Case No. 3:14-CV-04584-M (N.D. Texas, Dallas Division September 18, 2017). Chesapeake (CHK) took oil and gas leases on properties on which there were existing mortgages. Arbuckle, one of several plaintiffs in a putative class action suit, bought the properties out of foreclosure and claimed that the oil and gas leases granted on those properties were junior to the mortgages and were, therefore, terminated by the foreclosure sale.

Because this case was decided on a pre-certification motion for partial summary judgment, many facts are not yet clear. Four properties were proffered by the Arbuckle group and all appear to have these facts in common: CHK acquired leases on various commercial and residential properties in the Barnett Shale, which were covered by prior mortgages, the mortgagors defaulted, and were foreclosed. Arbuckle argued that the leases were terminated when the properties were sold at foreclosure because CHK had not obtained agreements subordinating the mortgages to the leases. CHK argued limitations, estoppel, laches, adverse possession, demanded strict proof of the terms of the mortgages and compliance with the Property Code; CHK also argued that the mortgagee's failure to give notice of foreclosure to CHK was a violation of CHK's due process right under the U.S. and Texas Constitutions.

Arbuckle sought a partial summary judgment that four CHK leases were subject to senior mortgages, which were then terminated by valid non-judicial foreclosure. In rejecting Arbuckle's motion, the court examined the title documents related to each of the four properties and, in each case, found the Plaintiff's title to be deficient (failed to show the minerals were part of the property when it was mortgaged, the foreclosure deed went to an entity other than the Plaintiff, there was no assignment from the mortgagee to the foreclosing bank, and the foreclosure sale was conducted under a mortgage dated in 2004 instead of 2003 and was not in the record provided to the court). So the court's decision was based on a failure of Arbuckle to prove its title and not whether a senior mortgage can extinguish an intervening lease.

At first blush, the proposition that a senior mortgage, when foreclosed, extinguishes the oil and gas lease seems unassailable. The comment to Texas Title Standard 15.90 Lien Priority and Subordination says "After a senior lien is validly foreclosed, junior liens and junior interests in the same property are extinguished."

Enter the Texas Legislature. In 2015, Section 66.001(b) was added to the Texas Property Code: "Notwithstanding any other law, an oil or gas lease covering real property subject to a security instrument that has been foreclosed remains in effect after the foreclosure sale if the oil or gas lease has not terminated or expired on its own terms and was executed and recorded in the real property records of the county before the foreclosure sale."

The new law goes on to (i) extinguish the *surface rights* of any such junior oil and gas lease upon foreclosure, (ii) allow a subordination agreement to control, (iii) prohibit any agreement between mortgagor and mortgagee to modify the effect of the law unless agreed to by the lessee, and (iv) deny the application of the law where the mortgage does not cover the minerals.

As to the underlying mineral ownership, the statute provides that

An interest of the mortgagor or the mortgagor's assigns in the oil or gas lease, including a right to receive royalty or other payment that become due and payable after the date of the foreclosure, passes to the purchaser of the of the foreclosed property to the extent that the

security instrument under which the real property was foreclosed had priority over the interest in the oil or gas lease of the mortgagor.

The fate of the mineral interest (reversionary right) is unclear since the above provision is limited to the mortgagor's interest in the oil and gas lease. Does the purchaser at foreclosure own the minerals after the

lease expires? Probably so since nothing in the statute purports to save the underlying mineral interest – just the leasehold interest.

The new law takes effect on January 1, 2016 but there is a timing limitation so that the law "applies only with respect to a foreclosure sale for which the notice of sale is given … on or after the effective date …."
In the *Arbuckle* case it appears (but is not clear) that the mortgage was foreclosed before the January 1, 2016 effective date making the new law inapplicable. The legal landscape may shift in later cases where both the mortgage and lease were in place before 1/1/16 but the foreclosure is after, especially as to whether the senior lien's priority status can retroactively be modified to deny the lien holder the traditional effect of extinguishing junior interest and whether one can, by statute, modify the terms of an existing oil and gas lease to surrender surface rights.

In Re: Jones, Case No. 16-31468-SGJ-13; Adversary No. 16-03110 (USBC, N.D. Texas, Dallas Division) August 30, 2017. As long as we are talking about foreclosures, here is an interesting tidbit in a bankruptcy context. Here the Bankruptcy Court decided that a bankruptcy filing the day after the date the foreclosure occurred could not bring the property back into the bankruptcy estate. A lender held a non-judicial foreclosure sale one day before the Debtor filed a Chapter 13 bankruptcy case at which a credit bid from the Lender was accepted but the Trustee's Deed was not delivered until after the bankruptcy case was filed. The debtor argued that the foreclosure sale was incomplete because the trustee's deed had not been recorded and, if it were not recorded, then the bankruptcy trustee could take the property as a BFP under §522(h) of the Bankruptcy Code. Analyzing Texas and Bankruptcy law, the court held that for the Debtor to step into the shoes of a hypothetical bona fide purchaser, it had to be without notice, either constructive or inquiry. Since the deed was not filed, notice could not be constructive. After a discussion the court concluded that the trustee was on inquiry notice of the mortgage and should have inquired of the record Substitute Trustee whether the property had been scheduled for foreclosure. Therefore the bankruptcy trustee was on inquiry notice and the property could not become part of the bankruptcy estate.

So, what about the standard Texas requirement for a valid conveyance: delivery. Texas Title Standard 4.30 says, in the comment, "Delivery is a formality essential to the effectiveness of conveyances, recorded or otherwise." The court found that the transfer to the lender was accomplished without the delivery of a deed: "In Texas, title acquired at an execution sale may be established by proof of a valid judgment, issuance of an execution thereon, a sale thereunder, the acceptance of a bid by the sheriff, payment of the costs, and payment of the purchase money either in cash or by crediting the judgment with the amount bid at the sale. Proof of these matters establishes an "equitable and superior' title in the purchaser. A deed from the sheriff is a ministerial act not essential to the investiture of title …" [Quoting *Glenn v. Hollums*, 80 F.2d 555, 556 (5th Cir. 1935).]

Take Away If you take a property based on ownership via a previous foreclosure, check again; if you own a lease covering foreclosed property, the lease may not be gone. If you loaned money against a property with minerals, you may not have the minerals.

GIBSON
OIL & GAS LAW

Martin Gibson
P.O. Box 864
Cedar Creek, Texas 78612
512-614-7785
mgibson@gibsonoilgas.com