

Chapter 10**Acquisition and Financing of Coal Reserves**

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Synopsis

§ 10.01.	Introduction: Coal Reserves Are Real Estate	318
§ 10.02.	Coal Reserves as Distinct from Other Real Estate.....	318
§ 10.03.	Extraction Value	319
	[1] — Creating Divergent Interests in Purchaser and Lender	319
	[2] — Rendering Title Insurance Inadequate Protection for Coal Mine Operator	320
§ 10.04.	Large Numbers of Tracts Involved in a Coal Reserve Transaction	320
§ 10.05.	Acceptable Title Standards for Coal Reserves	321
§ 10.06.	Title Standard Variations	323
	[1] — Reduction Standards	324
	[2] — Rejection Standards	324
	[3] — Multiple Title Standards	325
§ 10.07.	Real Property Interests in Coal Reserves.....	325
	[1] — Fee Coal.....	326
	[2] — Leasehold Coal.....	326
	[3] — Appurtenant Rights.....	327
	[4] — Caution: Dominant Estates	328
	[5] — Block Holdings; Windows	329
§ 10.08.	Title Assurance.....	329
	[1] — Title Insurance.....	329
	[2] — Tract Opinions.....	331
	[3] — Capstone Title Opinions	331
§ 10.09.	Creation and Perfection of Security Interests in Coal	332
	[1] — As-Extracted Collateral, Article 9 of the Uniform Commercial Code.....	333
§ 10.10.	Special Problems for Lenders	334
	[1] — Mandates to Mine.....	334
	[2] — Assignment Restrictions	335
	[3] — Holding Costs.....	335
	[4] — Evaporating Collateral	335
§ 10.11.	Practical Problems in Coal Reserve Transactions	335
§ 10.12.	Conflicts of Interest	336

§ 10.01. Introduction: Coal Reserves Are Real Estate.

Coal rights are real estate interests which “are attended by all the attributes and incidents peculiar to the ownership of land or real estate.”¹ Thus, many of the transactional practices and legal requirements associated with acquisition and financing of coal rights are much the same as those applicable to other commercial real estate transactions. However, they are not identical. “Mining agreements and leases ‘form a distinct class of instruments, creating special and peculiar legal rights and relations and requiring special rules of interpretation’ ”²

Coal reserves are areas where a number of tracts of coal have been assembled. These areas are generally large enough to support the operation of at least one coal mine.

§ 10.02. Coal Reserves as Distinct from Other Real Estate.

While the legal requirements pertaining to coal reserves are occasionally different from ordinary commercial real estate,³ it is the transactional practices that are most distinct. These transactional distinctions arise from the fundamental differences between the coal industry and other commercial real estate holders. Understanding these differences is critical to the proper structuring of a coal reserve transaction. Coal reserves have an extraction value – the value of extracted coal after conversion to personal property – much higher than their value as real estate. Reserves often contain a very large number of tracts of land and consist of an extraordinary variety of real property interests. Title standards for coal reserves differ from ordinary real

¹ Ill. Law and Prac., Mining, Oil and Gas, §7, 2008 *citing* Failoni v. Chicago & N.W. Ry. Co., 195 N.E.2d 619 (1964). *See also* Williams’ Administrator v. Union Bank & Trust Co., 143 S.W.2d. 297 (Ky. 1940), stating “It has long been the law of this State that minerals in place are real estate”

² American Law of Mining §130, Judicial Interpretation of Mining Agreements, quoting Fremont Lumber v. Starrell Petroleum Co., 364 P.2d 773 (Or. 1961).

³ *See* § 10.09[1] *infra* regarding special Uniform Commercial Code provisions regarding creation and perfection of “as- extracted collateral,” including coal.

estate. A typical coal reserve does not have merchantable title, as that term is usually understood in commercial real estate practice, yet such title may be commercially acceptable in the coal industry.

§ 10.03. Extraction Value.

Certainly all real estate has potential value greater than the purchase price, but a coal reserve is a special kind of real estate because it is purchased for the purpose of conversion to personal property worth many, many times the value of the coal in place. A very large increase in value, sometimes even 100 times, is anticipated by the purchaser. This enormous increase in value is significant in several respects. It makes the interests of the purchaser and lender more divergent than in a typical commercial real transaction, especially with regard to acceptable title risks. Certain practices used in ordinary commercial real estate are not appropriate, chief among them the use of title insurance for protection of the buyer. The realization of this increased value of the coal itself, and the converse, the depletion of the coal reserve as a *real estate* asset, is one of the aspects of coal reserve transactions that a lender must take into account in credit agreements and other loan documents. An example of this is extending the lender's lien to the coal as an as-extracted mineral, discussed in § 10.09[1].

[1] — Creating Divergent Interests in Purchaser and Lender.

In most commercial real estate transactions, the title risk for the buyer is the consideration paid for the property. The risk for the lender may not be identical but it is typically similar. In all real estate transactions, the purchaser and lender share an interest in making sure the seller has acceptable title, but with coal reserves, the consequences of title failure are greatly magnified for the purchaser. If title fails, the potential loss for a lender is generally limited to the amount of the loan secured by the coal reserve. If title fails to only a tract or two out of a thousand, it may be of little significance to a lender. However, for the purchaser, the potential loss is much greater.

Loss of title to a single piece of property may greatly impact borrower's mining plans. In a longwall operation, the discovery of title failure on a tiny

tract within a longwall panel could cause the effective loss of a large area of coal reserves. If title failure is discovered after extraction, the potential loss for wrongful mining of coal can be very large – not just the value of the coal reserve but the full value of the extracted coal⁴ – a high multiple of the purchase price for unmined coal in place, and it may even include punitive damages.⁵

[2] — Rendering Title Insurance Inadequate Protection for Coal Mine Operator.

Title insurance has little value to a coal mine operator. The amount of title insurance is generally limited to the purchase price. For an operator, this is very inadequate coverage for loss of a tract within a mine plan or for wrongful mining.⁶ Defects in title may be waived or “insured over” by the underwriter. However, the risk to an insurer is much lower than the risk to a miner, and the insurer will apply a far lower standard in waiving title defects. The odds may be 1,000 to one that a decedent had a child from an unknown prior family (or that some other event significant to title occurred) and the title insurer may waive inadequate proof of heirship on a small tract insured for the reserve value of coal in place. But for an operator dealing with 1,000 tracts of coal, and facing very high losses for wrongful mining or the early shutdown of a longwall panel, that risk is unacceptable. There are other reasons title insurance has limited value to a purchaser of coal reserves, discussed in § 10.08.

§ 10.04. Large Numbers of Tracts Involved in a Coal Reserve Transaction.

A sale of a coal reserve is usually the sale of a very large number of individual tracts. Title to each tract must be separately reviewed by the buyer and lender. Ordinary commercial surface real estate transactions sometimes

⁴ Donovan v. Consolidated Coal Co., 58 N.E. 290 (Ill. 1900).

⁵ Dethloff v. Zeigler Coal Co., 412 N.E.2d 526 (Ill. 1980).

⁶ See § 10.08[1] *infra*.

involve a number of tracts, but a coal reserve usually includes a very large number of tracts, commonly hundreds and occasionally thousands.

It should be rather obvious that a transaction involving title examination of an enormous number of tracts of land should be structured differently than one involving only a few tracts, yet it is common for transactional attorneys, especially those for lenders unaccustomed to dealing with coal reserves, to utilize commercial real estate boilerplate that is impractical or puts a party in an impossible situation.

One example of this is the typical provision for merchantable title.⁷ Another is time for completion of title due diligence. Coal reserves areas are typically concentrated in one general location, perhaps in one or two rural counties. If there is no existing title evidence such as abstracts or title opinions, completing title searches on hundreds of tracts in a rural county seat with only one set of title indices is extraordinarily time consuming. Even the most diligent and efficient examiners may need many months to complete that task. Seller, purchaser, and lender must account for this, either by allowing for such delay, or compromising on title due diligence, such as limiting full searches to critical areas.

§ 10.05. Acceptable Title Standards for Coal Reserves.

The typical commercial real estate sales agreement provides that seller shall provide evidence of merchantable title for all the property to be sold. Its counterpart in a credit agreement requires the borrower to do the same. Such requirements are inappropriate in most coal reserve transactions because such a standard can almost never be met. It is not industry practice to acquire merchantable title on each tract within a reserve. While experienced coal companies know this, lenders new to the coal industry do not. One of the hardest concepts for lenders to accept is that the borrower will not have merchantable title to the real estate proffered as security for the loan.

It should first be noted that the sheer number of tracts involved make the typical merchantable title provision impractical. If a transaction involves

⁷ See § 10.05 *infra*.

1,000 tracts of land, any transaction contingent on merchantable title to every single tract is likely to fail unless some defects, or even title failures, are waived. No seller or borrower would want to be in a position where he must rely upon a waiver by the other party – a discretionary act – in order to enforce his contract or loan commitment.

The most important reason, however, for variance from typical merchantable title demands is that *it is not industry practice to obtain merchantable title on an entire coal reserve*. Few coal reserves have merchantable title on each tract and many do not even have abstracts, title opinions or other title evidence.

In most coal reserve areas, especially those in Eastern basins, the coal was originally owned by a large number of small farmers and landholders. Coal reserves large enough to support a mine were assembled over long periods, one tract at a time. In these acquisition programs, title was rarely perfected on each tract. A few reserves, usually very small ones, indeed have very good title, the acquiring company taking pains to examine title and cure most problems prior to acquisition or soon thereafter. Other companies suspended curative work at some point, or perhaps obtained no title opinions at all, and merely relied on the grantors' claim of ownership in assembling the reserves.⁸ If a leasehold was acquired with a small advance royalty or other minimal holding costs, and mining was contemplated in the distant future, the coal company may have simply determined it did not have much at risk if title was imperfect or even if it failed. In terms of title, mineral reserves are usually works in progress.

The passage of time cures many problems in surface estates as the elements of title by adverse possession are usually present, but adverse possession is not available to cure defects on severed minerals.⁹ Some states

⁸ Leases taken in this manner are called “front porch” leases from the practice of signing whomever was on the front porch of the farmhouse located on the land. These persons often turned out to hold only a life tenancy, were mere co-tenants or otherwise could not convey good title.

⁹ See, e.g., *Pollard v. Simpson*, 199 So. 560 (Ala. 1940); *Catlin Coal Co. v. Lloyd*, 54 N.E. 214 (Ill. 1899); *McBeth v. Wetnight*, 106 N.E. 407 (Ind. 1914); *Ratliff v. Sinberg*, 79

have mineral lapse statutes which may impact coal reserves,¹⁰ and application of these statutes depends largely on non-record events, further complicating title examination.¹¹

For these reasons, cost of curing title problems is high, and given that most coal reserves are decades away from mining, coal companies often do not wish to incur this cost until the reserve, or targeted part of it, is designated for mining. Sometimes simply obtaining title evidence is impractical.¹²

§ 10.06. Title Standards Variations.

The most significant difference between coal reserves and typical commercial real estate is that *title is not merchantable and not expected to*

S.W.2d 717 (Ky. 1935); *Logsdon v. Brailer Mining Co. of Allegany Co.*, 123 A. 113 (Md. 1923); *Caldwel v. Copeland*, 37 Pa. 427 (1860); *Wallace v. Elm Grove Coal Co.*, 52 S.E. 485 (W. Va. 1905). *See also* Annotation, Acquisition of Mines or Minerals by Adverse Possession, 35 A.L.R.2d 124, §21[a]: “It has been held or recognized in a large number of cases that after title to the surface estate of land has been severed from title to the underlying mineral estate, title to the minerals cannot be acquired by adverse possession of the surface alone.”

¹⁰ *See e.g.*, the Indiana Mineral Lapse Statute, I.C. §32-23-10-1, *et seq.*

¹¹ The Indiana Mineral Lapse Statute “is, at best, inartfully drawn and in some respects raises more questions than it answers.” *McCoy v. Richards*, 623 F. Supp. 1300, 1309 (S.D. Ind. 1984).

¹² Setting aside cure costs, just examining title to minerals is costly for several reasons. In mineral producing areas, coal ownership is often fractionalized, sometimes greatly so, meaning that several chains of title must be examined for one tract. Existing title evidence, such as abstracts or title insurance, usually except severed minerals from coverage so new abstracts must be ordered or “stand-up,” *i.e.*, courthouse examinations must be made by examining counsel. Limitations acts which rely on possession are not available for severed coal, so great care must be taken in examination of the entire title chain, often going back more than a century to when the severance occurred. Examination of title may also be delayed because title evidence is unavailable as a practical matter. A team of landmen may acquire coal rights in tracts so numerous that the abstractor – and there is often just one abstractor in a rural county – cannot create abstracts of title in a timely fashion and run years behind their orders. The alternative of stand-up examination may be limited as well. In the small courthouses of rural counties, most without any computer search aids, only a few persons can examine title records simultaneously. Short hours and numerous public holidays further limit access. The number of attorneys with expertise in coal title examination is also limited.

be merchantable in the sense that such term is ordinarily used. It is industry practice that title to a coal reserve area, whether fee or leasehold, may not be perfected until that area is designated for mining. Thus titles to the various tracts which make up a reserve are in various states of imperfection. A buyer is stepping into the shoes of the seller. The question for purchasers and lenders is this: How good must those shoes be?

[1] — Reduction Standards.

Many sale agreements for coal reserves contain a title standard lower than the traditional “merchantable title” standard. Only this reduced standard must be met before the full agreed price is paid. For a reserve that is to be mined very soon or represented to be particularly good, the seller may be required to show that it has good title and sufficient mining rights on, for example, 97 percent of the reserve acreage. On a “throw in reserve,” one which is peripheral to the central objective of the transaction, it may be much lower, even 75 percent. If this standard is not achieved, the transaction still goes forward but the purchase price will be reduced according to a formula, often a fixed amount per acre. The penalty can vary, especially if there is failure in a critical area or there are deficiencies in important mining rights, such as cartage or subsidence.

Similarly, a credit agreement for a coal reserve may allow for a certain level of imperfections in title to the coal reserve which is to serve as security for the loan.

[2] — Rejection Standards.

If the seller’s shoes are particularly bad, that is, title fails on too much coal, the seller or lender typically is entitled to reject the deal. There is no standard threshold but 90 percent or higher would be common for a reserve targeted for production in the near future. However, the parties to a sale agreement may agree to a very low threshold, even only 50 percent, if combined with a reduction standard. The reason is that the buyer may be getting only half of what it bargained for, but if the price is cut in half, it may still be a deal the buyer wants. In such a situation, the buyer will still obtain

sufficient control of enough of the reserve area to prevent competition from coming into the area and it can fill in the windows¹³ on its own schedule.

[3] — Multiple Title Standards.

Coal reserve sale agreements may have different reduction standards and rejection standards for different parts of a coal reserve. If a part of the reserve is designated for imminent mining, the standards for that part of the reserve may be much higher than for a reserve which the buyer intends to keep as an inactive, long term reserve.

§ 10.07. Real Property Interests in Coal Reserves.

Coal reserves almost always consist of a complex assembly of real property rights, each requiring analysis and determination of its relationship to the whole reserve. A single reserve typically consists of fee interests, leaseholds and a variety of easements and servitudes. Coal leaseholds, even within the same coal reserve, often have widely varying provisions for critical terms such as those pertaining to advance royalty, earned royalty and primary term. Even fee interests may be subject to a variety of conditions subsequent and reversions. For both fee and leasehold coal, appurtenant rights (*e.g.*, cartage, subsidence) are often critical, sometimes as important as the coal itself. All interests may be subject to overriding royalties, a concept not found in ordinary commercial real estate transactions. Coal deeds and leases may cover only a particular coal seam or a horizontal strata of real estate defined by depth below the surface.

Most reserves were acquired over time and this often results in variations in the types of real property interests within a coal reserve and in the rights appurtenant to coal ownership. For example, longwall mining began in the United States in the late 19th century,¹⁴ and for several decades, many coal deeds contained a waiver of damages for subsidence. Longwall mining fell

¹³ See § 10.07[5] *infra*.

¹⁴ See *Culp v. Consol Pennsylvania Coal Co.*, 1989 WL 101553 (W.D. Pa. 1989) for a discussion of the history of longwall mining in the United States.

out of favor about 1930 and typical coal deeds after that did not include the right to subside the surface. Longwall mining returned in the 1970s and the right to subside has returned as a critical mining right.¹⁵ Thus a reserve may include areas where the coal owner holds subsidence rights and areas where the coal owner does not.

Coal reserves large enough to support modern mining are often assemblages of smaller reserves, put together by several companies in an era when a reserve could be quite small and still be mineable. Usually, each of these companies used different forms for acquisition of coal, so that seams acquired and appurtenant rights may vary significantly.

[1] — Fee Coal.

All or part of a coal reserve may consist of coal held in fee, an estate most analogous to ordinary commercial real estate. However, even this estate has distinctions. For example, fee coal is subject to overriding royalties. Enjoyment of fee coal rights may be subject to restrictions on mining method. Most importantly, the ability to enjoy the fee coal is greatly impacted by appurtenant rights.

[2] — Leasehold Coal.

The range of rights contained in American coal leases is so wide that it can only be summarized here in brief form. Each of the following elements must be analyzed in conducting title due diligence and in drafting transaction documents:

- a. advance royalty;
- b. earned royalty rates and minimums;
- c. overriding royalties and production payments;
- d. remaining length of primary term;
- e. secondary term provisions;
- f. other obligations (*e.g.*, mining mandates); and
- g. appurtenant rights.

¹⁵ *Id.*

Of course, it must also be established that the lease is valid, that is, that lessor had good title and the lease has not been terminated by reason of some default by lessee.

[3] — Appurtenant Rights.

For both fee and leasehold coal reserves, appurtenant rights are a very important part of the coal reserves being purchased or used as security for a loan. A deficiency in mining rights can render a coal reserve much less valuable.

In all jurisdictions, a grant of coal is accompanied by certain implied rights, such as the right to explore. These rights vary from state to state so it is important to determine what they are. It is also important to determine that they are not expressly negated in some way, an occurrence much more common in modern grants.

Among the appurtenant rights:

- a. exploration — the right to explore for coal, usually by core drilling;
- b. cartage — the right to use voids created by mining as haulways for coal, including other coal from tracts not described in the grant;
- c. subsidence — the right to conduct operations that remove support from the surface. This right is as critical as control of the coal itself in longwall mine operations. Mining cannot occur without both sets of rights;
- d. surface mining — the right to surface mine. For seams which can be mined by surface mining methods, the right to use the surface is as critical as control of the coal seam itself. Mining cannot occur without both sets of rights; and
- e. other appurtenant rights. These may include rail, pipeline, electric, and communication line easements, a variety of other easements and licenses and even options to purchase or use the surface.

[4] — Caution: Dominant Estates.

On any tract, the coal may be the dominant estate or the servient estate, depending on the provisions in the deed, lease or other relevant documents. It may also depend on the time of creation of a separate right. In most jurisdictions, there must be reasonable accommodation of other estates, yet one is nevertheless dominant. For example, if an oil and gas lease is granted, the lessee has all the rights that come with that lease. If there is a subsequent grant of a coal lease, then whatever rights the coal lessee takes are servient to the rights of the oil and gas lessee. Troublesome dominant rights for the coal operator include the following:

- a. Oil and gas. If the coal mine operator does not also control or have dominance over the oil and gas estate, it runs a significant risk of interference by oil and gas operations. It is usually impractical, if not impossible, to mine in an area with an active oil and gas production field. A coal reserve could be rendered less valuable, or even worthless, by oil and gas production.
- b. Coal bed methane (CBM). Historically, coal bed methane has been controlled by the coal owner for safety purposes,¹⁶ but its ownership may be split from coal by transfer or, in jurisdictions following the Western Rule on CBM ownership, by court decision.¹⁷ Since CBM is a component of coal itself,¹⁸ the potential for interference with coal production is obvious. Separation of ownership of CBM from the right to mine the coal is increasing in the United States.

¹⁶ Continental Res. of Ill., Inc. v. Ill. Methane, LLC, 847 N.E.2d 897 (Ill. 2006).

¹⁷ See, e.g., Newman v. RAG Wyoming Land Co., 53 P.3d 540 (Wyo. 2002); Carbon County v. Union Reserve Coal Co., 898 P.2d 680 (Mont. 1995).

¹⁸ U.S. Steel Corp. v. Hoge, 468 A.2d 1380 (Pa. 1983).

- c. Easements (major pipelines, transmission lines, rail and road rights-of-way). These estates may interfere with coal production, especially if mining is by surface or longwall methods.¹⁹
- d. Other coal seams. Obligations to protect one coal seam may hinder operations to extract coal from another seam. For example, a longwall operation may impact the overlying seam. If that seam is separately owned, then the longwall operator must obtain subsidence rights from the owner of that seam as well as from the surface owner.²⁰

[5] — Block Holdings; Windows.

The value of modern coal reserves is enhanced by assembly of several tracts into one large contiguous block. That value is influenced by how solid the block is and how few areas within the block are not controlled (so-called “windows”). A purchaser and a lender need this information to determine if there is a mineable block or if more time and capital must be expended to fill in the windows.

§ 10.08. Title Assurance.

Title assurance in a typical commercial real estate transaction is provided by a title insurance policy. Such policies remain *de rigueur* in many lenders’ internal transaction standards, but they are inadequate for most coal reserve purchasers. Prior to the advent of modern title insurance, title opinions issued by examining counsel were the method of title assurance used by purchasers and lenders. In the coal industry, this is still true.

[1] — Title Insurance.

As noted in § 10.03[2], title insurance does not provide a coal operator with adequate financial protection for loss of title to part of a coal reserve.

¹⁹ See, e.g., *Shell Pipe Line Corp. v. Old Ben Coal Co.*, 677 F. Supp. 572 (S.D. Ill. 1988) regarding a dispute between a longwall mine operator and the owner of a transcontinental pipe line.

²⁰ See *Cole v. Ross Coal Co.*, 150 F. Supp. 808 (S.D. W. Va. 1957) for a conflict between coal seam owners which did not involve longwall mining.

The need for a large amount of information (*e.g.*, appurtenant rights and holding costs) and useful analysis of that information is another reason that title insurance has limited value in coal reserve transactions.

Title policies do not provide information which is sufficient for coal reserve title analysis. Title insurers insure title – they do not sell information.²¹ An example of the application of this distinction is the case of *First Midwest Bank, N.A. v. Stewart Title Guaranty Co.*²² In that case, a mortgagee brought an action against an insurer for negligent misrepresentation in failing to note a recorded restrictive covenant in a title commitment. The court held that the title insurer was not liable.²³ The court found that a title commitment was “categorically different” from an abstract of title. “[W]hen an abstract of title is requested for a property, the abstracter examines the record and makes a summary of title, disclosing all defects, liens and encumbrances affecting that property. * * * [I]t is not the purpose of a title commitment to provide a listing of all defects, liens and encumbrances affecting the property. A title commitment is simply a promise to insure a particular state of title. * * * We conclude, therefore, that a title insurer is not in the business of supplying information when it issues a title commitment or policy of title insurance”²⁴

Some jurisdictions do allow claims in tort against title insurers,²⁵ but even if disclosure of recorded documents is made, title insurance commitments rarely contain detail sufficient for a mine operator or lender. Typically a coal lease may be identified by recording data, with no report or analysis of the lease’s terms.

²¹ Joyce Palomar, 1 Title Insurance Law, § 12:3 (2007).

²² *First Midwest Bank, N.A. v. Stewart Title Guar. Co.*, 843 N.E.2d 327 (Ill. 2006).

²³ *Id.*

²⁴ *Id.* at 335-36. *See also* *Arapahoe Land Title, Inc. v. Contract Financing, Ltd.*, 472 P.2d 754 (Colo. 1970); *Trenton Potteries Co. v. Title Guar. & Trust Co.*, 68 N.E. 132 (N.Y. 1903); *Chicago Title Ins. Co. v. McDaniel*, 875 S.W.2d 310 (Tex. 1994); Cal. Ins. Code §§ 12340.10, 12340.11 (West 2008); Mont. Code Ann. § 33-25-111 (2007).

²⁵ *See, e.g.*, *Altman v. Circle City Glass Corp.*, 484 N.E.2d 1296 (Ind. Ct. App. 1985); *Henkels v. Philadelphia Title Ins. Co.*, 110 A.2d 878 (Pa. Super. Ct. 1955).

As a practical matter, a thousand title insurance commitments (or one commitment covering a thousand tracts) would be of limited value to a coal reserve purchaser and its lender. Such commitments would likely contain thousands of exceptions. Few purchasers or lenders would have the ability or inclination to properly analyze such commitments in the context of the value of the reserve.

[2] — Tract Opinions.

Tract opinions provide title information which is critical to coal mining on a particular tract. Is there complete control of the coal? Are there sufficient mining rights to go with ownership of the coal? Are there any dominant estates that will hinder coal development (oil and gas, CBM, surface estates)? Are the lease terms acceptable? Mining is never prudently conducted without title opinions which answer these questions and contain the critical information relevant to mining.

[3] — Capstone Title Opinions.

A potential purchaser performing due diligence or a lender contemplating a loan on a coal reserve is unlikely to read hundreds of title opinions and less likely still to analyze them in a useful way. A capstone opinion offers a summary of the status of title for the entire reserve and guides the purchaser or lender in its assessment of the property. The subjective nature of the capstone opinion may seem daunting, but it is no more so than assessing the risk of pending litigation, estimating the true value of accounts receivable and many other due diligence tasks. The writer of a capstone opinion will ordinarily be an experienced title analyst and the client will ordinarily be sophisticated in the coal industry, so each will understand the subjective nature of the opinion.

A capstone opinion (1) identifies area-wide failings of title, such as insufficient mining rights or uniform deficiencies in the form of acquisition documents; (2) determines if the title evidence reviewed reveals defects which are excessive in number or scope given the size of the area and targeted mineral formation; and (3) identifies major defects which the recipient's staff, utilizing its expertise and planned use of the reserve, may determine to be

sufficient to render title to the reserve area unacceptable, notwithstanding general approval.

The capstone opinion provides a general opinion on the status of overall title in relation to what could ordinarily be expected for such a reserve. Buyers and lenders know that title is not perfect, but how imperfect is it? The examiner reviews the title opinions, or other title data, reserve wide and concludes that title is, or is not, acceptable, given the standards in the industry. The writer of the opinion relies on his experience in determining whether or not the number and severity of problems is acceptable. The capstone opinion also identifies title concerns applicable to the whole reserve (typically mortgages) or a critical part (typically, property in the immediate mine plan). For an operating coal mine, a serious title problem on a key tract soon to be mined can be a serious title problem for the reserve.

The potential buyer may contemplate a particular operation which the capstone opinion takes into consideration. If the purchaser contemplates a longwall mine, and the lender is lending based on the productivity of such a mine, the opinion will address the appurtenant mining rights needed for that type of operation. If the sales agreement contains rejection or reduction standards,²⁶ the capstone opinion will report on achievement of those standards.

It is important that the capstone opinion format be succinct and direct. The reader is less interested in detail than a conclusion he can rely upon to decide whether to go forward with the transaction.

§ 10.09. Creation and Perfection of Security Interests in Coal.

Since coal reserves are real estate, they may be mortgaged by the owner like any other realty. Generally, forms for loan commitments, credit agreements, promissory notes, mortgages and other transactional documents, if satisfactory for other commercial real estate in the applicable jurisdiction, may also be utilized for coal reserve loan documentation. Of course, as in all

²⁶ See § 10.06 *supra*.

transactions, the forms must be adapted to the terms and peculiarities of the particular transaction. A common example of this in the coal industry is the repayment schedule. Many loans secured by coal reserves have repayment schedules based on production. Typically, repayment is primarily pegged to an amount per ton of coal extracted, but this is usually accompanied by a minimum payment schedule unrelated to production.

Another complexity commonly found in coal reserve loans arises from the variety of interests which the borrower may encumber: fee coal, leaseholds, royalties as coal owner, overriding royalty interests, and production payments, all of which may be classified as real estate.²⁷ When the coal is directly related to a stream of income, the lender has an interest in knowing detail about that stream and credit agreements and other loan documentation generally have accounting and reporting requirements not usually found in ordinary loan documentation. Covenants to protect the collateral are often expanded and may be connected to a single matter critical to the loan collateral, such as compliance with a coal supply agreement.

[1] — As-Extracted Collateral, Article 9 of the Uniform Commercial Code.

As noted in § 10.03, coal in place is real estate but the intent of the borrower is to convert it to personal property. When coal in place is mortgaged, the mortgagor has implied permission to extract the coal without regard to any injury he may thus cause to the lender's collateral.²⁸ Minerals, once severed, are subject to the Uniform Commercial Code.²⁹ In order for

²⁷ See, e.g., *Kentucky Bank & Trust Co. v. Ashland Oil and Transp. Co.*, 310 S.W.2d 287 (Ky. 1958) holding that the right to receive unaccrued mineral royalty was real property in the nature of an incorporeal hereditament.

²⁸ *Minor v. Pursglove Coal Mining Co.*, 189 S.E. 297 (W. Va. 1937); *Young v. Northern Ill. Coal & Iron Co.*, 13 F. 806 (N.D. Ill. 1880); *Ward v. Carp River Iron Co.*, 15 N.W. 889 (Mich. 1883).

²⁹ See *Matter of Fullop*, 6 F.3d 422 (7th Cir. 1993), *rehearing and suggestion for rehearing en banc denied*; and *Federal Deposit Ins. Corp. v. Hulsey*, 792 F. Supp. 729 (W.D. Okla. 1992), *aff'd in part, rev'd in part*, 22 F.3d 1472 (10th Cir. 1994).

the lender to have a complete protection of its collateral, it must also assure that it has perfected its interest in the extracted coal under Article 9 of the Code.

The Uniform Commercial Code Section 9-102(a)(6) defines “as-extracted collateral” as “(A) oil, gas or other minerals that are subject to a security interest that (i) is created by a debtor having an interest in the minerals before extraction; and (ii) attaches to the minerals as extracted; or (B) accounts arising out of the sale at the wellhead or minehead of oil, gas or other minerals in which the debtor had an interest before extraction.” The comments to Article 9 state: “To take account of financing practices reflecting the shift from real to personal property, this Article contains special rules for perfecting security interests in minerals which attach upon extraction and in accounts resulting from the sale of minerals at the wellhead or minehead.”³⁰

Although a separate financing statement may be filed, in practice lenders take advantage of Section 9-502(c) which provides that a mortgage is effective as a financing statement covering as-extracted collateral related to the real property described in the mortgage, provided it satisfies the other requirements for a financing statement (except the requirement there be an indication that it is to be filed in the real property records). Financing statements for as-extracted minerals are to be filed in the same office as mortgages (generally, the county recorder’s office) rather than the state’s central filing location.

§ 10.10. Special Problems for Lenders.

Lenders must know that the collateral for the loan can be placed in commerce if there is foreclosure. Otherwise, it has no value as collateral. Coal reserves can present special problems in this regard.

[1] — Mandates to Mine.

Although uncommon in modern times, a coal lease occasionally contains an obligation to mine. Given the cost of opening a modern coal mine, this

³⁰ See, e.g., U.C.C. § 9-102 cmt. 4.c. (2008).

could be a promise to spend a large amount of money, even hundreds of millions of dollars for certain underground reserves. If the “asset” is really a liability, it will have no value as collateral.

[2] — Assignment Restrictions.

Assignment restrictions are an anathema to lenders and if any significant part of coal reserves contain restrictions on transfer, such as lease provisions requiring lessor consent prior to assignment, the collateral value of the reserves is likely to be considered diminished.

[3] — Holding Costs.

Leases almost always have advance or minimum royalty provisions in order to avoid being declared void as “royalty leases” which lack mutuality.³¹ The extent of this burden is important to the lender. On fee coal, the amount of *ad valorem* taxes generally represents the cost to maintain the asset.

[4] — Evaporating Collateral.

The expiration dates of primary terms on leases are obviously critical elements in analyzing their value as collateral. Of course, all commercial leaseholds have terms limiting their length but coal reserve leases differ because they also have a *habendum* clause extending this fixed term so long as mining continues, into what is known as the secondary term. The collateral may include leases that are already in the secondary term and these may terminate as soon as mining stops, an event rather common for a borrower in default.

§ 10.11. Practical Problems in Coal Reserve Transactions.

There are a few practical problems which seem to commonly occur in coal reserve transactions, mostly related to the size of the reserve and the number of tracts.

³¹ *Munroe v. Armstrong*, 96 Pa. 307 (1880), *Petroleum Co. v. Coal, Coke and Mfg. Co.*, 18 S.W. 65 (Tenn. 1890); *Davis v. Nokomis Quarry, Inc.*, 397 N.E.2d 216 (Ill. App. Ct. 1979).

In large reserves, there is great temptation to attach maps or data base summaries as a substitute for proper legal descriptions. These may fail to give adequate notice and may prevent recording. Recording statutes provide a way to notify the public of the interests of purchaser and lender,³² but it is important that the legal descriptions provide adequate notice by properly describing the property conveyed or mortgaged. Generally, maps are suspect and any reference to a recorded document, such as a coal lease, should include the document number or book/page in order to clearly identify it.

Many local jurisdictions are unaccustomed to mineral transfers and have local rules incompatible to some degree with mineral filings. Recorders have been known to require real estate tax identification numbers for each tract on a thousand tract conveyance, even though such numbers were non-existent and would have to be created by the assessor's office. Others have specific requirements regarding legal descriptions, references to prior recorded documents, font size, margins, and transfer taxes or forms. It is important that these requirements are known prior to closing; otherwise filing may be delayed and protection for the purchaser or lender may be jeopardized.

§ 10.12. Conflicts of Interest.

Certainly conflicts of interest arise in ordinary commercial real estate transactions, but there are reasons why coal reserve transactions are of particular concern. The universe of coal lawyers is small and most law firms which practice in this area represent more than one coal company. While the American coal industry is large and vibrant, there are still a relatively small number of companies that maintain reserves. Lenders active in mineral lending are also few in number. The limited number of companies and lenders, and the limited number of lawyers who represent them, make it common for a law firm to be faced with requests for representation in coal reserve transactions which create a conflict of interest between clients. It is also common for the clients to deem it in their best interest to waive the conflicts.

³² Loeb v. Conley, 160 Ky. 91 (1914).

Loyalty and independent judgment are essential elements of the lawyer-client relationship. For the practitioner, it is critical to (1) clearly identify the clients, (2) recognize the conflicts of interests, (3) decide whether the conflict is waivable, (4) fully explain the conflict to each impacted client and, if the conflict is waivable, and (5) obtain written waivers of the conflict from each party.

The Model Rules of Professional Conduct of the American Bar Association provide at Section 1.7, Conflict of Interest, Current Client:

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

- (1) the representation of one client will be directly adverse to another client; or
- (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

- (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
- (2) the representation is not prohibited by law;
- (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
- (4) each affected client gives informed consent, confirmed in writing.

It is especially common for counsel to be asked to represent the purchaser and lender with regard to title due diligence. Because their interests are not identical, this can create at least some potential conflict. However, the time

and cost involved in title due diligence is so great that it would rarely make sense for the purchaser and lender to separately perform title due diligence. This area is one of the most common for waivers of conflict of interest.

A conflict of interest is created when the coal purchaser/borrower's attorney is asked to deliver counsel's opinion to the lender regarding the status of the coal purchaser and the enforceability of loan documents under local law. These requests are common in all major real estate transactions, as are waivers of them. If a lender is new to the mineral industry, it may even ask the purchaser/borrower's attorney to prepare loan documentation.

In almost all instances, work performed by the attorney for the lender is paid for by the borrower. This circumstance creates a conflict of interest discussed in Comment 13 to the above stated Rule 1.7:

A lawyer may be paid from a source other than the client, including a co-client, if the client is informed of that fact and consents and the arrangement does not compromise the lawyer's duty of loyalty or independent judgment to the client. See Rule 1.8(f). If acceptance of the payment from any other source presents a significant risk that the lawyer's representation of the client will be materially limited by the lawyer's own interest in accommodating the person paying the lawyer's fee or by the lawyer's responsibilities to a payer who is also a co-client, then the lawyer must comply with the requirements of paragraph (b) before accepting the representation, including determining whether the conflict is consentable and, if so, that the client has adequate information about the material risks of the representation.³³

Because of the small universe of companies and counsel, it is quite common for a lawyer to have, at some time in the past, provided services to both purchaser and seller. The law firm may have previously examined title to a reserve area for the seller and now the purchaser and lender need an update. Examining title again by another law firm may cause great delay and

³³ Model Rules of Prof'l Conduct R. 1.7 cmt. 13 (2002).

expense, so any conflict of interest created by this situation is often waived. The practitioner should be familiar with the requirements of ABA Rule 1.9, or its jurisdictional equivalent, which deals with conflicts of interest arising from representation of former clients.

