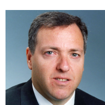
Beware of Pushing the 'Defeasance Button' Too Soon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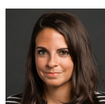
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One of the rights a borrower has in a fixed-rate CMBS loan transaction in lieu of prepayment is called defeasance. In general, defeasance allows the borrower to "prepay" its existing loan after a specified lock-out period by substituting for the real estate collateral, which serves as security for the loan, a basket of U.S. government-backed securities, which will mirror and generate cash flow sufficient to pay the ongoing debt service of the loan and pay the principal amount due at maturity. The reason for this collateral substitution is that the bondholders of CMBS loan transactions purchase their securities with an expectation of receiving a certain yield, and they expect their interest payments to match their yield expectations. A prepayment would reduce the yield the buyers of bonds expect, especially those that purchased at a premium or interest-only buyers. Accordingly, when the real estate collateral is substituted for matching U.S. government securities, the CMBS transaction continues to receive debt service payments on the existing loan from the securities as if the real estate collateral were still in place. It is also important to note that because most CMBS loan transactions are intended to qualify, for U.S. tax purposes, as a real estate mortgage investment conduit (a "REMIC"), the loan defeasance provisions must meet certain requirements in order for the trust to continue to qualify as a REMIC. This includes, among others, that the collateral consist of qualifying U.S. government securities, and that the defeasance not take place within two years of formation of the REMIC. When the election to defease is made, there are several logistical steps that must be accomplished for a defeasance to close simultaneously with a refinance involving a new lender. The closing of both the defeasance and the new loan must happen within a specified 24-48 hour period or the borrower will incur significant breakage costs and fees.

In a non-mortgage tax jurisdiction, there are several steps that are required in a defeasance. First, the underlying existing loan documents must expressly give the borrower the right to defease, which provisions generally require, among other things, the length of the lock-out period before the borrower may defease

(typically 2 to 3 years from the closing date of the existing loan) and the type of securities that can replace the real estate collateral (as mentioned above, these must be solely "government securities" as defined in Section 2(a)(16) of the Investment Company Act of 1940 and within the meaning of Treasury Regulation Section 1.860G-2(a)(8)). Once the borrower elects to defease, they must send a notice to the servicer 30-60 days before the desired closing date of the defeasance and the new loan. The borrower would then typically engage a defeasance consultant and accountants to structure the basket of securities that will replace the real estate collateral to provide a stream of debt service payments in at least the amount that the existing real estate collateral would have provided. The borrower must also form a successor borrower entity which will assume the existing borrower's obligations under the existing loan and own the new substituted securities collateral.

In these beginning stages, the servicer's counsel is also engaged to draft the defeasance loan documents. The core defeasance documents are: (1) a pledge and security agreement, under which the existing borrower pledges the U.S. government securities as collateral to the existing lender (this pledge replaces the mortgage), (2) an account agreement, which establishes an account with a securities intermediary (usually a bank) that will hold the pledged U.S. government securities and governs the intermediary's role in the administration of the securities account, and (3) an assignment, assumption and release agreement, under which the existing borrower assigns, and the successor borrower assumes, the new pledged collateral, the pledge and security agreement and the account agreement, which results in the successor borrower becoming the borrower under the existing loan with the existing lender. The new lender is not a party to these documents and does not play a role in the defeasance transaction, unless the existing real estate collateral is in a state like New York that levies significant mortgage tax (as discussed in the next paragraph). Once the defeasance documents are finalized, the securities portfolio has been selected and approved by the borrower and the servicer, and the new loan is ready to close, the borrower will then give the servicer's counsel authorization to cause the securities to be purchased. Once the borrower has given this authorization, it is then obligated to complete the purchase of the securities and the defeasance transaction (which must close within 24 hours of this authorization). The next day, amounts necessary to defease the existing loan and purchase the securities must be funded into an escrow account (along with any other closing transaction costs, new loan proceeds, etc.), and then the escrow agent releases the required defeasance amount to the intermediary in order to allow the intermediary to purchase the securities for the securities account established pursuant to the account agreement. The existing borrower owns these new securities for a moment in time and then pledges them to the existing lender, who simultaneously releases the real estate collateral, and then the successor borrower assumes the new securities and obligations under the defeasance and existing loan documents. Once the escrow agent has confirmation that the defeasance has closed, the rest of the funds for the new loan transaction are disbursed and the entire transaction is then considered closed. There are usually early cut-off times for the defeasance funds to be received by the intermediary in order for the entire loan to close on that second day.

In jurisdictions which levy significant mortgage tax when a borrower incurs new mortgage debt (such as New York), the incoming lender will usually agree to take an assignment of the existing debt from the existing lender so that the borrower

does not have to pay mortgage tax as if it were a new loan. The borrower will only be required to pay mortgage tax on the difference in any increase from the outstanding balance of the existing loan to the new or refinanced loan. In a "New York"-style defeasance, the end result is the same: a successor borrower becomes obligated to the existing lender and the loan is instead secured by U.S. government securities. The mortgage tax issue adds an extra step to the defeasance and the new lender becomes a key player. This extra step involves assigning the existing loan to the new lender first. In order to accomplish this, the following additional defeasance documents must be drafted and executed: (1) an allonge to assign the existing note from the existing lender to the new lender, (2) a new defeasance promissory note under which the new lender issues a new note to the existing borrower which mirrors the existing note in the amount of the outstanding balance of the existing loan and is secured by the pledge agreement and the account agreement (which are both signed by the existing borrower and the new lender instead of the existing lender), (3) an allonge to the new defeasance note which is endorsed by the new lender and assigned back to the existing lender, and (4) an additional assignment and assumption agreement whereby the new lender assigns the new defeasance note, the pledge agreement and the account agreement to the existing lender. The new lender will hold the securities as collateral for a period of time before it receives the real estate collateral. Once the defeasance documents are finalized and the new loan is ready to close, the same closing steps are followed as in a standard defeasance outlined above, except that the securities to be purchased are circled (*i.e.*, identified and committed to be purchased) by the securities intermediary for an additional day. In this case, the closing must occur within 48 hours of the borrower "hitting the defeasance button" instead of the next day because of the extra day needed to "circle" the securities.

Because the proceeds from the new lender's loan are used to purchase the securities and close the defeasance, the new lender needs to be ready to close on the same day as the closing of the defeasance. In a perfect world, the new loan closes within the 24-48 hour window that is allotted for the defeasance to close. Once the borrower "hits the defeasance button," the borrower becomes obligated to purchase the securities within the window allotted for closing the defeasance. If there is an issue with the new loan transaction and the new lender decides not to close within that window, the borrower will be responsible for all breakage costs of the defeasance, including costs incurred by the securities intermediary and legal fees.

When involved in a loan transaction that will require a defeasance in order to close, it is important to consider how the various steps, the location of the real estate collateral and the role of the parties will affect the timeframe for the closing. As a practice tip, the incoming lender's counsel and the borrower's counsel should have a conversation early on in the transaction to make sure all the parties (including the servicer and servicer's counsel) are on the same page regarding the closing timeframe because once the borrower "pushes the defeasance button," the borrower must close the defeasance and the new loan within the allotted window or face incurring significant costs in "breaking" the defeasance transaction.