

Dollars and (Common) Sense: Prepayment and Defeasance

Defeasance first became a part of the commercial mortgage-backed securities (“CMBS”) world during the early 1990s as a mechanism to make pricing on CMBS more favorable and is now a fixture in the CMBS industry. Defeasance eliminates the prepayment risk associated with fixed-rate loans by providing an alternative mechanism under which the borrower can obtain a release of the lien of the mortgage securing the loan to accommodate a sale or refinance of the real estate collateral by delivering government securities as substitute collateral for the loan. In the CMBS industry, certificateholders holding securities backed by the securitized loans want predictable and uninterrupted cash flow. Prepayments whether voluntary or involuntary, create a disruption to this cash flow. In particular, interest-only certificateholders (“IO-holders”) who invest in the right to receive distributions only from the interest collected on securitized loans do not want CMBS loans prepaid because such a prepayment would cut off the IO-holders’ right to receive interest from the prepaid loan.

To address the interests of the certificateholders in receiving a predictable and continuing cash flow, virtually all CMBS loans prohibit a borrower’s prepayment of a loan prior to the expiration of a specified “lock-out” period. In the CMBS market, this lock out period typically extends until the last 60-90 days of the loan term. Without this prohibition on the borrower’s ability to prepay the loan, investors in the Real Estate Mortgage Investment Conduit (“REMIC”) trust holding the CMBS loans would hold the interest rate risk associated with the loans that the REMIC trust holds. If interest rates increased, rational borrowers would simply sit tight and continue to perform their loans (which would carry an interest rate below current market conditions). In contrast, if interest rates decreased, shrewd borrowers would pay off their loans in order to take advantage of the lower interest rate environment in the market.

Defeasance is a means to balance the effect of the loan’s lock-out provisions against the borrower’s need to obtain a release of the REMIC trust’s lien on the related collateral (as may be the case in a refinancing or sale of the collateral).

What is Defeasance?

Defeasance is the substitution of one type of collateral for another. In the CMBS industry, defeasance is the process by which the real estate and related collateral securing a mortgage loan is replaced by government securities (as defined by the Investment Company Act) in order to release the original collateral while keeping the payment stream for the mortgage loan intact. In a defeasance, the original loan continues to be held by the REMIC. The government securities that replace the real estate collateral are modeled so that the income stream from those securities replicates the remaining payments due under the terms of the loan. It is important to remember that the loan obligation is not cancelled when defeasance occurs, as would occur with a prepayment. Instead, the note and loan remain in full force and effect through the maturity date, with the payments under the loan being paid as the government securities redeem.

Defeasance is favorable to certificateholders holding certificates backed by securitized loans because the opportunity for a borrower to default following a defeasance is significantly reduced (thereby avoiding the

risk of early payment due to acceleration of the loan). Default risk is reduced because the lender holds government securities which the borrower has no right to sell or liquidate and which make the loan payments directly.

REMIC Qualification and Defeasance

When mortgage loans are securitized in the CMBS industry, they are put into REMICs which are governed by complex tax regulations. A REMIC generally retains its tax-free status only if the REMIC holds “qualified mortgages” and “permitted investments.” Loans held by REMICs that have been significantly modified cannot, under most circumstances, be considered “qualified mortgages” as, by definition, an obligation is a “qualified mortgage” only if the obligation is contributed to the REMIC within the three-month period ending on the REMIC startup day. A significant modification of a qualified mortgage held by a REMIC outside this three-month period can result in a loan losing its status as a qualified mortgage.

Under general tax rules relating to taxable exchanges of nonrecourse loans, a substitution of a “substantial amount” of the collateral for a nonrecourse loan results in a significant modification of that loan. Given the foregoing, how then is the 100% substitution of collateral (from real estate to government securities) that results from a defeasance of a loan permitted under the REMIC rules applicable to qualified mortgages?

REMIC Defeasance Requirements

Under a special REMIC rule, a release of the REMIC’s lien on real property collateral will not cause the related loan to cease being a qualified mortgage provided the defeasance transaction satisfies four conditions.

- § First, the borrower’s loan documents must “allow for” the defeasance.
- § Second, the borrower must pledge substitute collateral comprised of “government securities” within the meaning of the Investment Company Act.
- § Third, the defeasance transaction cannot occur within the period ending two years after the REMIC’s startup day (see below).
- § Fourth, the defeasance transaction must be undertaken to facilitate the sale of the related real estate collateral or some other customary commercial transaction (such as a refinancing) and cannot be part of an arrangement designed to collateralize the REMIC with obligations that are not real estate mortgages.

By allowing for a defeasance under these circumstances, the REMIC rules balance the need to prevent a borrower’s prepayment of its loan, while at the same time allowing borrowers to obtain the release of the REMIC’s lien on the related real property collateral. Because the borrower’s loan documents must “allow for” defeasance, it is critical that the loan documents contain detailed defeasance provisions which permit the borrower to defease the loan subject to the satisfaction of various conditions. Because of the disastrous REMIC tax consequences that may result from collateral substitutions, care must be taken to insure that a collateral substitution incident to a defeasance satisfies the four conditions for REMIC-qualified defeasances noted above. If these conditions are not satisfied, the defeasance transaction can result in the

REMIC holding a loan that is no longer a qualified mortgage and may cause the REMIC to lose its tax-free status.

An additional requirement imposed by the REMIC rules is a prohibition on the defeasance of a loan held by a REMIC prior to the second anniversary of the startup day of the REMIC, which is the first day when securities in that REMIC are issued. Accordingly, standard defeasance provisions incorporated into loan documents will include a prohibition on defeasance or a defeasance “lock-out period” during this two-year prohibited period.

What Types of Securities Can Be Used?

The REMIC rules require that defeasance collateral consist of “government securities” as defined in the Investment Company Act. These are defined as “any securities issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to the authority granted by the Congress of the United States.” U.S. Treasury obligations, Fannie Mae obligations, and Freddie Mac obligations are included within the scope of defeasance collateral permitted by the REMIC rules.

The loan document provisions relating to defeasance may require a specific type of government security that must be delivered as defeasance collateral and often specify the use of U.S. Treasury obligations. If loan document provisions require U.S. Treasury obligations to be delivered as defeasance collateral, most servicers will not allow a modification of those provisions to allow agency paper such as Fannie Mae or Freddie Mac obligations because of the perceived higher creditworthiness of U.S. Treasury obligations. The loan documents will also require that the government securities be non-callable and non-prepayable to assure predictable cash flow.

How is Defeasance Accomplished?

In general terms, the borrower acquires and pledges government securities in amounts and having maturities designed to mimic the payment stream required under the terms of the mortgage loan. This substitute defeasance collateral is then transferred to, and the loan is then assumed by, an unaffiliated special purpose entity which becomes the new borrower on the defeased loan (the “Successor Borrower”).

1. The documents used to evidence the defeasance transaction are:

Defeasance Pledge and Security Agreement: Pursuant to the Defeasance Pledge and Security Agreement, the borrower grants the lender a security interest in the government securities that will replace the real estate collateral (together with a security interest in the proceeds from those government securities) to secure the payment and performance of all amounts payable under the applicable loan. The note continues in full force and effect after the date of the defeasance, secured by the government securities. The Pledge Agreement contains detailed representations and warranties from the borrower with respect to the lender holding a perfected security interest in the securities, the sufficiency of the securities to cover the payments due under the loan, and other representations and warranties that track the defeasance requirements of the loan documents. The Pledge Agreement replaces the mortgage as the instrument granting the lender the security for the loan. Parties to the Pledge Agreement are the borrower, securities intermediary (see below), trustee of the REMIC, and the servicer.

Defeasance Account Agreement: The Defeasance Account Agreement governs the responsibilities of the securities intermediary (typically either Wells Fargo Bank, N.A. or LaSalle Bank National Association) to hold the pledged government securities in a pledged account and to apply the income stream from the securities each month to the monthly payments and the final payment due at maturity under the loan. The Account Agreement requires the securities intermediary to wire the proceeds from the securities each month directly to the servicer's collection account to cover the monthly debt service payments due and the final amount due at maturity. The Account Agreement further establishes the account with the intermediary where the securities will be held and sets forth the manner in which the account will be operated and managed by the intermediary during the life of the loan. Pursuant to the Account Agreement, the lender has the right to direct all further transfers and sales of the pledged securities and neither the borrower nor the successor borrower have the right to cause or request the purchased securities be sold while the loan is outstanding. The parties to the Account Agreement are the borrower, securities intermediary, trustee of the REMIC and the servicer.

Defeasance Assignment, Assumption and Release Agreement. The Defeasance Assignment, Assumption and Release Agreement evidences the assignment by the borrower of its rights to the government securities constituting the defeasance collateral to the Successor Borrower and the assumption by the Successor Borrower of all of the borrower's rights and obligations under the defeasance documents, including the Pledge Agreement and Account Agreement. Additionally, under the Assignment, Assumption and Release Agreement, the borrower is released from liability under the loan documents (including the Note) and the defeasance documents, except for certain "bad boy" carve-out items, such as fraud, misrepresentation, and surviving hazardous waste indemnification obligations. Parties to the Assignment, Assumption and Release Agreement are the borrower, intermediary, trustee of the REMIC, servicer, and the Successor Borrower.

Certificate of Borrower: Pursuant to the Certificate, the borrower confirms that all of the conditions to defeasance set forth in the loan documents have been met. The certifications in the Certificate of Borrower track the defeasance requirements in the loan documents.

Waiver and Consent: Pursuant to the Waiver and Consent, the lender waives any technical defeasance requirements that are not complied with in connection with the defeasance. Items typically waived by servicers are failure to give the 30 or 60 day advance notice, failure to defease on a scheduled payment date, and the failure to collect interest through the actual defeasance date. If there are any scrivener's errors or ambiguities in the defeasance provisions, the Waiver and Consent will address those issues as well. The borrower and the trustee of the REMIC are parties to the Waiver and Consent.

2. Required Opinions: Most loan documents and Pooling and Servicing Agreements (which govern the servicers' responsibilities with respect to the loan securitized in the REMIC) require that a REMIC opinion be given that confirms that the defeasance does not disqualify the REMIC or create a prohibited transaction under the REMIC rules and a perfection opinion confirming that the lender has a perfected security interest in the pledged securities. Servicer's counsel typically gives the REMIC and perfection opinions. Also, borrower's counsel will be required to give an authorization/enforceability opinion confirming the enforceability of the defeasance documents against the borrower. Finally, the successor borrower's counsel must also give an authorization/enforceability opinion confirming the enforceability of

the defeasance documents against the successor borrower and a nonconsolidation opinion confirming that assets of the successor borrower would not be consolidated with those of any affiliates of the successor borrower who file bankruptcy.

3. Accountant's Verification Report: A standard requirement for all defeasances is that an accounting firm that has been approved by the rating agencies and meeting the requirements of the loan documents issue a verification report confirming that the securities are sufficient to cover all remaining payments due under the loan. The accountants will review the amortization schedule provided by the servicer and the securities portfolio and issue a report addressed to the trustee of the REMIC, the servicer, the borrower, the successor borrower, and any rating agencies, confirming that the securities are adequate to cover the remaining payments due on the defeased loan.

4. Successor Borrower: To protect the government securities which will constitute the new collateral for the loan from being subject to the claims of creditors or liens relating to trailing liabilities of the borrower, the rating agencies require, and it is standard in the CMBS market for, an unaffiliated newly-formed successor borrowing entity to assume each defeased loan simultaneously with the closing of the defeasance. Most loan document provisions relating to defeasance also require that a successor borrower assume the loan to ensure that the government securities would not be subject to the claims of the borrower's creditors that may have claims or liens related to the borrower's ownership of the real property. There are several companies offering the service of forming successor borrowers and it is current market standard for such third party companies to be used.

5. Defeasance Consultant. The defeasance requirements of loan documents require that the income from the pledged government securities must be sufficient to cover all of the payments due under the loan through and including the maturity date. Typically a defeasance consultant is used to assist the borrower in selecting the portfolio of securities for a defeasance transaction. The defeasance consultant obtains the relevant loan information and amortization schedule and then identifies a portfolio of securities that is available in the market that have the required redemption dates to fund the remaining loan payments. The adequacy of the securities portfolio is then verified by the accountant's report (see above).

6. Closing Mechanics. A three-day process is utilized to close a defeasance as follows:

- § Day One—The securities are purchased (typically using funds of the defeasance consultant). The lender's counsel finalizes the closing instruction letter which includes all final defeasance costs and lender's counsel sends the mortgage release out to the title company/escrow agent. The closing instruction letter contains disbursement and recording instructions for the title company/escrow agent to follow on Day Three.
- § Day Two—The borrower's refinance or sale transaction is closed and funded into escrow. The title agent/escrow agent receives the closing instruction letter and the mortgage release.
- § Day Three—The defeasance consultant arranges for delivery of the securities to the securities intermediary. Upon confirmation from the intermediary of receipt of the securities, lender's counsel authorizes an initial wire to the intermediary for the cost of the securities. Upon confirmation by the intermediary of receipt of the wire for the cost of the securities and settlement of the trade for the securities, lender's counsel authorizes the title company/escrow agent to record

the mortgage release and the deed or refinance mortgage, as applicable, and authorizes the escrow agent to make all remaining disbursements.

The government securities are purchased as book-entry securities. No physical certificates are delivered. Instead, ownership of the securities is recorded by a book-entry on the records of the securities intermediary. Delivery of the securities is handled by the defeasance consultant, who is either a licensed broker dealer or who works through a licensed broker dealer. The lender's security interest in the book-entry securities is perfected once the intermediary, acting as the lender's custodian, records by book entry that it is holding the securities for the account and benefit of lender and not for the borrower and sends the lender confirmation of its book entries in favor of the lender.

It is standard for the borrower to use the proceeds of its sale or refinance to purchase the securities; however, in some instances, some borrowers will use their own cash to purchase the securities.

7. Costs to be Paid: The borrower will pay the following costs in connection with a defeasance:

- § Cost of the accountant's verification report regarding the adequacy of the defeasance collateral
- § Cost of rating agency approvals, if required
- § Fees of securities intermediary
- § Fees and costs of the company forming the successor borrower
- § Fees of the defeasance consultant
- § Borrower's counsel's fees to render the authorization/enforceability opinion
- § Lender's counsel's fees and costs
- § Servicer processing fee (and any required special servicer fees).

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