New York Law Journal
Real Estate Trends
WWW.NYLJ.COM
An ALM Publication
VOLUME 254—NO. 4
WEDNESDAY, JULY 8, 2015

TRANSACTIONAL REAL ESTATE

The Role of Defeasance In Real Estate Finance


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Defeasance is now a common feature of real estate finance, allowing a borrower to effectively prepay a loan that is not by its terms prepayable. A defeasance is a substitution of a loan's real estate collateral with collateral consisting of securities—thus freeing up the real estate in order that it may be sold or refinanced—and a corresponding substitution of a new borrower for the original borrower. Defeasance is often seen in commercial mortgage-backed securities (CMBS) loans, in large part because of restrictions on prepayment of such loans that arise under the statutory scheme governing the real estate mortgage investment conduits (REMICs) used to package these loans for sale to investors.

As a general matter, prepayment restrictions and penalties protect lenders from borrowers' prepaying their loans whenever interest rates go down (which would likewise force lenders to reinvest the prepayment funds at the then lower interest rate). Prepayment penalties can take a variety of forms, including amounts based on a simple percentage of the principal being prepaid and yield maintenance premiums based on the differential between the interest that would have been received by the lender on the amount being prepaid and the interest that would be earned on specified investments if the amount being prepaid were used to purchase such investments.

Prepayment restrictions in the CMBS context raise a special set of issues because (i) the tax code restricts how and when prepayments can be made on CMBS loans and (ii) prepayment disproportionately affects certain categories of CMBS investors. As a consequence of these factors, defeasance has become the preferred method of addressing prepayment in CMBS loans.

In a defeasance, refinancing or sale proceeds or other cash amounts are used to purchase substitute collateral for the mortgage loan (which survives and is secured by the substitute collateral). This protects the economic expectations of the CMBS investors while allowing the borrower the flexibility to sell and/or refinance its property free of the mortgage loan. Because interest rates have been at historic lows for some time now, any borrower in a position to refinance has likely done so already in anticipation of the inevitable and predicted swell in interest rates. For the time being, defeasance is most likely to arise in the context of a property disposition or when a borrower seeks to tap into property equity through a cash-out refinancing.

The substitute collateral in a defeasance consists of a "basket" of U.S government securities purchased by the existing borrower and assigned to a newly formed, unaffiliated successor borrower. These securities are selected to produce a monthly payment stream that replicates what the existing borrower would have paid in monthly debt service for the remaining term of the loan. The successor borrower (i) assumes most of the existing borrower's obligations under the loan (though the existing borrower generally retains certain liabilities relating to the formerly mortgaged property or the defeasance itself,—e.g., the obligation to indemnify the lender for environmental matters that survive repayment or potential liabilities arising under representations relating to the defeasance) and (ii) pledges the securities as collateral for the assumed debt. When the security interest in the new collateral is granted, the existing borrower's real property is released

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from the lien of the security instrument (or, as is common in New York, the lien of the security instrument is assigned to the new lender).

The documents effecting the defeasance are typically prepared by the loan servicer's counsel and generally include: (1) a pledge agreement providing for the pledge of the securities to the securitization trust, (2) an accountant agreement that describes how a "securities intermediary" will receive payments from the securities and use them to make monthly debt service payments, (3) an assignment, assumption and release agreement that describes the transfer of rights and obligations from the existing borrower to the successor borrower and the release of the existing borrower and (4) a waiver and consent agreement that waives certain defeasance provisions in the original loan documents (for example, a requirement to obtain rating agency approval of the defeasance or a minimum notice period if the defeasance is being conducted on an expedited basis).

REMICs and Prepayment

CMBS loans are originated for the purpose of being sold into a securitization trust that makes a tax election to be treated as a REMIC. REMICs do not pay entity-level income tax on the receipt of interest payments provided that the REMIC complies with certain requirements imposed by the tax code. The code imposes serious consequences for noncompliance. For example, REMICs must hold "qualified mortgages" which are "principally secured" by real property. The release of a portion of the property securing a mortgage loan (or the release of one or more properties in a multi-property mortgage transaction) in connection with a partial prepayment triggers tests relating to whether the related mortgage loan remains a qualified mortgage.

After giving effect to a release, a loan continues to be principally secured by real property if (a) the fair market value of the remaining property or properties (as of the date of the prepayment) is at least 80 percent of the outstanding balance of the loan (after giving effect to the prepayment) or (b) the fair market value of the remaining property or properties exceeds the fair market value of the mortgaged property prior to the release (e.g., if the borrower encumbers a more valuable property in substitution for the released property). [26 CFR 1.860G-2(a-b)]. If the loan fails these tests, the REMIC as a whole could become subject to entity-level taxation and any further payments received on account of the disqualified loan could be taxed at 100 percent.

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The draconian effect of disqualification prompts CMBS lenders to impose significant prepayment restrictions. Assuming prepayment is not barred outright, it is very common to see provisions that precondition prepayment on (i) the loan's continued qualification under the valuation tests after giving effect to the prepayment and release and (ii) a minimum prepayment in an amount sufficient to generally assure that the mortgage remains a qualified mortgage. These provisions naturally affect the economics of potential property dispositions and may be untenable to the borrower.

Alternatively, the tax code provides a safe harbor against disqualification if the desired property release is accomplished in connection with a defeasance that meets certain requirements. [26 CFR 1.860G-2(a)(8)]. The defeasance must occur not less than two years after the REMIC's "start-up date" (and CMBS loans are typically locked out to defeasance during this period), but the REMIC valuation tests that apply to actual prepayments and releases do not apply to defeasance. Defeasance may therefore give the borrower more flexibility than a prepayment to refinance or dispose of mortgaged assets (although note that lenders typically still require a minimum release price of at least 110-120 percent of the allocated loan amount for the released property, notwithstanding there being no such requirement in the tax code). Moreover, the lender can take greater comfort that the release will not result in REMIC disqualification.

CMBS Bondholders

The use of defeasance in CMBS loans also results from the manner in which such loans are securitized and marketed to investors. The attractive interest rates offered in CMBS loans are the result of loan originators aggregating loans and then slicing and repackaging them into tranches. Interests in these tranches (i.e., bonds) can be sold to a wide range of investors, resulting in an overall lower cost of capital than a balance sheet loan. The senior tranches are typically sold to investors at a yield slightly less than the interest rate of the note given the lower risk profile of those tranches. Loan originators commonly structure a subordinate, interest-only strip—(the "IO") that is paid from the loan interest in excess of the interest necessary to service the senior principal and interest tranches. Originators offer the principal/interest tranches to investors at close to "cost" or par, and they use the IO to generate most of their profits. Thus, the overall competitive pricing of the senior bonds—and consequently the competitive rates of the loans included in the securitization—depends, in part, on the IO and the investors who purchase such interests.

Prepayment is a greater issue for IO holders (and any other bondholders whose investment is tied to interest payments) than for the typical lender. An IO holder's investment consists exclusively of the right to collect a revenue stream derived from monthly payments on the loan over the life of the loan in excess of payment due on the other tranches—IO holders typically are not entitled to payments on account of principal repayments under the related loans. Hence, a borrower's prepayment (which is passed on to the senior note holders upon receipt) eliminates the IO holder's revenue stream and reduces or eliminates the value of its investment. A simple lump-sum prepayment penalty may not adequately compensate the IO holders because such a payment fails to reproduce the present value of the IO buyers' original investment. Yield maintenance (if properly formulated) would compensate bondholders for the present value of their investments, but yield maintenance premiums are sometimes exclusively reserved for a one class (or a subset) of bondholders (to the exclusion of the IO holders and the senior bondholders). Defeasance, on the other hand, preserves the status quo across all tranches.

Because defeasance offers comfort against both the risk of REMIC disqualification and the reduction in the value of the IO holder's investment, it has become the preferred method of accommodating a CMBS borrower's need for flexibility to effectively prepay its loan. Moreover, government securities are a secure form of collateral that largely eliminate any risk of default. For these reasons (and because preserving the status quo is generally preferable to liquidation for bondholders), CMBS loans that provide for defeasance generally price more favorably with CMBS investors than loans that provide for yield maintenance. In such cases, borrowers can expect that the interest rate spread in a loan that provides for defeasance will be lower than the spread in a loan that provides for yield maintenance. Nevertheless, defeasance is not without its own costs, so the reduced spread must be balanced against the costs of actually defeasing a loan.

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Defeasance Costs

Defeasance results in transaction costs that would not be incurred in the case of a prepayment. A defeasance is a complex set of transactions that typically takes weeks or longer to orchestrate. The borrower must (a) negotiate various defeasance-related contracts (including engaging a defeasance consultant), (b) obtain a portfolio of securities that replicates the debt service payment stream and (c) obtain various legal and accounting opinions.

In addition, a defeasance sometimes results in residual value that may be difficult for the borrower to recover. Although securities portfolios can efficiently replicate a loan's payment stream, additional interest ("float") beyond what is payable under the loan can accrue if the timing of the securities maturing does not exactly match the loan's monthly payment dates. Residual value also results when a borrower has the right to prepay the loan at par and without penalty a short period prior to the loan's maturity date (a "par repayment right"), but the borrower is nonetheless required to post substitute collateral that makes payments through the maturity date. The residual value in this scenario can be several months' worth of interest payments. Residual value can be difficult for the borrower to recover given that the borrower retains virtually no control rights once the defeasance occurs. The foregone residual value often ends up being just another cost of defeasance.

Borrowers frequently hire defeasance consultants to mitigate the costs of a defeasance. Consultants can often manage the defeasance process more efficiently than either borrowers or general transaction counsel. Consultants can also advise how to negotiate defeasance provisions in new loan documentation in a way that is advantageous to the borrower--e.g., advising borrowers to negotiate for a right to designate the successor borrower so that the borrower can more easily recover the residual value—although lenders may resist such provisions.