

Property & the Law

Navigating a 'New York-style' Defeasance

Mortgage recording taxes can be significant, but the New York-style defeasance offers a way to minimize those taxes. In New York State (and certain other states), it is possible to avoid paying mortgage-recording taxes on the existing debt secured by a property, even when the loan documents require defeasance.

Most fixed-rate conduit loans, such as those backing CMBS, prohibit prepayment throughout the loan term, except during the last few months of the term. Such a prepayment restriction would be problematic for a property owner who wants to sell or refinance, so the loan documents allow the borrower to obtain a release of the real estate from the lien of the mortgage by defeasing the loan. In a typical defeasance, the borrower uses proceeds from a sale or refinance to purchase a portfolio of US government securities that generate sufficient cash flow to make all remaining debt service payments. The securities are pledged to the lender as collateral for the CMBS loan, and in return, the lender releases the real estate from the lien of the mortgage.

In New York and some other jurisdictions with significant mortgage recording taxes, it is common for the borrower to assign the existing note and mortgage to the refinance lender or the buyer's lender, as applicable, as part of a strategy to minimize mortgage recording taxes. This type of assignment is fairly routine for notes that otherwise can be prepaid and canceled. But what if the note must remain outstanding with the original lender after a defeasance?

Fortunately, the same mortgage recording tax savings can be achieved with what has become known as a "New York-style" defeasance. There are just a few more steps.

STRUCTURE

In a defeasance, the promissory note remains outstanding, but after closing, it is secured by a portfolio of US government securities instead of real estate. As a result, the REMIC trust cannot simply assign the existing note and mortgage to the new lender and forget about it. Because the existing note must be defeased, additional steps are required to achieve the same tax savings. Once the existing loan is assigned to the new lender, the new lender issues a "mirror note," called a defeasance note, in an amount equal to the outstanding balance of the existing loan. The defeasance note is then assigned back

to the existing lender (the REMIC trust) along with a pledge and security agreement and an account agreement that the new lender and the borrower sign.

In the end, the existing lender holds the defeasance note secured by the portfolio of government securities pursuant to the defeasance pledge and security agreement, and the new lender has the original note secured by the real estate tied to the original mortgage.

CRITICAL COMPONENTS

Here are some key components of a New York-style defeasance:

- **Weigh the costs involved.** The new lender, the existing lender and their respective counsel may charge additional fees for accommodating the New York-style defeasance structure, so it is important for the party benefiting from the structure to weigh the potential tax savings against the additional costs.

- **Additional opinion requirement.** If the real estate is located in a state other than New York, the servicer's counsel usually requires a tax opinion from the borrower. The exact form of the opinion will vary depending on the counsel and the location of the property.

- **Refinance considerations.** A New York-style defeasance requires the cooperation of both the loan servicer for the existing loan and the refi lender, so it is important to make sure that the refi lender is comfortable with its role in the process.

- **Sale considerations.** In a sale transaction, the buyer's lender must agree to the New York-style defeasance for the buyer to avoid unnecessary mortgage recording taxes, and the seller must be willing to enter into the defeasance note, pledge agreement and account agreement. In other words, to achieve the mortgage tax savings, the buyer will need to make sure that its lender and the seller are on board.—RENY



Davis



Holland



Ahern

The views expressed in this article are those of the authors and not Real Estate New York.

Jon Davis, Dawn Holland and John Ahern are originator, deal manager and VP of sales for New York, respectively, at Commercial Defeasance LLC. Ahern can be reached at 212-404-2225.