# Anatomy of a Defeasance

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## I. Introduction

A. Background. Many CMBS (commercial mortgage-backed securities also called securitized or conduit loans) prohibit prepayment. However, in lieu of prepaying the loan, after a lockout period (usually three years), the borrower is permitted to pledge US treasury obligations as substituted collateral and obtain the release of the liens encumbering the property. This process is known as “defeasance.” The reason that conduit loans must be defeased rather than prepaid is that most conduit loans are held in REMICs. The pass-through tax treatment of a REMIC generally requires that the REMIC invest only in “qualified mortgages.” However, IRS regulations permit a defeasance to be done in conjunction with the sale or refinancing of the mortgaged property under Treas. Reg. 1.860G-2(a)(8). Although simple in concept, a defeasance can be difficult in practice.

B. Substitution of Collateral. From the lender’s perspective, the key to a defeasance transaction is to receive substituted collateral in a way that (1) will not cause any interruption in the payments under the note, and (2) will not cause the note to be paid in full for federal income tax purposes; and (3) to meet the IRS requirements to maintain REMIC status.

1. The first goal is achieved by requiring the borrower to purchase a portfolio of US Treasury obligations that will mature on or shortly before the payment dates in amounts that closely approximate each note payment. An initial cash deposit can be used to plug any “holes” or shortages that may occur, particularly at the front end.

2. The second goal is achieved by receiving the bonds in such a way as to avoid “constructive receipt” of the bonds. Treas. Regs. Section 1.451-2 (a) describes the doctrine of constructive receipt as follows:

   > “Income although not actually reduced to a taxpayer’s possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he may have drawn upon it during the taxable year if notice or intention to withdraw had been given. However, income is not constructively received if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions.”

   A taxpayer will be found to be in constructive receipt where the taxpayer has an unrestricted right to receive the income, the taxpayer is able to collect it, and the failure to receive it resulted from the exercise of the taxpayer’s own choice. A recent case, *Boccardo v. Comm*, 98-2 USTC #50795 ($9^{th}$ Cir. 1998) has extended this doctrine to final constructive receipt where a loan was extended after maturity in a situation where the maker had the financial ability to pay the debt but the lender agreed to an extension in consideration of an increase in the interest rate. The tax court held that since the lender had the unrestricted right to collect the debt and the debtor was financially capable of paying the debt, the lender's choice to agree to an extension amounted to constructive receipt of the debt.

In TAM 9238005 the IRS ruled that the substitution of obligors as well as the change in form of the collateral did not result in taxable disposition of an installment obligation. See also *Affiliated Capital Corp v. Comr.*, 88 T.C. 1157 (1987); and Rev. Rul. 75-457, 1975-2 C.B. 196. In a typical securitized loan, prepayment is prohibited. Thus, the lender should not have an unrestricted right to the prepayment unless the borrower is in default. Accordingly, as long as the lender does not have the unrestricted right to the collateral in the absence of a default, but must await on payments as and when made, the substitution of collateral should not be considered to be the constructive receipt of payment of the debt.

3. Regs. 1.860G-2(a)(8) provides that a mortgage that contains a defeasance provision whereby the mortgagee may release its lien on the real property securing the mortgage in return for the mortgagor's pledge of substitute collateral does not affect its status as a qualified mortgage if conditions are met which ensure that the defeasance transaction is undertaken as part of a customary commercial transaction. Regs. 1.860G-2(a)(8)(i)-(iv) requires that the following conditions be met: (a) the substitute collateral is in government securities; (b) the defeasance is undertaken pursuant to terms of the mortgage; (c) the defeasance does not occur within two years of the start-up day; and (d) the lien is released to facilitate the mortgagor's disposition of the encumbered property or as part of a customary immediate transaction that is not part of an arrangement to collateralize a REMIC offering with obligations that are not real estate mortgages.

A. Original Borrower.

B. Loan Service. This is typically a life insurance company, bank or other party that has acquired the servicing rights for the entire loan portfolio of which the particular CMBS loan is a part.

C. Bond Trustee. This is typically a large New York bank which will hold the bonds as collateral. It generally is the same bank which acts as agent for the underlying bond owners in making the payments to the holders of the CMBS obligations.

D. Assuming Entity. This is generally an entity formed by the CMBS sponsor (typically a large securities dealer) to "assume" the loan in conjunction with the substitution of collateral. This "assumption" removes the original borrower from the transaction. It also has the effect of causing any excess funds in the bond account to revert to the assuming entity (rather than the original borrower) when the loan is finally paid off at maturity.

E. Rating Agencies. These are the usual bond rating agencies such as Standard and Poors or Duff & Phelps. The agency or agencies who rated the initial bond offering must issue a letter (known as a "no down-grade letter") to the effect that the substitution of collateral will not cause the obligation to be downgraded in quality.

F. Title Company. A defeasance is closed through an escrow with the title company handing the sale or refinancing of the property. An experienced, sophisticated closer is essential to a defeasance. A closing in which a defeasance is involved will generally take at least two and probably three business days to complete.

G. Source of Funds. Since a defeasance is usually part of a sale or refinancing of the mortgaged property, the source of funds is generally a new lender who either loans directly to the borrower (in a refinancing) or to the purchaser (if the property is being sold). A potential source of conflict exists between the new lender's escrow instructions and the requirements of the defeasance. These conflicts can be minimized by addressing the defeasance requirements in the earnest money contract and/or loan commitment (for the new loan).

The basic documentation for a defeasance is not extensive and consists primarily of the following:

A. Defeasance Provisions. As required by Treas. Reg. 1-860G-2(a)(8), the Note or Deed of Trust must contain the basic defeasance provisions. This enabling language typically is very general and leaves considerable discretion to the loan servicer.

B. Collateral Pledge/ Security Agreement. This is the document pursuant to which the Treasury bonds are pledged to secure the loan. This document typically will be prepared by the loan servicer's counsel.

C. Assignment and Assumption Agreement. This is the agreement whereby the original borrower assigns the bonds to an assuming entity who assumes the loan. This document generally will be prepared by the loan sponsor's counsel on behalf of the assuming entity.

D. Release of Lien. The borrower's counsel generally will prepare the release and UCC termination statements and send them to the loan servicer's counsel for execution and delivery in escrow to the title company at closing.

One of the most difficult aspects of a defeasance transaction is coordinating and obtaining the various legal opinions and reports typically required by the loan servicer and the rating agencies. The required opinions and reports will include the following:

A. Opinion of Borrower's Counsel. This resembles a typical due authorization opinion delivered at a loan closing and should not present a major problem.

B. Opinion of Borrower's Special NY Counsel. If the new collateral pledge will be governed by New York law (as is very common), the borrower's counsel may not be able to opine as to the enforceability of the pledge agreement under New York law. Also, the rating agencies may require that this opinion come from a licensed New York attorney.

C. REMIC Opinion. The rating agencies generally require an opinion that the substitution of collateral arrangements will not create a REMIC (real estate mortgage investment conduit) problem. This opinion is generally given by the attorney for the assuming entity.

D. Bond Verification Report. This report is critical. Both the servicer and the rating agencies will require a written report from a national CPA firm, stating that the bonds are sufficient to pay the loan. When bonds are purchased in a defeasance, the bonds must be purchased in a way to make each monthly payment without the need of selling bonds. Therefore, a combination of cash, strips, and bonds of varying maturity will be identified to, in effect, take the place of the property as a source of payment, so that the monthly payments will continue uninterrupted. Of course, the availability of these financial obligations and their pricing continuously changes with market conditions. A preliminary bond verification report is issued a day or two before closing. Once the actual bonds are purchased, a listing is provided to the CPA firm and the final report is sent out.

In order to close a defeasance, several steps are needed to initiate and complete the process, as follows:

A. Notice. The loan servicer should be notified in writing at least 60-90 days before closing of intent to defease.

B. Fee Deposit. A fee deposit will be required by the loan servicer to pay its fees, the fees of its counsel, and the bond trustee. These combined fees will likely exceed $35,000- $40,000.

C. Hire Accounting Firm. A national CPA firm will need to do the bond verification report. This firm must be engaged and notice given to the loan servicer for approval. Fees for a bond verification report will be paid by the borrower directly to the CPA firm or at closing and typically range from $3,500 to $10,000.

D. Financial Advisor. The borrower will need to engage a knowledgeable financial consultant to assist in the bond purchase. This consultant will need to help the borrower design the portfolio to fit the loan, identify available securities, and actually consummate the purchase of the securities.

E. Bond Schedule. A pro forma bond purchase schedule will need to be prepared and circulated for preliminary approval.

F. NY Counsel. The borrower may need to engage New York counsel for a New York enforceability opinion, as discussed above.

G. No Downgrade Letters. No downgrade letters from rating agencies will be obtained by counsel to the loan servicer based on the various legal opinions and the bond verification report.

The closing of a defeasance presents several problems, primarily because there are so many parties and "parts" to the process. Generally, however, the closing should work as follows:

A. Escrow Instructions. Title closer will receive instructions from the loan servicer's counsel specifying:

   1. Amount of funds to be wired to bond trustee (usually includes a "cushion");

   2. Any additional fees to be collected over and above the initial deposit; and

   3. That a release of lien will be delivered upon bond purchase.

   The cushion is often as much as 15% of the bond purchase amount. It will be returned to the title company for refund to the borrower to the extent not used. The release is sometimes actually delivered in escrow to the title company to hold pending confirmation of the bond purchase.

B. Real Estate Closing. A typical real estate closing will be conducted, with all funds and documents tendered into escrow with the title company.

C. Funds Transferred. The title company in accordance with the escrow instructions will wire funds to the bond trustee. Upon receipt the bond trustee notifies the financial advisor to make the bond purchase.

D. Bond Purchase. The financial advisor purchases bonds and notifies the trustee.

E. Bond Delivery. The bonds are delivered to trustee, with a list to the servicer and the CPA firm.

F. Final Report. A final bond verification report is made and the funds are wired to the broker by the trustee.

G. Escrow Closed. The title company is notified by the servicer to close escrow and record the release.

H. Excess Funds Returned. Any excess funds not used for the initial bond purchase will be returned to the title company to be refunded to the borrower. However, any excess funds remaining with the bond trustee after the loan is finally paid will not be repaid to the original borrower, but will go to the assuming entity.

I. Timing. A defeasance closing can take up to 3 business days to close, and 2 more days to get the refund of the "cushion" amount.

V. **Recommendations**.

In order to make a defeasance transaction go more smoothly, I would prefer the following suggestions:

A. Contract Documents. Address the defeasance requirements in the earnest money contract (if a sale is involved) or loan commitment (if it is a refinancing). For example, in a sales contract, the Buyer could agree to cooperate in the defeasance, agree that the closing may take up to three business days to complete, including a "pre-closing" one day prior to the funding date, the agreement of the buyer to initiate its funding by wire transfer at the opening of business on the funding date and to fund into escrow with the title company in order to accommodate the defeasance.

B. Start Early. Start early by contacting and staying on top of the loan servicer.

1. Demand a written defeasance checklist from the servicer ASAP.

2. Make early contact with the servicer's counsel.

3. Get a copy of the servicer's pro forma escrow instructions to the title closer.

4. Determine if NY opinion will be required.

C. Pre-Closing. Have a pre-closing one day before the actual closing to sign all documents.

D. Wire Early. Start the new lender's and/or buyer's wire transfer(s) as early as possible on the day of closing.

E. Don't Give Up. Don't be discouraged—it can be done!

F. Defeasance is Expensive and Time-Consuming. The total fees to attorneys and accountants easily will exceed $50,000 and could even reach or exceed $100,000 in some cases.

G. Good Professionals are Essential. It helps to involve a CPA firm that regularly does bond verifications, a financial advisor who has handled bond purchases for defeasance transactions, and a very good commercial title closer.

H. Learning Curve. Loan servicer's and their counsel are gaining experience, but are still in the learning process.

Defeasance Loans are not for Everyone. Generally, defeasance loan are appropriate for "professional borrowers" who have sufficient financial expertise and staff to deal with the complexity of a defeasance. Clients should carefully consider the costs and complexity of a defeasance before entering into a loan transaction which requires defeasance to sell or refinance.