

DEFEASANCE: NOW A VIABLE OPTION IN NEW YORK STATE

By Joshua Stein

Until recently, New York title companies and real estate lawyers feared that New York State would charge a second mortgage recording tax in connection with any “defeasance” of a mortgage. Because defeasance can play a crucial role in refinancing some securitized loans, a second tax would have prevented securitized borrowers and lenders in New York from taking full advantage of a refinancing option that raises no problem elsewhere.

New York State’s Department of Taxation & Finance put some of these fears to rest on February 25, 2000 when it issued advisory opinion no. TSB-A-00(1)R (the Advisory Opinion). In the Advisory Opinion, the Department said it would not impose a second tax on one type of defeasance, referred to here as a New Note Defeasance. Though complicated, a New Note Defeasance does let securitized borrowers and lenders use defeasance as an option when they structure a New York deal.

What is defeasance? How does it work outside New York? Why might it create mortgage recording tax problems? How does a New Note Defeasance avoid these problems? The following discussion tries to answer these questions and explain the Advisory Opinion.

The concept of defeasance of a mortgage arises from the needs of today’s mortgage loan securitization industry, where lenders originate mortgage loans to transfer them to a special-purpose entity that issues bonds backed by the cash flow of the mortgages (a Trust).

To maximize the total selling price of the bonds, the transaction sponsors must predict with certainty the amount and timing of every mortgage payment the Trust will receive. Bond buyers want certainty and will pay more for it. Therefore, the Trust will pay an originator more for certainty.

If the originator can count on more sales proceeds from the bonds, it can charge less interest on its mortgages. Anything that increases the predictability of payment streams on securitized mortgages should therefore indirectly reduce the cost of mortgage finance.

Although mortgage originators want predictable payment streams, borrowers want flexibility. Interest rates might drop. Rents and values might rise, supporting a refinancing to take cash out of the property. A borrower might want to do things the loan documents prohibit. For these and other reasons, a borrower wants freedom to sell or refinance at any time. (The rest of this discussion considers only a refinancing, not a sale.)

Before securitization, a borrower would stay flexible by keeping the right to prepay its loan at any time, maybe with a fee. Today, though, the mere possibility of a prepayment of a

securitized loan, even with a fee, may reduce the utility of that loan for securitization. The borrower might then not be able to obtain the lowest possible interest rate.

The securitization market lets borrowers and lenders both meet their needs by having a borrower give its lender new collateral in place of the real estate -- but without changing the timing or amount of payments on the secured loan. This collateral substitution is called a defeasance. Properly structured, a defeasance complies with federal income tax rules that are technical and specific, and expensive if violated.

In a state without a mortgage recording tax, the parties would accomplish a defeasance as follows (referred to here as a Simple Collateral Substitution):

- The Trust releases the real estate from the mortgage.
- In exchange, the Trust receives new collateral: United States government bonds (Treasuries) with a payment stream identical to the old mortgage.
- The payments on the Treasuries go directly to the Trust or its agent.
- The old borrower's obligations under the loan go to a new borrower.
- The old borrower can then refinance the real estate free of the old mortgage.
- The Trust and its bondholders still have the same stream of cash they had before, plus an extra benefit: absolute certainty of payment, in place of whatever uncertainty comes with any payment stream backed by real estate.

To accomplish a defeasance, the old borrower needs to buy enough Treasuries to give the Trust the right payment stream. Whatever the purchase price for those Treasuries, this discussion assumes the borrower has decided that a defeasance makes practical business sense. The borrower will probably place a new mortgage on the property to buy the Treasuries and generate some cash. Net effect: the borrower replaces an old mortgage with a new mortgage and probably pulls some money out of the property. It's just another refinancing.

A Simple Collateral Substitution works fine in any state without a mortgage recording tax. In New York, though, it creates issues, because to save mortgage recording tax in a refinancing, the borrower and the new mortgage lender (the New Lender) need to pretend they are modifying, amending, and increasing an existing mortgage, one on which mortgage recording tax has already been paid. They can't create a new mortgage. As long as the old lender doesn't "release" the old mortgage, the borrower pays mortgage recording tax only on the incremental increase in mortgage debt, the new money the borrower takes out of the property through the refinancing.

Under a Simple Collateral Substitution, though, New York State would probably say the old mortgage was released at the moment when the old lender accepted Treasuries rather than real estate as security. The borrower would then owe mortgage recording tax on the entire new loan, not just the new money.

The New Note Defeasance structure, as described in the Advisory Opinion, eliminates any release of the old mortgage. Instead, it adds to the transaction a second promissory note, which the borrower signs just before the defeasance. The new note has the same payment stream as the old mortgage note, but the borrower does not deliver the new note straight to the Trust. Instead, borrower and lender do this:

- Just before closing, the borrower delivers the new note to the New Lender. (The New Lender probably lends the borrower enough money to buy the necessary Treasuries.)
- To secure the new note, the borrower pledges Treasuries to the New Lender.
- At closing, the New Lender transfers to the Trust the new note and the pledged Treasuries.
- At the same time, the Trust transfers to the New Lender the old mortgage note and the old mortgage.
- The new borrower agrees to pay the new note.
- The Trust releases the old borrower from liability under the new note.
- When the dust clears, the Trust holds the new note secured by Treasuries, a mirror of the old note and functionally identical, and the New Lender holds the old note and the old mortgage. Neither was ever released.
- The borrower can now amend and modify the old note and mortgage to refinance without paying more tax, or can increase the loan amount by paying more tax, in the usual way.

According to the Advisory Opinion, under a New Note Defeasance, “the new Lender pays consideration for the assignment of the Mortgage in the form of an assignment of the New Loan rather than the traditional cash consideration.” And, a mortgage can be assigned “either for cash or any other bona fide consideration.” Because of that principle, and because the mortgage never stopped securing a bona fide indebtedness, the Advisory Opinion concluded that the New Note Defeasance achieves the intended result.

The Advisory Opinion implies that for a New Note Defeasance, the State will not say that the old mortgage was released. The State has passed up some opportunities to make technical arguments that the New Note Defeasance somehow doesn't work. Instead, the State recognizes that under a New Note Defeasance, the old note and mortgage are never repaid, no collateral ever released. The Advisory Opinion means the parties can amend and restate the old mortgage loan for their next refinancing and save mortgage recording tax.

In practice, the tax-free availability of a New Note Defeasance will probably make the difference between closing a defeasance and not closing it. In a market where borrowers and lenders negotiate interest rates by 1/100th of a percent, the imposition or nonimposition of a tax equal to 2.75 percent of principal will make a huge difference.

If New York had made technical rationalizations to impose a second mortgage recording tax on a New Note Defeasance, this position would (in the author's opinion) probably not have produced a single dollar of additional mortgage recording tax revenue. It would just have prevented the parties from consummating a New Note Defeasance, because the parties would not have wanted to incur the possible mortgage recording tax exposure.

The Advisory Opinion means New York borrowers should be able to use a New Note Defeasance to help them benefit from securitized lending and from the lower interest rates it can bring to the table. The Advisory Opinion represents a step toward applying the mortgage recording tax in a way that accommodates new transaction structures rather than blocks them.

Unfortunately, the Advisory Opinion does nothing to simplify – indeed, it complicates -- the convoluted transaction structures that New York real estate lawyers perpetrate to save mortgage recording tax. As the State's next step in facilitating modern real estate transactions, might the State simplify or even eliminate this wretched tax?

This article appeared in the New York Real Estate Weekly on April 26, 2000. Final editorial changes made by the publication might not be reflected in this near-final version of the article.

Joshua Stein¹

¹ The author, a member of the American College of Real Estate Lawyers, is a real estate partner in the New York office of Latham & Watkins, where his practice includes structuring and closing substantial mortgage loans for borrowers and lenders. He recently completed a chapter on the law and practice of New York mortgage loans, to be published by West Group. His articles have appeared in *Real Estate Weekly*, *Real Estate Review*, *The Practical Real Estate Lawyer*, *Secured Lender*, and many other publications. He is a member of the Executive Committee of the Real Property Section of the New York

State Bar Association and co-chair of its Commercial Leasing Committee. He can be reached at (212) 906-1342 or joshua.stein@lw.com. Copyright (C) 2000 Joshua Stein. Opinions expressed are those of the author and have not been approved, endorsed, or confirmed by any law firm. Legal conclusions should not be relied upon for any particular transaction. The question of who can rely on an Advisory Opinion and for what raises issues outside the scope of this summary. For those and many other reasons, anyone who plans to structure a “defeasance” must consult their own counsel.