

Negotiating Defeasance Provisions at Origination Can Materially Impact the Bottom Line

BY CHERYL PAVIC HENNER

DEFEASANCE IS A PROCESS BY WHICH BORROWERS OBTAIN A release of their properties—typically for the purpose of selling or refinancing—from a mortgage that has been securitized. Once loans are securitized, lenders have little flexibility in changing the provisions established at origination. Because of this restriction, understanding and being able to negotiate defeasance provisions in the term sheet of a new loan go a long way in mitigating future defeasance costs.

UNDERSTANDING DEFEASANCE

Understanding defeasance provisions and their impact on the borrower's bottom line when negotiating the terms of a new loan can save money and prevent surprises when it is time to defease. Securitized commercial real estate loans are typically held in a structure called a real estate mortgage investment conduit, or REMIC. The Internal Revenue Code and Treasury Regulations promulgated under the code outline the governance of REMICs. After originating and securitizing the loan, lenders have little flexibility in changing the provisions negotiated at origination because of the restrictions these regulations place on lenders.

The concept of defeasance originated in the municipal bond market and in the early 1990s was adapted to the commercial real estate market in response to the increasing securitization of fixed-rate loans. To make these securitizations attractive to investors, prepayment on loans was restricted, enabling predictable cash flows. Loan documents first included defeasance provisions in 1998 to create an avenue for borrowers to exit a securitized loan for a sale or refinance.

Often, defeasance is the only mechanism borrowers can use to release property from a securitized mortgage lien. The process allows borrowers to purchase a portfolio of high-quality government securities, commonly called defeasance collateral, to serve as a substitute for the property collateral identified at loan origination. But borrowers who pay attention to defeasance provisions and negotiate favorable terms at the onset of loan origination can avoid additional costs related to this sometime arduous process.

This article suggests that certain provisions provide borrowers with flexibility if and when they choose to defease a loan. In the suggested language, certain terms are bracketed to indicate that terms may differ by lender, though the substance should remain the same.



About the Author

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AVOIDING LONG LOCKOUT PERIODS

Frequently, the first thing many borrowers notice in loan documents is a provision related to the earliest date—the lockout expiration date—that borrowers can defease the loan. Regulations mandate that securitized loans cannot be defeased until two years after the date of securitization. The period from origination to the date two years later is called the REMIC prohibition period. A defeasance provision in loan documents should allow borrowers to defease upon the expiration of this period. The lockout expiration date is the date a securitized loan first becomes eligible for defeasance. To ensure borrowers have the greatest flexibility in timing defeasance, it is important that the lockout expiration date immediately follows expiration of the REMIC prohibition period.

An example of desirable language is: *“Borrower may cause the release of the property from the lien of the security instrument at any time after the earlier of: (i) three (3) years from the date of the origination of this Note, or (ii) two (2) years from the “startup day,” within the meaning of Section 860G(a)(9) of the Internal Revenue Code of 1986, as amended, of a “real estate mortgage investment conduit, that holds this Note.”*

DEFEASING TO THE PREPAYMENT DATE VS. THE MATURITY DATE

Borrowers may have the option of prepaying a loan anytime from one month to six months before maturity of a loan without penalty or premium. The date on which borrowers may repay the loan is the prepayment date, and the period from the prepayment date to maturity

Figure 1

Defeasing to Prepayment Date vs. Maturity Date

Sample Commercial Property Loan Terms

| | |
|--------------------------------|---------------------|
| Original Principal | \$20 million |
| Interest Rate | 6% |
| Amortization Term | 30 years |
| First Payment Date | July 1, 2007 |
| Open Period Start Date | Dec. 1, 2016 |
| Balloon (Maturity) Date | June 1, 2017 |
| Defeasance Date | July 1, 2010 |

Estimated Cost of Defeasance Collateral That Provides for Payments Through Various Dates

| BALLOON PAYMENT DATE | COLLATERAL COST ¹ | TREASURE WITH CLOSEST MATURITY TO BALLOON DATE ² |
|----------------------|------------------------------|---|
| Dec. 1, 2016 | \$20.576 million | 11/15/2016 |
| Jan. 1, 2017 | \$20.641 million | 11/15/2016 |
| Feb. 1, 2017 | \$20.707 million | 11/15/2016 |
| March 1, 2017 | \$20.618 million | 2/15/2017 |
| April 1, 2017 | \$20.682 million | 2/15/2017 |
| May 1, 2017 | \$20.745 million | 2/15/2017 |
| June 1, 2017 | \$20.610 million | 5/15/2017 |

¹ Estimated costs are based on market rates as of Feb. 1, 2007

² Denotes U.S. Treasury securities issued as of Feb. 1, 2007

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rity is called the prepayment period or open period. A defeasance provision typically requires borrowers to purchase substitute collateral that provides for payments from the date of defeasance through the maturity date, without regard to whether a prepayment right exists in loan documents.

Savvy borrowers have been successful in negotiating terms that allow them to purchase defeasance collateral to provide for payments through the start of the open period. As a result, borrowers have a chance to realize substantial securities portfolio cost savings by eliminating the final months' interest payments.

In some cases, however, purchasing defeasance collateral that provides for payments up to the start of the open period may actually be more expensive than purchasing defeasance collateral that provides for payments through any payment date within the open period. This scenario, typical for loans with several years remaining to maturity, is true if at the time of defeasance a U.S. government agency has not yet issued securities that will mature in time to cover the final loan payment on or close to the desired balloon payment date.

Figure 1 illustrates the costs of defeasance collateral for a sample loan that allows for payments to the start of the open period or on any payment date thereafter. Because the loan has several years remaining until maturity, it is particularly sensitive to this defeasance provision.

The following language gives borrowers maximum flexibility in selecting the most advantageous and cost-effective date for the final defeasance collateral payment: *"The Borrower shall purchase [Defeasance Collateral] that provides for payments on or prior to all successive [regularly scheduled payment dates] occurring after the [Release Date], including the outstanding principal balance of the Loan on, subject to the Borrower's sole and absolute discretion, a [regularly scheduled payment date] that falls within the Prepayment Period or on the Maturity Date."*

MAXIMIZING THE BENEFITS OF PREPAYMENT RIGHTS

If borrowers must defease to the maturity date and cannot have the flexibility of purchasing defeasance collateral portfolios that make a final payment before the maturity

date, loan documents should provide that any right to prepay the loan should survive the defeasance. Eliminate any loan document provisions that preclude the right to prepay the loan after a defeasance has occurred.

In many instances, the ability to prepay loans is especially valuable in the context of a defeasance if borrowers have the right to designate what entities will act as the successor borrowers upon defeasance. If borrowers have prepayment rights and can designate successor borrowers, they may be able to enter into an arrangement with successor borrow-

Savvy borrowers have been successful in negotiating terms that allow them to purchase defeasance collateral to provide for payments through the start of the open period.

ers' parent companies whereby borrowers have a right to a portion of the proceeds that successor borrowers receive if and when they prepay the loan. In this case, the original borrowers will realize all or a portion of the savings from the loan interest that otherwise would have accrued for the remaining months.

PROVIDING DEFEASANCE DEPOSIT VS. DEFEASANCE COLLATERAL

A defeasance deposit is the amount of money required to purchase the defeasance collateral portfolio that provides for monthly payments through the remaining life of the defeased loan. Some loan documents provide that borrowers must deliver defeasance deposits—not actual defeasance collateral—to lenders. If borrowers are required to deliver defeasance deposits, lenders have a right to play a role in various aspects of selecting the defeasance collateral including the structure and purchase of the portfolio. This right can result in potential embedded costs and inefficient pricing.

Conversely, if the defeasance provisions allow borrowers to provide the actual defeasance collateral to lenders and do not require defeasance deposits, the borrowers' defeasance consultant will be able to structure an optimized securities portfolio and hold a competitive auction to ensure best pricing. An example of desirable language is: *"Borrower shall deliver to Lender the [Defeasance Collateral]."* Further, borrowers should be careful that the defeasance provision does not mention a defeasance deposit.

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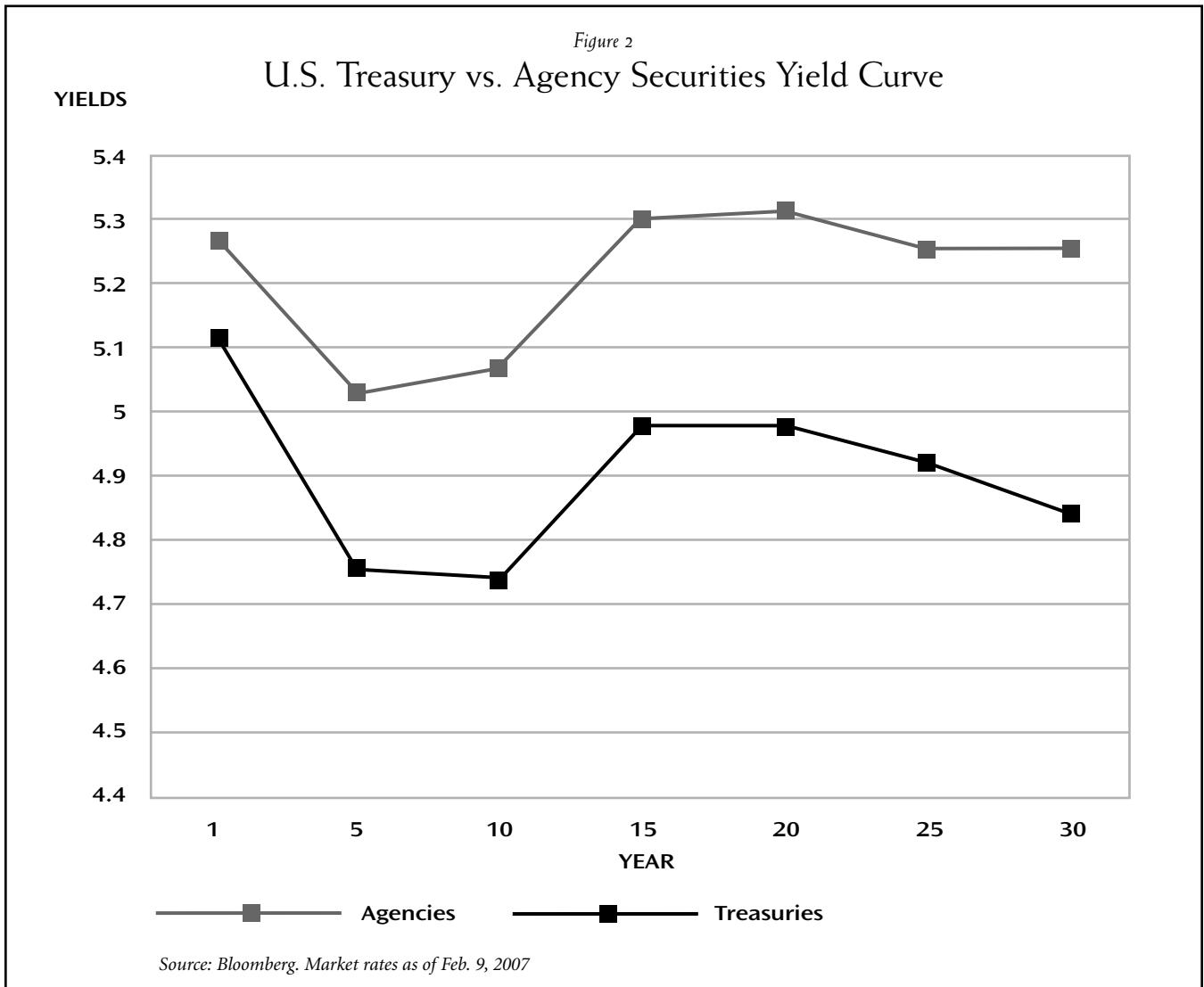
AGENCIES VS. TREASURIES AS DEFEASANCE COLLATERAL

Perhaps the one provision that has the greatest impact on the overall cost of a defeasance is the type of securities that can serve as defeasance collateral. Generic language such as “U.S. obligations” or “government securities” limit these securities to direct U.S. government obligations such as bills, notes, and separate trading of registered interest and principal of securities, also called STRIPS. Though this type of portfolio is not fundamentally detrimental to the borrower, broadening the universe of possible securities will usually result in a more cost-effective portfolio.

Agencies of the U.S. government, or government sponsored entities—including the Federal National Mortgage

Association, or Fannie Mae, and the Federal Home Loan Mortgage Corp., or Freddie Mac—issue fixed-rate bonds that offer higher yields (see Figure 2). These agency bonds also lend more liquidity to the universe of available securities. Because higher yields mean lower prices and increased liquidity creates greater efficiencies, using agency bonds will usually result in a cheaper securities portfolio (see Figure 3). With larger transactions, such as those greater than \$50 million, government agencies may even be able to structure a customized bond where the cash flows on the bond identically match the payments required on the defeased loan.

Specific language is necessary in the defeasance provision of loan documents to ensure flexibility in selecting the



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Figure 3

Agencies vs. Treasuries—Defeasance Collateral Comparison

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Sample Commercial Property Loan Terms

| TYPE OF PORTFOLIO ⁵ | COLLATERAL COST ² |
|--------------------------------|------------------------------|
| U.S. Treasury | \$20.610 million |
| Agency | \$20.340 million |

¹Denotes securities issued as of Feb. 1, 2007
²Estimated costs are based on payments through the maturity date, and market rates as of Feb. 1, 2007

Figure 4

Potential Residual Value of Defeased Loan

Sample Commercial Property Loan Terms

| | |
|--------------------------------|---------------------|
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Potential Residual Value of U.S. Treasury Portfolio at Maturity

| | |
|---|-------------------------|
| Treasury With Closest Maturity¹ | May 15, 2017 |
| Balloon Date | June 1, 2017 |
| Time Difference | 17 days |
| Assumed Money Market Rate | 5% |
| Balloon Payment Amount | \$17.085 million |
| Future Value of Interest | \$40,404 |

¹ Denotes U.S. Treasury securities issued as of Feb. 1, 2007

most efficient, cost-effective defeasance collateral. Borrowers should use language similar to the following in the definition of defeasance collateral or in the provision that describes what type of substitute collateral borrowers can purchase: “Obligations which are ‘government securities’ within the meaning of Section 2(a)(16) of the Investment Company Act of 1940.”

SELECTING THE SUCCESSOR BORROWER

Loan documents typically require that successor borrowers take the place of original borrowers upon defeasance. Successor borrowers are the entities that will assume responsibility for all payments remaining on loans after they are defeased, thereby releasing original borrowers from any financial obligations under the loan. It is most advantageous for borrowers to have the right to designate what entities will act as successor borrowers. If a defeasance provision gives lenders the right to form or designate successor borrowers, the borrowers may lose the opportunity to potentially benefit from residual value created by portfolio inefficiencies.

Unless a custom security is structured so that payments exactly match principal and interest payments due on the loan, a portfolio of defeasance collateral will have some inherent inefficiency. These inefficiencies are a result of mismatches in timing between cash receipts from the defeasance collateral—coupon payments or bond maturities—and the monthly payments of principal and interest due. The mismatches accrue interest at money market rates over the life of the defeased loan. Custom securities are not available in many cases and though defeasance collateral portfolios can be structured for high efficiency, some residual value is likely to accrue.

Rules governing the structuring of the defeasance collateral stipulate that the earned interest cannot be applied toward scheduled loan payments. However, all accrued interest can be realized when the loan matures. If successor borrowers offer a sharing arrangement, borrowers can receive a portion of this residual value (see Figure 4). For

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this reason, it is important for borrowers to be able to designate successor borrowers. As previously mentioned, this tactic also enables borrowers to benefit if the right to prepay the loan survives the defeasance. An example of language that secures this right is: *“Borrower shall, in its sole discretion, establish or designate a successor entity which is acceptable to the Rating Agencies.”*

THINKING ABOUT DEFEASANCE AT ORIGINATION

Defeasance provisions represent just one element of a loan—an element that does not necessarily influence upfront costs or monthly debt service payments. Thus,

defeasance provisions are easy to overlook when negotiating the term sheet of a new loan. However, defeasance is typically the only way borrowers can release property for sale or refinance purposes. Because regulations preclude modifications to defeasance provisions after a loan is securitized, the best time to shape the destiny of a defeasance is at origination. Understanding the various defeasance provisions and requesting preferential language when negotiating the term sheet of a new loan will minimize future defeasance costs for borrowers. ■