The Basics of Commercial Mortgage Defeasance

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THE BASICS OF COMMERCIAL MORTGAGE DEFEASANCE

Commercial Mortgage Based Securities (CMBS)

Over the course of the last decade, an increasing number of commercial mortgages have been securitized. The process of securitizing a commercial mortgage is carried out by packaging a number of commercial mortgages with other loans to form a pool of loans that essentially back securities. The commercial mortgage based securities (CMBS) are then sold to investors.

A key feature of CMBS loans is that there is a prohibition against pre-payment. As a result, the only exit strategies offered to borrowers under securitized loans are either the sale of the property against which the mortgage has been registered with an assumption of the loan by the new buyer, or a loan defeasance.

The United States of America has experienced a boom in the securities loan market. For example, more than $169 billion dollars in commercial mortgage loans were securitized in 2005. Along with this boom in the securitization of mortgages has come an increase in the incidence of defeasances of commercial mortgages. According to Moody’s Investors’ Services, the United States market has seen an increase in defeasance volume from a single $5.6 million dollar loan in 1999 to 2,090 loans totalling $21.2 billion dollars in 2005. It should also be noted that the 2005 total was quadruple the volume experienced in 2004. It is reasonable to assume that these trends will be followed in Canada in the coming years.

Defeasance

A mortgage defeasance is a simple concept to describe, however, the process of carrying out a defeasance can be quite complicated. The essence of a defeasance is a substitution of collateral. New collateral is pledged in favour of the lender in return for a release of the mortgage encumbering the borrower’s real property. It is important that the debt obligations continue to exist at all times while the substitution of collateral is carried out.

The specific type of substitute collateral that is required in order to successfully complete a commercial mortgage defeasance is typically government securities or bonds. These securities must be acquired in an amount that will generate a cash flow that is sufficient to pay all of the remaining principal and interest due on the mortgage loan through to maturity. It should be noted that the defeasance has existed for many years in connection with the bond finance market and the concept of defeasance was imported into commercial real estate at the same time as securitized lending.
CMBS investors want their securities to look and act very similar to the corporate bonds that represent their investment competition. Therefore, they demand predictability even more than traditional lenders. The only way for lenders to provide the predictability that is desired by CMBS investors is to prohibit repayment of their loans or mortgages.

The flip side of the predictability desired by CMBS investors is the maximum flexibility that is important to borrowers with respect to options to repay mortgage loans prior to maturity. The defeasance of a commercial mortgage bridges the gap between the predictability required by CMBS investors and the flexibility sought by borrowers. Following a successful defeasance, the loan remains outstanding for its term but the borrower acquires a release of the mortgage lien against its real property and obtains the ability to either re-finance the property or sell it free and clear.

**Pre-conditions for a Defeasance**

1. It is common for mortgage documents to stipulate that defeasance cannot occur within two years of the “start up date”. The start up date is the date that the loan was securitized and not the day that the loan closed. In some cases, mortgage documents provide for longer periods from the start up date during which the defeasance or mortgage release is prohibited; and

2. The loan documents must expressly permit defeasance. Amending mortgage documents to add the right of defeasance is not permitted.

**The Costs**

A commercial mortgage defeasance is, in general terms, a relatively expensive transaction. It is not uncommon for closing costs to be in the range of $50,000.00.

The other really significant cost encountered in a defeasance is the cost of purchasing the collateral or securities. The greater the gap between the interest rate prevailing on the loan and the interest rate prevailing on the eligible securities, the greater the cost of the defeasance to the borrower. The difference between the interest rate on the eligible securities and the interest rate on the mortgage is known as the “defeasance premium” and the greater the gap in the two interest rates, the greater the premium.
The Players

As previously stated, the relatively simple concept of mortgage defeasance has, in practice, become a complicated transaction. As a result, a number of specialists have emerged to play a role in the defeasance process.

1. **Defeasance Consultant**

   The Defeasance Consultant charges a fee to quarterback virtually all aspects of the defeasance process. The expertise of the Defeasance Consultant can be invaluable to a borrower and, in most instances, the Consultant’s fee will be far less than the extra fees and costs that will result if an inexperienced borrower elects to try to carry out its own defeasance. In many cases, the lender will require that a Defeasance Consultant be involved in the transaction.

2. **The Servicer**

   The Servicer is generally the party that was the master servicer under the pooling and servicing agreement that governed the original pool of securitized loans. The Servicer’s role is relatively minor in the defeasance process however, the Servicer continues to be involved based on the concept that the obligations of the original loan continue on through the defeasance process.

3. **The Intermediary**

   The Securities Intermediary is required to handle the pledged collateral that is substituted for the real property. The role of the intermediary is governed by the defeasance documents.

4. **The Bond Rating Service**

   A Bond Rating Service is involved in the defeasance process in order to confirm that the pledged securities or collateral will be acceptable substitutes for the real property.

5. **Accountant**

   The accountant is retained to ensure that the substitute securities generate sufficient funds to pay off the principal and interest through to the end of the term of the mortgage.

In addition to the parties listed above, there are, of course, the Borrower, the Lender and their respective counsel.
The Agreements

As mortgage defeasance transactions have become more common in recent years, a number of standard agreements have been developed for use in those transactions. The most commonly used agreements are the following:

6. **Defeasance Agreement:**

   This Agreement sets out the general terms of the defeasance. This document generally identifies the parties to the defeasance and sets out the date of the defeasance and contains some other key terms such as provisions that prohibit the borrower from permitting any liens against the defeasance collateral as well as the requirement that there be no novation of the loan through the defeasance process. The legal concept of novation is the substitution of a new contract or debt for an existing one. It is an important requirement of the defeasance process that new collateral is provided for the loan but that the loan itself continue on without termination.

   It should be noted that in some instances, if the defeasance provisions in a loan are sufficiently detailed, the defeasance agreement may be dispensed with and only a few of the key provisions will appear in other defeasance documents.

7. **Defeasance Pledge and Security Agreement**

   This document sets out the terms under which the substitute collateral securities are pledged. It further sets out the role of the pledgor (or borrower), the intermediary and the pledgee (or lender). This document is very detailed and contains provisions that deal with events of default and remedies upon default.

8. **Defeasance Account Agreement**

   This agreement establishes the Defeasance Account and sets out the distributions from the pledged collateral account. This document also dictates that any amounts remaining in the account at the end of the mortgage term will be returned to the borrower.

9. **Promissory Note**

   The obligations of the borrower are also secured by a Promissory Note that may be used to make up any shortfall in the securities provided as the pledged collateral.

In addition to these documents, defeasance transactions generally close through an Escrow Agreement and there is usually a Waiver and Acknowledgement document, an Authorization and Direction document and additional documents that complete the transaction and confirm the complexity of the defeasance process.
Securities Transfer Act, 2006

An important requirement of lenders in a mortgage defeasance is the priority interest that they obtain in the pledged collateral. A lender can typically determine its priority with respect to real property pledged as security for a mortgage and lenders require that they have the same first priority claim against the pledged collateral put in place through the completed defeasance.

The Securities Transfer Act, 2006 ("STA") came into effect on January 1, 2007. Sections 23 through 28 of the Act define “control” of certificated and uncertificated securities. Section 26 of the STA states that where an interest in a security entitlement and is granted by the entitlement holder to the entitlement holder’s own securities intermediary, the securities intermediary has “control” of the security entitlement. In the context of the defeasance process, the interest in the pledged collateral is perfected by control. Section 30.1 of the Personal Property Security Act ("PPSA") states that a security interest of a secure party having control of investment property has priority over any other security interest to which the PPSA applies.

There is a significant amount of cross-referencing between the PPSA and the STA. In particular the definitions of “control” in the STA are referred to in the priority provisions contained in Section 30.1 of the PPSA.

Based on the provisions of the STA, and the expertise that has been developed in Ontario, the vast majority of commercial mortgage defeasance transactions are taking place in this province. As part of the transaction, the lender requires a priority opinion that must be based on the specific provisions of the PPSA and the STA and for that reason, lenders generally dictate that the defeasances take place in Ontario.

Conclusion

Given the fact that commercial mortgage defeasance can be very costly to a borrower, it is appropriate to ask why any borrower would become involved in a defeasance. In the case of a borrower undertaking a defeasance of a loan for a single commercial property, it would generally be necessary for the borrower to have received a very good offer to purchase that property. In fact, the offer would need to be good enough that the cost of the defeasance would be absorbed and still leave substantial profit from the sale.

In other cases, a defeasance of a commercial mortgage is undertaken where a group of commercial properties or a whole property portfolio are sold and only perhaps one or two of those properties are subject to loans that can only be released through a defeasance process.
As was previously noted, the incidence of commercial mortgage defeasance has increased exponentially in the United States of America. Accordingly, it seems likely that Canada will experience a similar increase in commercial mortgage defeasance transactions. Ontario continues to enjoy the Canadian statutory environment that is best suited to commercial mortgage defeasances and it seems likely that lenders will continue to dictate that the majority of mortgage defeasances continue to be Ontario transactions.