



defeasance

Defeasance: It takes a team of professionals to guide you through every step of the process

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The use of defeasance, or the substitution of one form of collateral for another, has been rising steadily since the late 1990s. According to a Moody's Special Report from March of 2006, *U.S. CMBS: Strong Real Estate Appreciation Drives Defeasance to Record Levels*, defeasance activity in 2005 was four times greater than in 2004, and twice

the volume for all preceding years combined.

Background

The growing use of defeasance clauses in commercial mortgage documents results largely from the efforts of tax-favored Real Estate Mortgage Investment Conduits (REMICs) to protect themselves from potential short falls due to pre-payment of the underlying commercial mortgages. Defeasance offers the lender the security of ongoing income over the full life of the mortgage, while giving the borrower the option to refinance or sell the property long before the original loan period ends. Everybody wins? Most of the time.

There are costs associated with

the defeasance process. First, there's the cost of the replacement securities—government securities are the only substitute collateral a REMIC can accept and still maintain its tax status. Then, there are other cost factors: interest rates, the market value of the original property and transaction fees. What's more, cost issues aside, defeasance is always a complex process. And, there are financial penalties if the transaction isn't conducted properly. Make no mistake, you need professional help.

Your Defeasance Consultant

Once you've made the decision to proceed, the biggest hurdle is structuring a portfolio of government securities that are of sufficient value and have maturity dates that match

as closely as possible the payment schedule of the original mortgage loan. Identifying this portfolio and helping you obtain these securities is one of the primary functions of the defeasance consultant. You will also need an accountant's report verifying that the securities are sufficient to cover the outstanding mortgage.

In fact, you will need a series of written opinions and agreements before you get to the closing table:

- Your written agreement to give the lender an interest in the securities as collateral for the loan.

- A successor borrower agreement assigning your rights and obligations to a successor entity (usually a new LLC created solely for this purpose). The successor borrower

is necessary because the REMIC cannot be in constructive receipt of the securities.

- An agreement governing the third-party (called the custodian or securities intermediary) who will hold the securities and make the loan payments as they come due.

- Written confirmation that this transaction does not disqualify the REMIC from its tax-favored status.

- Your certification that you have met all the defeasance provisions of the mortgage.

- The lender's waiver of any provisions you may not have met - typically, timing issues.

For all this and for sheer endurance, keep your defeasance consultant and your attorney close at hand.

Your Title / Escrow Agent

With the closing table in sight, it's time to turn your attention to your title/escrow agent, who is at the center of a precisely-orchestrated, series of legal and financial maneuvers. Experience, knowledge and timing are critical to a successful closing. That's why it's so important to choose your title/escrow agent carefully.

Step One:

- The defeasance consultant prepares a letter outlining all the costs involved and giving the title/escrow agent instructions on what disbursements to make.

- You close with your new lender and your title/escrow agent places the funds and new mortgage documents in escrow.

- Loan servicer instructs the defeasance consultant to purchase the securities.

Step Two:

- Your defeasance consultant delivers the securities to the securities intermediary.

- The securities intermediary advises the title / escrow agent that it has the securities.

- The title/ escrow agent wires funds to cover the cost of the securities and related fees.

- The defeasance parties and the new lender now authorize the title/escrow agent to record the release of the mortgage and the deed and/or new mortgage documents and disburse the remaining funds.

Given the right mixture of interest rates and market prices, defeasance can work to your advantage. But, you need a team of experienced professionals—your defeasance consultant, your attorney and your title/escrow agent—to guide you through every step of this intricate process.

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