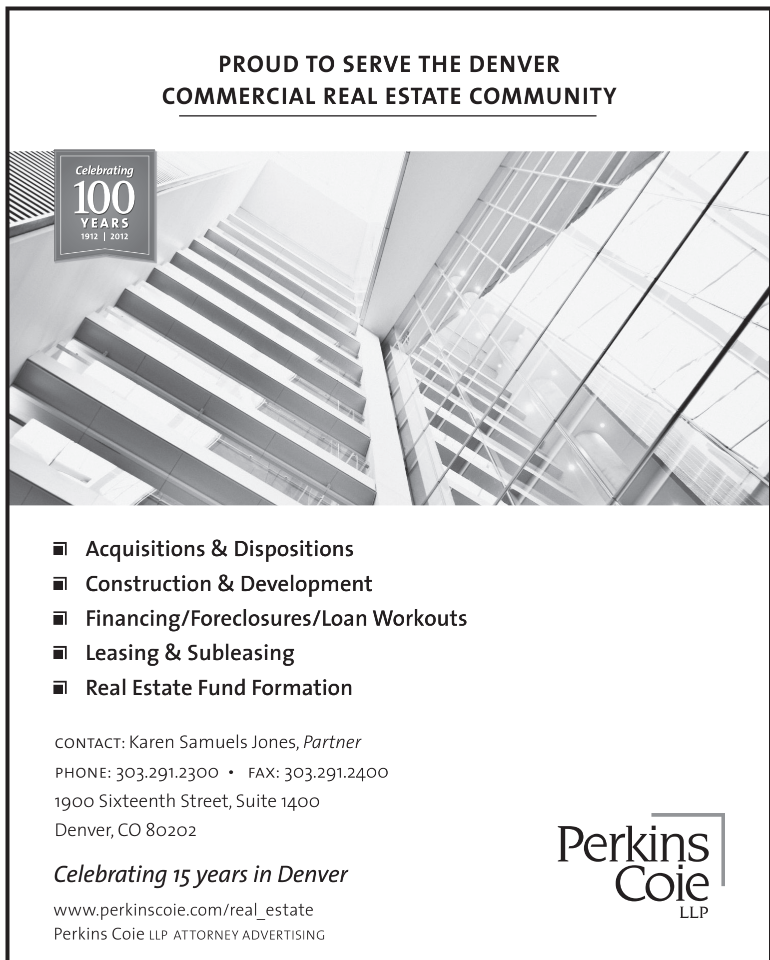

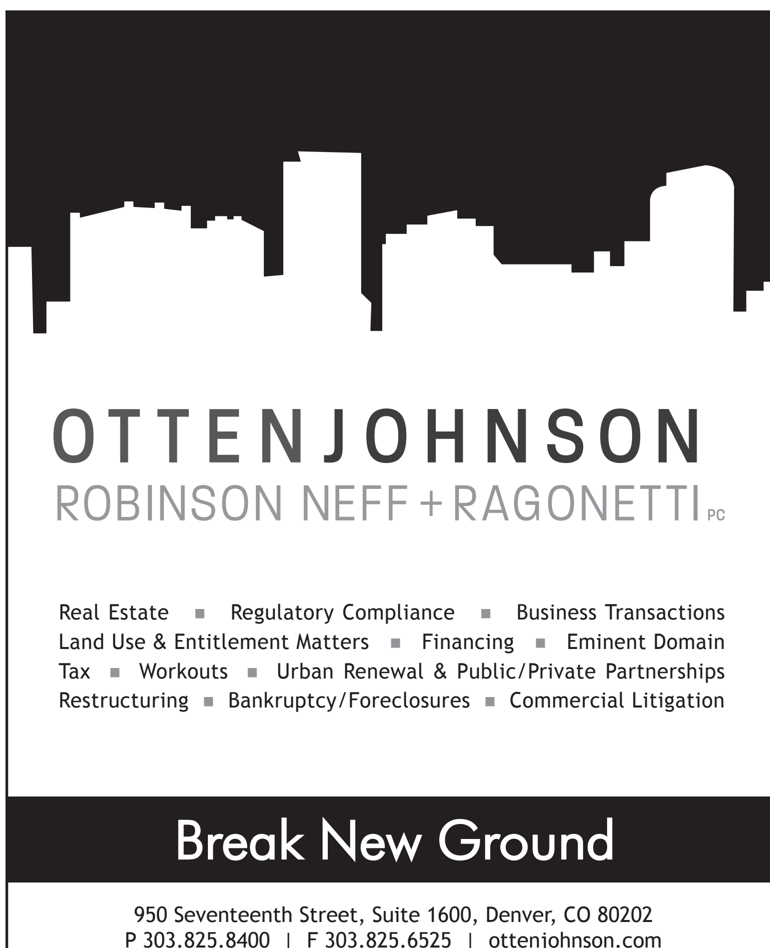

Prepayment versus defeasance

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In light of the recent "return" of some commercial mortgage-backed securities loan originators to the capital markets, and the outstanding volume of pre-2008 CMBS loans that require defeasance in lieu of prepayment, now is an ideal time for a refresher on the nuances of defeasance. This article will provide a brief overview of CMBS defeasance and distinguish it from loan prepayment. Although both yield a similar result for the borrower – release of the deed of trust from its property – the transactions provide a much different result for the lender – satisfaction of the promissory note when the loan is prepaid, versus assumption and continuation of the note when the loan is defeased. *Note: This article applies to performing loans, and is not intended to address defaulted loans.*

■ **Prepayment.** Many traditional commercial mortgage lenders require a prepayment or "make-whole" premium as a condition to prepayment. This premium is intended to compensate the lender for any loss resulting from having to reinvest the prepaid amount in an investment that yields a return lower than the interest rate on the loan. Prepayment premium formulas are often based on the yield of a U.S. Treasury security with the same maturity date as the promissory note. When the loan is prepaid, the note is cancelled and the lender releases the deed of trust encumbering the borrower's real property.

■ **Defeasance.** Unlike traditional mortgage lenders, CMBS "lenders" – the holders of bonds secured by a bundle of commercial mortgage loans – are averse to prepayment, even with a prepayment premium, and prefer to receive their scheduled monthly payments through the original maturity date. CMBS bondholders can be assured that they will receive ongoing payments by purchasing loans that restrict prepayment and only allow the borrower to obtain a release of its property by defeasing the loan. With defeasance, the CMBS borrower purchases a portfolio of government securities (usually U.S. Treasuries) that are pledged as collateral for the loan in place of the real property collateral. At the same time, a successor borrower entity – an entity that is most often unrelated to the original borrower and that is typically formed by the defeasance consultant engaged by the original borrower to consummate the transaction – assumes the original borrower's obligations under the note, and the lender releases the original borrower going forward. More importantly, the lender releases its deed of trust from the borrower's real property. The note remains in place, secured by the package of government securities. As each loan payment comes due, the securities are sold, the proceeds are applied by the lender to make the payment, and the bondholders continue to receive the expected payments.

■ **Defeasance Lockout.** A borrower who wishes to defease may find himself frustrated by the mandatory lockout period. A traditional lender may restrict prepayment for an initial time period, but that period is negotiable when the loan is made. CMBS loans are subject to a defeasance lockout period, but this period is not negotiable. In order to comply with tax regulations, the CMBS lender must prohibit the loan from being defeased for a certain time – generally the earlier of two years after loan securitization or four years after the loan closing. Since the borrower is generally prohibited from prepaying its CMBS loan, there will be no way to obtain a release of its property from the lien of the deed of trust during this period.

■ **Defeasance Costs.** Often, the acquisition price for the defeasance securities portfolio is comparable to the prepayment premium another lender might charge – but defeasance typically ends up costing more than prepayment because of other costs, including fees for the defeasance consultant, the loan servicer, the lender's account custodian, legal counsel for the lender, the successor borrower and the original borrower, plus costs for various legal opinions, verification of the adequacy of the securities and, in some cases, fees for rating agencies and their counsel. Defeasance expenses can quickly approach six figures; with a prepayment, by contrast, the borrower often pays only the lender's nominal fees for processing the payoff and release.

■ **Time.** Not only is defeasance more costly than prepayment, but also it likely will require more of the borrower's time and patience. Prepayment typically requires notice to the lender, the issuance of a payoff statement from the lender, a wire transfer to the lender and the lender's release of the deed of trust. With defeasance, the beginning and end steps – notice and release of the deed of trust – are the same. Defeasance is, however, more complicated than a payoff, requiring creation of a securities portfolio by a securities broker, confirmation by an independent accountant that the portfolio will satisfy all amounts due under the note, assumption of the loan and assignment of the securities to a successor borrower entity, pledge of the securities to the lender, delivery of the securities to an account custodian, and negotiation of a number of transaction documents. In addition, the lender typically requires diligence on the parties, including organizational documents and legal opinions. Most borrowers must hire a defeasance consultant to coordinate the transaction.

■ **Negotiation of Prepayment Rights.** Many borrowers believe CMBS loans can never be prepaid and must always be defeased. The reality is that prepayment can be negotiated at the time the CMBS loan is originally made, but the borrower can expect to pay for this flexibility in the form of a higher interest rate on the loan. Considering the added steps and expenses associated with defeasance, there are certainly situations that may warrant paying the higher rate.▲