

AMERICAN BAR ASSOCIATION -- SECTION OF TAXATION

2006 Joint Fall CLE Meeting

TITLE: Defeasance Transactions

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PANEL: Conduit Loan Defeasance

DATE: 10/20/06 11:00a

COMMITTEE: Real Estate

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COMMERCIAL **DEFEASANCE**
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Conduit Loan Defeasance

ABA Section of Taxation Fall Meeting

Denver, CO

October 20, 2006

Presented by:

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David Shechtman (Drinker Biddle & Reath LLP)

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COMMERCIAL **DEFEASANCE**
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What is defeasance?

The preferred form of call protection for fixed-rate CMBS loans.

- Defeasance is best thought of as a substitution of collateral in which qualified U.S. Government Securities replace the real estate.
- Redemption of principal and interest from the securities pays the scheduled monthly debt service and the balloon payment.
- Technically the Note remains in place but is repaid from proceeds of the securities purchased.

DEFEASANCE TAX ISSUES

TAX RESULTS DIFFER BASED UPON TYPE OF DEFEASANCE

- **LEGAL DEFEASANCE:** BORROWER TRANSFERS SECURITIES TO TRUSTEE AND IS LEGALLY RELEASED FROM DEBT
- **IN-SUBSTANCE DEFEASANCE:** BORROWER TRANSFERS SECURITIES TO TRUSTEE BUT IS NOT LEGALLY RELEASED FROM DEBT
- **REV. RUL. 85-42:** BORROWER REQUIRED TO INCLUDE INTEREST EARNED ON SECURITIES IN INCOME ONLY FOR IN-SUBSTANCE DEFEASANCE NOT LEGAL DEFEASANCE

DEDUCTION FOR DEFEASANCE PREMIUM

EXAMPLE: BORROWER MUST ACQUIRE \$23MM OF SECURITIES TO DEFEASE \$20MM DEBT – IS \$3MM PAYMENT CURRENTLY DEDUCTIBLE?

- IN AN IN-SUBSTANCE DEFEASANCE, BORROWER IS NOT RELEASED ON DEBT. MAY DEDUCT PREMIUM RATABLY OVER TERM OF LOAN
- IN LEGAL DEFEASANCE, PREMIUM SHOULD BE CURRENTLY DEDUCTIBLE AS PREPAYMENT PENALTY. REGS. §1.163-7(c)

LENDER'S TAX ISSUES

- IS THERE A “SIGNIFICANT MODIFICATION” OF THE DEBT INSTRUMENT AND THEREFORE A TAXABLE EXCHANGE OF OLD DEBT FOR NEW DEBT UNDER REGS. §1.1001-3?
- GENERALLY MUST CONCLUDE THAT SECURITIES REMAIN AS COLLATERAL (I.E., NOT LENDER'S PROPERTY) TO CONCLUDE NO TAXABLE EXCHANGE
- IF NEITHER LENDER NOR BORROWER WANTS TO BE TREATED AS OWNER OF SECURITIES THEN WHO?

1031 EXCHANGES AND DEFEASANCES

BOOT ISSUES

- IF BUYER, CLOSING AGENT OR QI FUNDS ARE USED TO ACQUIRE SECURITIES, DO WE HAVE CASH BOOT OR MORTGAGE RELIEF BOOT?
- CASH BOOT TREATMENT FOR DEFEASANCE PREMIUM, BUT IS THERE A CURRENT DEDUCTION?



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About Commercial Defeasance

With a background in structured finance, conduit lending and real estate, Commercial Defeasance, LLC was founded in 2000 to provide a single source solution for borrowers who want to defease a commercial loan. At Commercial Defeasance we handle every step of the defeasance process, including:

- Actively managing the process and parties to meet closing deadlines
- Optimizing and bidding out the securities portfolio
- Obtaining servicer, special servicer and rating agency consent
- Coordinating the “gap” style closing

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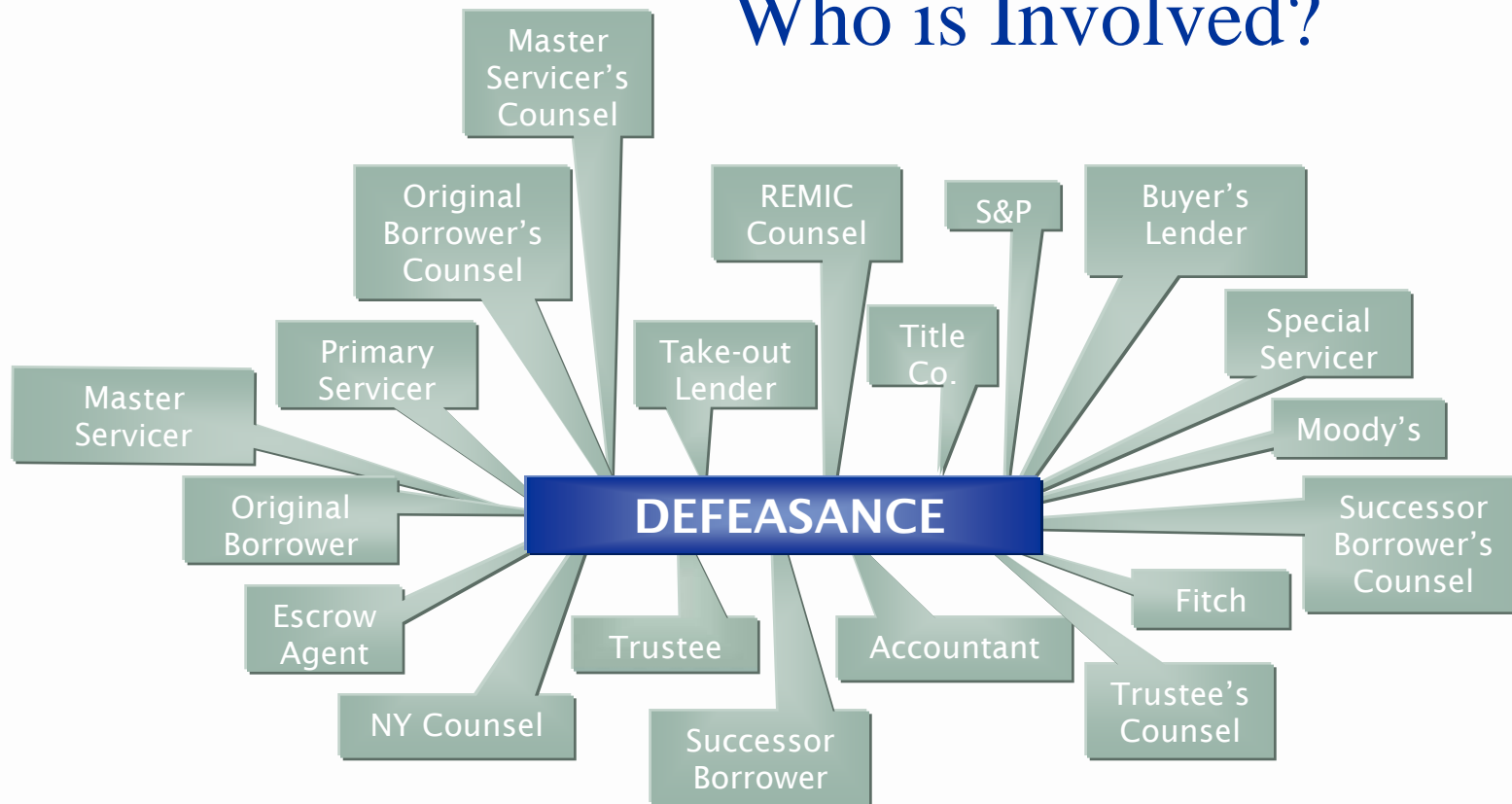


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The Ground Rules

- First, the borrower's loan documents must “allow for” the defeasance.
- Second, the borrower must pledge substitute collateral comprised of “government securities” as defined in the Investment Company Act (or the loan documents if narrower than the Investment Company Act).
- Third, the defeasance transaction cannot occur within the period ending two years after the REMIC's startup day.
- Fourth, the defeasance transaction must be undertaken to facilitate a sale or refinance or some other customary commercial transaction and cannot be part of an arrangement designed to collateralize the REMIC with obligations that are not real estate mortgages.

Who is Involved?





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What is Involved in a Defeasance Transaction?

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Diagram 1

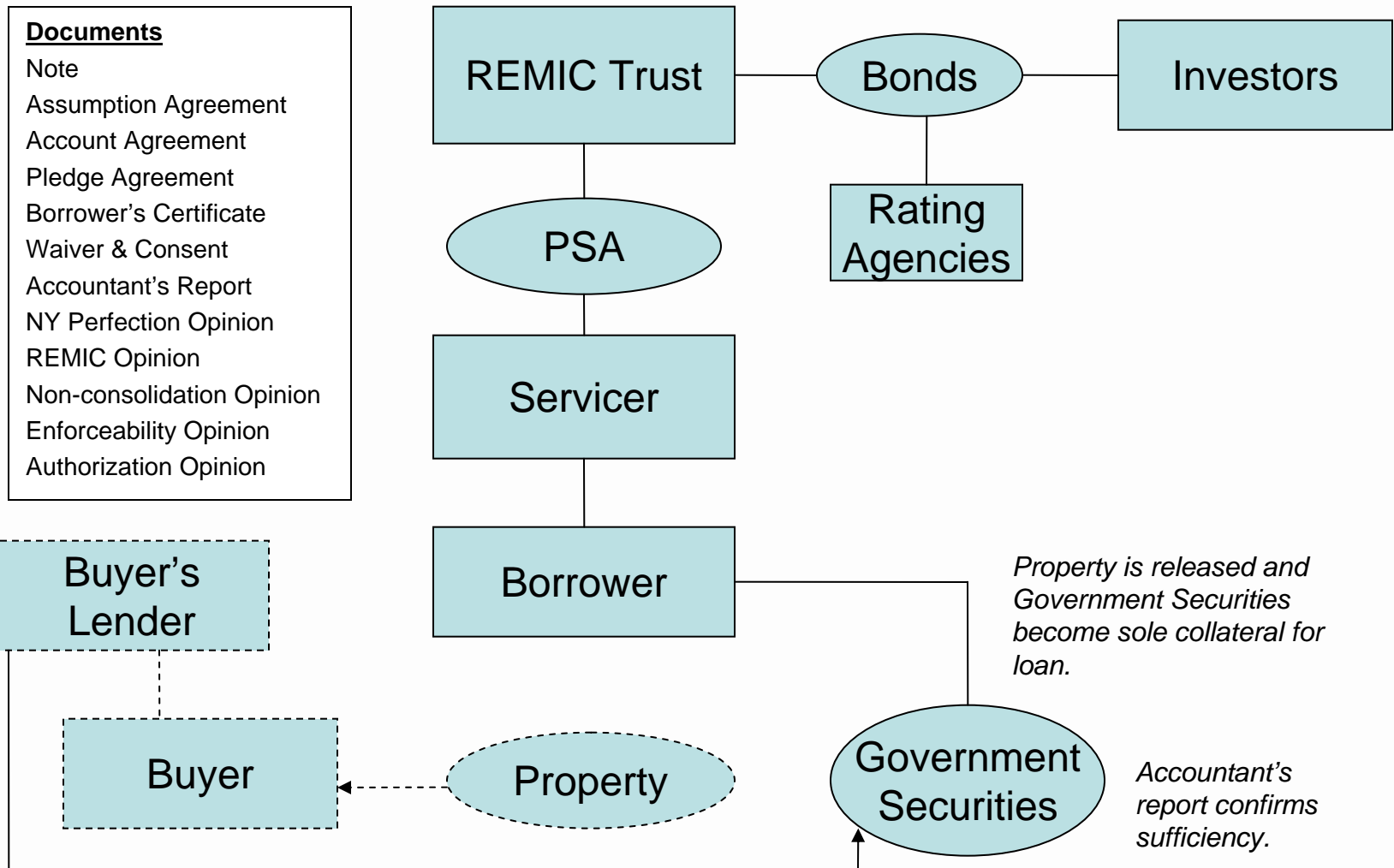
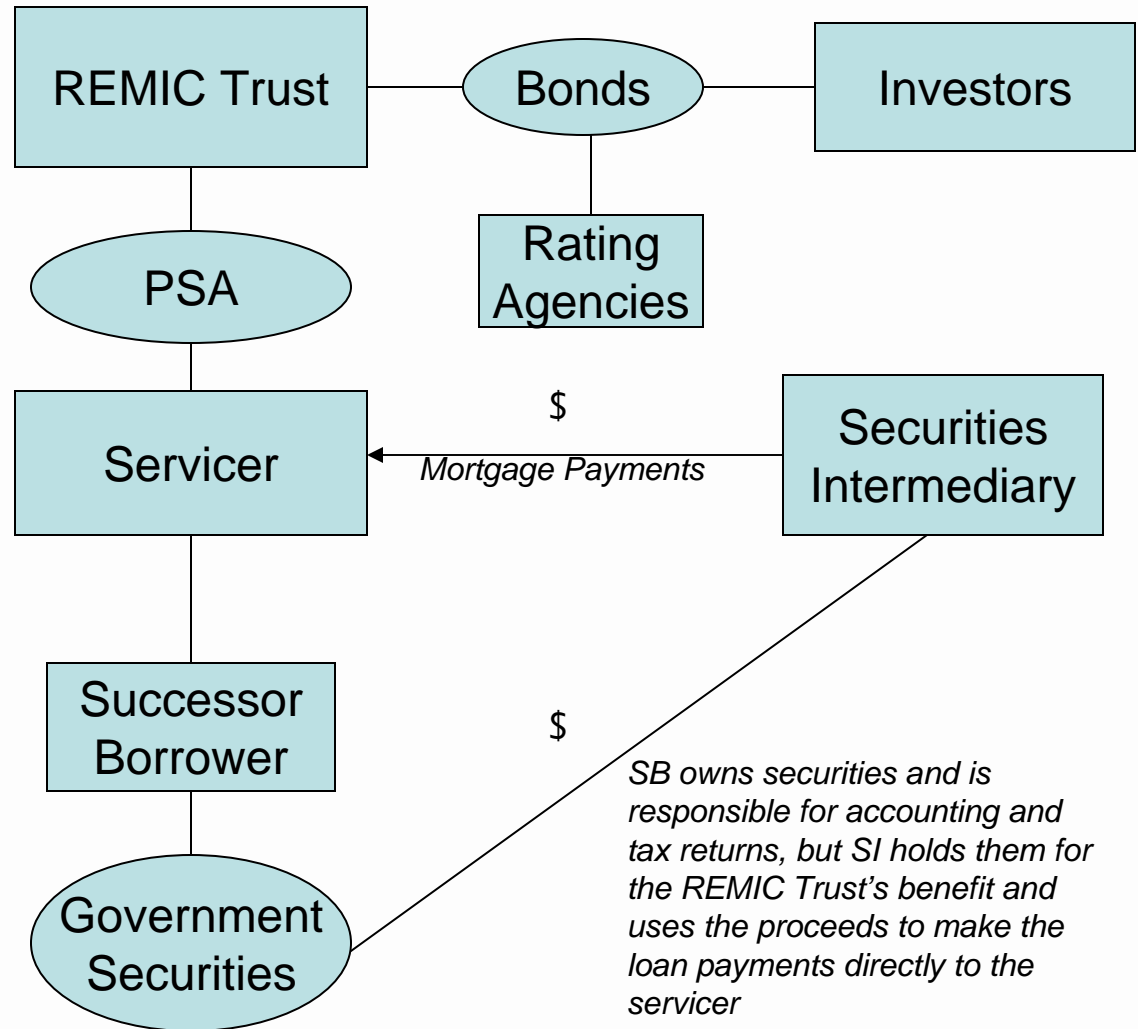


Diagram 2

- Documents**
- Note
 - Assumption Agreement
 - Account Agreement
 - Pledge Agreement
 - Borrower's Certificate
 - Waiver & Consent
 - Accountant's Report
 - NY Perfection Opinion
 - REMIC Opinion
 - Non-consolidation Opinion
 - Enforceability Opinion
 - Authorization Opinion

SB takes assignment of government securities and assumes note, pledge agreement and account agreement through assumption agreement

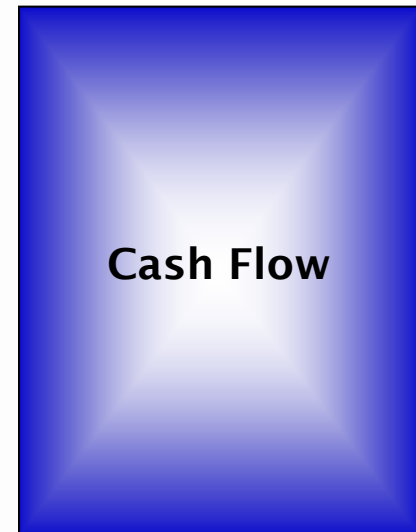


SB owns securities and is responsible for accounting and tax returns, but SI holds them for the REMIC Trust's benefit and uses the proceeds to make the loan payments directly to the servicer



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How is the Portfolio of Securities Structured?





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AMORTIZATION SCHEDULE

Date	Coupon	Interest	Principal	Total P&I	Prin. Balance
1/01/2006	7.669%	32,016.11	4,642.22	36,658.33	4,843,257.58
2/01/2006	7.699%	31,985.45	4,672.88	36,658.33	4,838,584.70
3/01/2006	7.699%	29,893.00	6,765.33	36,658.33	4,831,819.38
4/01/2006	7.699%	31,909.91	4,748.42	36,658.33	4,827,070.96
5/01/2006	7.699%	30,850.21	5,808.12	36,658.33	4,821,262.84
6/01/2006	7.699%	31,840.20	4,818.13	36,658.33	4,816,444.71
7/01/2006	7.699%	30,782.30	5,876.03	36,658.33	4,810,568.68
8/01/2006	7.699%	31,769.57	4,888.76	36,658.33	4,805,679.92
9/01/2006	7.699%	31,737.28	4,921.05	36,658.33	4,800,758.87
10/01/2006	7.699%	30,682.05	5,976.28	36,658.33	4,794,782.60
11/01/2006	7.699%	31,665.32	4,794,782.60	36,658.33	-



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SECURITIES COST

Maturity	Type	Coupon	Yield	\$ Price	Par Amount	Principal Cost	Accrued Interest	Total Cost
2/15/2006	STRIPS-P	-	1.122%	99.3039163%	72,000	71,498.82	-	71,498.82
5/15/2006	STRIPS-P	-	1.253%	98.9163536%	60,000	59,349.81	-	59,349.81
7/31/2006	T-NOTE	2.250%	1.132%	101.2031250%	36,000	36,433.13	337.87	36,771.00
8/15/2006	T-NOTE	6.000%	1.130%	105.4218750%	35,000	36,897.66	788.95	37,686.61
9/30/2006	T-NOTE	1.875%	1.134%	100.9218750%	37,000	37,341.09	174.39	37,515.48
10/31/2006	T-NOTE	2.125%	1.146%	101.2968750%	4,775,000	4,836,925.78	17,095.28	4,854,021.06



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CASH FLOWS

Date	Event	Type	Maturity	Principal	Coup	Interest	Cash Flow	Balance
1/01/06	Balance							36,300.35
1/31/06	Income	T-NOTE	7/31/04	-	2.250%	405.00	405.00	36,705.35
2/01/06	Debt Service	-	-	-	-	-	(36,658.33)	47.02
2/15/06	Income	STRIPS-P	2/15/04	72,000	-	-	72,000.00	72,047.02
2/15/06	Income	T-NOTE	8/15/04	-	6.000%	1,050.00	1,050.00	73,097.02
3/01/06	Debt Service	-	-	-	-	-	(36,658.33)	36,438.70
3/31/06	Income	T-NOTE	9/30/04	-	1.875%	346.88	346.88	36,785.58
4/01/06	Debt Service	-	-	-	-	-	(36,658.33)	127.25
4/30/06	Income	T-NOTE	10/31/04	-	2.125%	50,734.38	50,734.38	50,861.63
5/01/06	Debt Service	-	-	-	-	-	(36,658.33)	14,203.30
5/15/06	Income	STRIPS-P	5/15/04	60,000	-	-	60,000.00	74,203.30
6/01/06	Debt Service	-	-	-	-	-	(36,658.33)	37,544.97
7/01/06	Debt Service	-	-	-	-	-	(36,658.33)	886.64
7/31/06	Income	T-NOTE	7/31/04	3,6000	2.250%	405.00	36,405.00	37,291.64
8/01/06	Debt Service	-	-	-	-	-	(36,658.33)	633.31
8/15/06	Income	T-NOTE	8/15/04	35,000	6.000%	1,050.00	36,050.00	36,683.31
9/01/06	Debt Service	-	-	-	-	-	(36,658.33)	24.98
9/30/06	Income	T-NOTE	9/30/04	37000	1.875%	346.88	37,346.88	37,371.86
10/01/06	Debt Service	-	-	-	-	-	(36,658.33)	713.53
10/31/06	Income	T-NOTE	10/31/04	4,775,000	2.125%	50,734.38	4,825,734.38	4,826,447.92
11/01/06	Debt Service	-	-	-	-	-	(4,826,447.92)	-



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What Costs are Involved?

Defeasance costs fall into two categories:

Cost to Purchase
the Securities

Transaction
Costs



Securities Cost

Current Defeasance Calculation

US 5 Year Treasury 5.00 %

Defeasance in 2 Years

Assumed Forward Rate 7.00%

Today's Date: 03/06/2006

* Property Name: 123 Main Street

* Purpose of Defeasance: Other

* Servicer: Other

* Original Loan Amt (\$): 5,000,000

* Loan Term (months): 120

Interest Only Period (months)?

* Amortization (months): 360

* Coupon/Interest Rate (%): 5.25

* Interest Calculation: Act/360

* Payment due on 1st day of month.

* Note Dated: 6 / 1 / 2002

* Est. Defeasance Date: 6 / 1 / 2006

* NOTE: Required Fields

I have read and understand the [Disclaimer](#)

Calculate >> Clear >> Print >> Save >>

MONTHLY DEBT SERVICE:	\$27,610	?
PRINCIPAL BAL. AT DEFEASANCE:	\$4,711,037	?
SECURITIES COST:	\$4,865,972	?
DEFEASANCE "PREMIUM":	\$154,934	?
<hr/>		
TRANSACTION COST:	Estimated	
Rating Agency Fee:	\$0	?
Servicer Processing Fee:	\$10,000	?
Special Servicer Fee:	\$0	?
Custodian Fee:	\$10,000	?
Servicer Legal Fee:	\$20,000	?
Special NY Counsel Fee:	\$0	?
Accountant Fee:	\$4,000	?
Successor Borrower Fee:	\$8,000	?
Commercial Defeasance Fee:	\$15,000	?
<hr/>		
Total Transaction Cost:	\$67,000	?
<hr/>		
TOTAL ESTIMATED DEFEASANCE COST:	\$4,932,972	?
(Securities Cost + Est. Transaction Cost)		
<hr/>		
Treasury Curve:	6 Month: 4.76	
	2 Year: 4.76	
	3 Year: 4.76	
	5 Year: 4.73	

MONTHLY DEBT SERVICE:	\$27,610	?
PRINCIPAL BAL. AT DEFEASANCE:	\$4,542,134	?
SECURITIES COST:	\$4,342,293	?
DEFEASANCE "PREMIUM":	\$-199,841	?
<hr/>		
TRANSACTION COST:	Estimated	
Rating Agency Fee:	\$0	?
Servicer Processing Fee:	\$10,000	?
Special Servicer Fee:	\$0	?
Custodian Fee:	\$10,000	?
Servicer Legal Fee:	\$20,000	?
Special NY Counsel Fee:	\$0	?
Accountant Fee:	\$4,000	?
Successor Borrower Fee:	\$8,000	?
Commercial Defeasance Fee:	\$15,000	?
<hr/>		
Total Transaction Cost:	\$67,000	?
<hr/>		
TOTAL ESTIMATED DEFEASANCE COST:	\$4,409,293	?
(Securities Cost + Est. Transaction Cost)		
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Enter the desired shift & recalculate.		
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How long does it take?

(“My refinancing is closing in three days, is that going to be a problem?”)

- A defeasance will typically take 30-45 days to close (initial notice to closing).
- Servicers and counsel experiencing high defeasance volume will enforce notice periods (usually 30 to 60 days).
- Still much shorter than assumption process and not much longer than time it takes to get a yield maintenance calculation.
- Defeasance transactions generally will run parallel to either the closing of a refinance loan, or in the case of a sale, the closing of the acquisition loan with the buyer’s new lender, because the proceeds of either a refinancing or sale are typically used to purchase the defeasance collateral.



Mechanics and Timing

- Borrower engages defeasance consultant in connection with transaction
- Borrower gives required notice to Lender/Servicer requesting defeasance
- Servicer/Servicer's Counsel review defeasance provisions in loan documents
- Successor Borrower (if applicable) is identified by Lender or Borrower
- Accountant is engaged by Borrower to prepare verification report
- Servicer provides Borrower/Defeasance Consultant/Investment Bank with the loan amortization schedule and balance at maturity to determine payment requirements



Mechanics and Timing (con't)

- Servicer's Counsel prepares checklist and Defeasance Documents
 - Defeasance Pledge and Security Agreement
 - Defeasance Account Agreement
 - Defeasance Assignment, Assumption and Release Agreement
 - Certificate of Borrower
 - Defeasance Waiver and Consent Agreement
- Defeasance Consultant/Investment Bank performs “preliminary securities run” to identify securities to match payments required under the note
- Accountant prepares preliminary verification report based on Servicer payment schedule and preliminary securities run
- Borrower's Counsel prepares release of mortgage and required opinion(s)
- If Rating Agency approval is required, Servicer's Counsel or Servicer delivers review package to Rating Agencies with recommendation for confirmation



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The “3-Day” Closing Process

- Pre-Day One – Servicer’s Counsel distributes counterparts of the Defeasance Documents for execution by Borrower, Lender, Servicer, Securities Intermediary and Successor Borrower. Counterparts are returned to Servicer’s Counsel for delivery on Day One.
- Day One – The securities are purchased (“circled”) on credit for the Borrower. The lender’s counsel finalizes the closing instruction letter which includes all final defeasance costs, and delivers the closing instruction letter and executed mortgage release to the title company/escrow agent. The closing instruction letter contains disbursement and recording instructions for the title company/escrow agent to follow on Day Three.
- Day Two – The borrower’s refinance or sale transaction is closed and buyer or refinance lender funds proceeds to escrow agent. The title agent/escrow agent receives the closing instruction letter, the mortgage release and the sale or refinancing proceeds.
- Day Three – The defeasance consultant arranges for delivery of the securities to the securities intermediary. Upon confirmation from the securities intermediary of receipt of the securities, lender’s counsel authorizes an initial wire to the intermediary to pay for the securities. Upon confirmation by the intermediary of receipt of the wire for the securities and settlement of the trade, lender’s counsel authorizes the escrow agent to make all remaining disbursements and to record the mortgage release.



Defeasance Cost Estimate

For a free defeasance cost estimate, e-mail or fax us the following:

- *Promissory Note
- *Loan Statement
- *Target Closing Date

We will provide a cost estimate within 24 hours!



* For estimates and explanations, ask for one of these individuals

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