

REAL ESTATE FINANCING THROUGH THE COMMERCIAL MORTGAGE BACKED SECURITIES MARKET

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I. OVERVIEW

A. THE MARKET

The commercial mortgage-backed securities (CMBS) market plays an increasingly important role in real estate finance by bringing together the real estate industry and the investment banking community. CMBS securitization programs did not exist at all in the 1980's, yet estimates indicate that despite a market adjustment late in 1998 which affected the volume of loans, twenty percent (20%) of all commercial and multi-family real estate debt will be securitized by the close of the year 2000. The introduction of Real Estate Mortgage Investment Conduits (REMICS) in the Tax Reform Act of 1986, the RTC's securitization efforts in the early 1990's and the diminished role of savings and loan associations in commercial real estate finance, have added to the impact of CMBS on real estate finance.²

In 1992 alone, the RTC sold \$9.2 billion worth of mortgages through securitization efforts, in part because it perceived there was no other market for

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² By the end of 1984, forty percent (40%) of the nation's thrifts were insolvent. In 1989, the Financial Institution Reform, Recovery and Enforcement Act (FIRREA) created the Resolution Trust Corporation (RTC). One commentator estimates that as of 1999, commercial banks enjoyed a 40% share of the commercial mortgage market, life insurance companies were at 15%, and thrifts were at 8%.

this product. CMBS issuance rose from \$1.6 billion in 1990 to \$20 billion in 1994, and a remarkable \$78 billion in 1998. CMBS issuance “dipped” to \$60 billion in 1999, prompting experts to forecast an annual average of \$50-\$75 billion in CMBS issuance for the foreseeable future.

B. POTENTIAL ISSUES

How does real estate financing through the CMBS market affect borrowers and their counsel? The efficiencies of the secondary market are designed to lower the cost of capital to borrowers. That’s obviously a positive force. In addition, commentators have reasoned that this alternative source of financing will ameliorate the impact of the cyclical credit crunch which has historically affected the real estate industry. On the other hand, CMBS related loans have different requirements and restrictions than do loans originated by portfolio lenders. That’s what we need to come to grips with.

REMIC restrictions provide that CMBS loans must be secured by income-producing real property. CMBS lenders focus on stable properties (because the investors look at historical cash flow) rather than deals with possible “upside” potential. REMIC rules also restrict loan modifications [(see IRC § 1001 and Treasury Regulations 1.860-G-2(b)(1) and (2)]. Essentially, a loan may not be significantly modified, or such a transaction would be deemed to be an impermissible exchange of mortgages. If the new mortgage represents more than a *de minimus* (1%) amount of the REMIC’s assets, then the REMIC would cease to qualify as a REMIC and would become subject to federal

income tax. Partial releases of collateral and the ability to place additional debt on the property are severely limited. Loan assumptions, however, are permitted under certain circumstances. Because of the value of having uniformity in loans which are designed to be pooled and securitized, negotiation of loan documents is discouraged. Significant reserves for repairs and replacements, tenant improvements and leasing commissions, and similar items may apply. Prepayment lockout periods and defeasance provisions will apply. Extensive information regarding the borrower, the recourse guarantors and the property will be disclosed to rating agencies and investors.

C. THE PLAYERS & PROCESS

In order to discern some of the important differences between portfolio loans and CMBS loans, it is helpful to discuss how the CMBS process works.³ For some borrowers, the differences between portfolio loans and CMBS loans will not be apparent. For others, the issues presented by the added layer of involvement by secondary market participants are something they will need to identify and address early in the process.

Briefly stated, the process of mortgage securitization involves the creation of a new financial instrument that represents an ownership interest in a pool of mortgage loans. The process is often called “structured finance” because of the “tranches” or

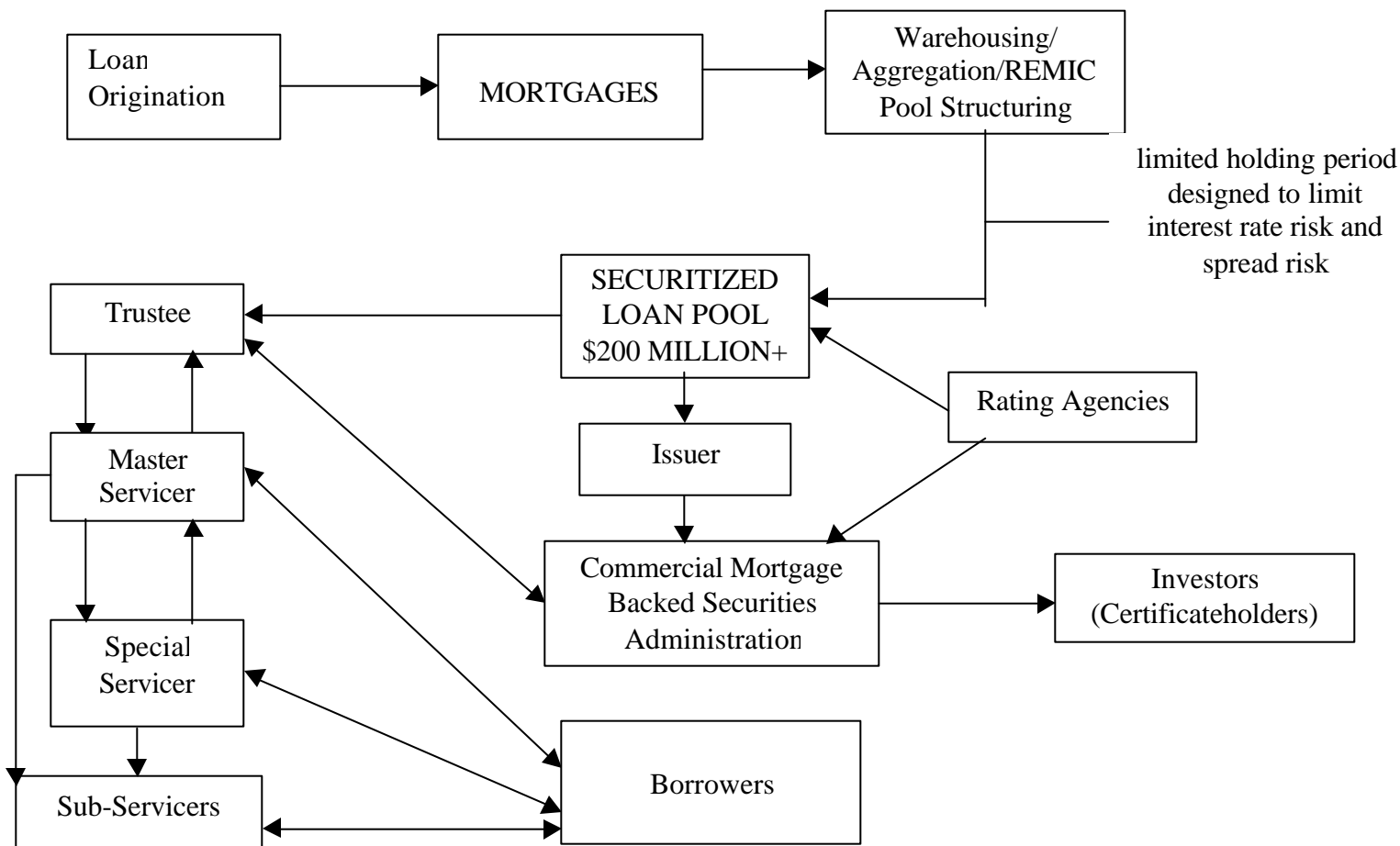
³ For more general information on the CMBS market, refer to *“From Main Street to Wall Street: Commercial Mortgage-Backed Securities”*, by Joseph Philip Forte, ABA Probate & Property, January/February 1996; the Commercial Mortgage Securities Association website, www.cssambs.org and the Mortgage Bankers Association website, www.mbaa.org.

layers of interests which are rated and valued through the risk/reward structure. The following quote offers a descriptive summary of the structure:

“[CMBS is]... built on the basic notion of creating a secure senior tranche by creating a junior (subordinated) security to bear losses from the underlying mortgages up to the full face amount of the junior security... The senior tranche receives all principal payment cash flows: amortization, early repayment, or collections from foreclosure. The subordinated tranche receives no principal payments until the senior tranche is retired. If there are any losses on the mortgages, they are completely allocated to the subordinated, or “first loss” tranche until its principal balance is reduced to zero. In summary, principal collections are allocated “top down” – first to the senior class and later to the more junior class. Losses are allocated “bottom up” – first to the junior classes. If investors can estimate an upper limit on the total losses from a pool of mortgages, they can create a default free senior security by making the junior tranche large enough to bear the maximum loss. Many variations on this basic idea are possible, including adding intermediate tranches between the senior security and the first-loss class and creating more gradations of default risk.” (John P. Harding and C.F. Sirmans, *Commercial Mortgage-Backed Securities: An Introduction for Professional Investors*, Real Estate Finance, Spring 1997.)

The following chart summarizes the inter-relation of participants in the CMBS structure. Definitions of a number of the participants follows for further explanation of the process:

BASIC CMBS LOAN PROCESS



1. Issuer

The typical securitized transaction is initiated by an issuer which acquires mortgages that will secure bonds that it sells to investors on Wall Street. Lehman Brothers, Donaldson Lufkin & Jenrette (DLJ) and Merrill Lynch are three active issuers in the market.

2. Trustee

The Trustee represents the REMIC Trust that holds the legal title to the collateral for the benefit of all Certificateholders (Investors). The Trustee's duties include, among other things: (a) holding the mortgage collateral; (b) distributing all funds collected by the Master Servicer to the Certificateholders; (c) supervising the Master Servicer and Special Servicer to ensure that they act in accordance with the terms of the Pooling and Servicing Agreement; and (d) appointing a new servicer if the terms of the Pooling and Servicing Agreement are violated. LaSalle Bank, Wells Fargo, Chase Manhattan and State Street Bank are active Trustees.

3. Master Servicer

The Master Servicer is required to service the underlying mortgage loans which collateralize the CMBS. The Master Servicer acts on behalf of and for the benefit of the Certificateholders. The Master Servicer's duties are specified in the Pooling and Servicing Agreement. These duties include: (a) collection of mortgage payments (often through a lock box arrangement) and delivery of fund to the Trustee; (b) maintaining escrow (taxes and insurance) and reserves (repair, replacement, tenant improvements, etc.); (c) advancing any late payments to the Trustee; (d) monitoring the loans' performance and providing mortgage performance reports to Certificateholders; and (e) transitioning all loans to the Special Servicer that go into REO or non-performing status. Master Servicers include Midland Loan Services, GE Capital, GMAC Commercial and First Union.

4. Special Servicer

A Special Servicer is the servicer who takes on servicing responsibilities when a loan goes into default, and conducts the "work-out" or foreclosure process.⁴ Special Servicers are generally: (1) those sellers/issuers retaining the first-loss piece; (2) those investing in "B" pieces (high risk tranches) in return for special servicer rights (and the

⁴One of the beneficial byproducts of CMBS is the amount of information now available on real estate finance related topics. The American Council of Life Insurers (ACLI) has reported that of CMBS loans which have gone into default, ½ are restructured (resulting in a 30% loss) and ½ are foreclosed (resulting in a 50% loss).

fees associated with those rights); and (3) those appointed because of asset-management expertise. Lennar Partners, ORIX (Banc One), GMAC Commercial and Lend Lease Asset Management collectively have nearly 85% of the market share for special servicer work.

5. Investors

Investors buy the securities. In the category of the investment-grade tranches (AAA to BB), the primary investors are generally life insurance companies, pension funds, and commercial banks. Banks are attracted to this investment, in part as a method to avoid the cost of maintaining risk reserves for these loans. Some estimates indicate that life insurance companies now own fifty percent (50%) of the outstanding investment-grade CMBS. For below-investment grade tranches (BB and below), the securities are placed pursuant to Rule 144(a), and as such must be sold to a Qualified Institutional Buyer. The demand for below-investment-grade tranches has come primarily from real estate investment funds and CMBS servicing entities, both of which have the sophistication necessary to properly underwrite the real estate risk inherent in these tranches.

6. Rating Agencies

Rating agencies examine the securities and their underlying collateral (at issuance and as a part of post issuance surveillance) and rate the securities based upon their own criteria. Ratings range from AAA (highest) to CCC (lowest). Ratings are a quantification of credit risk, and are a major influence on CMBS structure (subordination levels) and pricing. Proposed modifications to CMBS loans will generally require a “no down-grade” letter from the applicable Rating Agency as a precondition to that transaction. The four rating agencies of CMBS are Duff & Phelps, Fitch IBCA, Moody’s and Standard & Poor’s.

II. ISSUES

A. BANKRUPTCY-REMOTE SPECIAL-PURPOSE ENTITIES

Securitization is premised on the ability to focus on the value of the security, separate from any bankruptcy risk of the borrower/mortgagor. As such, lenders, along with other participants in the commercial mortgage backed securities market, have become increasingly enamored with the concept of requiring borrowers to form bankruptcy remote Special-Purpose Entities (SPE’s) to serve as the borrower/mortgagor. An SPE is structured as an entity (1) which is unlikely to become insolvent as a result of

its own activities (2) which is insulated from the consequences of any related party's insolvency and (3) which permits the lender to more easily obtain relief from the automatic stay should a bankruptcy filing occur. SPE-related provisions are typically incorporated into both the entity's organizational documents and the loan documents. Note that there are several different levels of bankruptcy remoteness. An SPE's general partner or member may also be required to be an SPE, for loans over \$5 million; a non-consolidation opinion and independent director may be required for loans over \$10 million. The size of the loan is not absolutely determinative. The requirements change in relation to the percentage of an entire pool represented by a single loan.

SPE criteria can generally be divided into four categories:

1. *Provisions designed to prohibit the SPE from incurring additional liability:*⁵

⁵ Lenders seek to prohibit or limit additional indebtedness, particularly secured loans, for a variety of reasons. These include (1) subordinate liens are a very real impediment to relief from the stay because subordinate secured creditors will constitute a class that must be dealt with in a bankruptcy proceeding and may be provided for at the expense of the first lien lender; (2) bankruptcy judges often tend to be more considerate of the interests of subordinate creditors than of debtors; (3) the possibility that a debt restructure in a workout, if not agreed to by the subordinate lien holder, may result in the prime lender risking loss of lien priority; (4) diversion of cash flow to service subordinate loans; (5) possibility of a marshaling claim which may delay or otherwise impede the lender's realization on collateral or require the lender to realize on an asset in a manner not consistent with other business concerns of the lender; (6) possible inability of the prime lender advancing additional funds to add the amount so advanced to the debt secured by its first mortgage lien.

- a. Limitation of purpose. The entity's purpose is limited to owning and operating the mortgaged property, acting as general partner of a limited partnership borrower or acting as a member of a limited liability company borrower.

- b. Limitation of assets. The entity has not and will not have any assets other than the mortgaged property or its partnership or membership interests in the limited partnership or limited liability company which owns the mortgaged property.

- c. Limitation of indebtedness. The entity is limited in that the debt it may incur shall be only the subject loan and unsecured trade payables in the ordinary course of business related to the ownership and operation of the mortgaged property. No other direct or contingent debt, secured or unsecured is permitted.

- d. Limitation of liquidation, consolidation, merger, etc. Unanimous consent of all partners or members is required to accomplish any of these tasks.

2. *Provisions designed to insulate the SPE from liabilities of third parties:*

a. Separateness covenants. “Separateness Covenants” are included in both the loan documents and the organizational documents, whereby the entity covenants:

- To maintain books and records separate from any other person or entity;
- To maintain its accounts separate from any other person or entity;
- Not to commingle its funds or assets with those of any other entity;
- To conduct its own business in its own name;
- To maintain separate financial statements, accounting records and other entity documents;
- To pay its own liabilities out of its own funds;
- To observe all partnership, limited liability company or corporate formalities, as applicable;
- To maintain an arm’s-length relationship with its affiliates;

(Separateness Covenants, Continued)

- To pay the salaries of its own employees and maintain a sufficient number of employees in light of its contemplated business operations;
- Not to guarantee or become obligated for the debts of any other entity or hold out its credit as being available to satisfy the obligations of others;
- Not to acquire obligations or securities of its partners, members or shareholders;
- To allocate fairly and reasonably any overhead for shared office space;
- To use separate stationery, invoices, and checks;
- Not to pledge its assets for the benefit of any other entity or make any loans or advances to any entity;
- To hold itself out as a separate entity;
- To correct any known misunderstanding regarding its separate identity;
- To maintain adequate capital in light of contemplated business operations; and
- To enter into transactions with its partners, members, shareholders or affiliates only in the ordinary course of

(Separateness Covenants, Continued)

business and on terms which are intrinsically fair and no less favorable than would be obtained in a comparable arm's-length transaction with an unrelated third party.

- b. Non-consolidation opinions. One of the fundamental concepts of an SPE is that the insolvency of an affiliate of an SPE should not impact the SPE. However, under the equitable provisions of Section 105 of the Bankruptcy Code, a court has the power to “substantively consolidate” ostensibly separate but related entities. Substantive consolidation treats the assets and liabilities of the entities as if they belonged to one, enabling the creditors of each formerly separate estate to reach the assets of the consolidated estate. Non-consolidation opinions confirm that the structure of the transaction and the structure of the entities are sufficient to avoid substantive consolidation.⁶

⁶ Note that Substantive Consolidation was not a popular approach among debtor's counsel in the most recent real estate recession, but caught the attention of those on Wall Street nonetheless.

3. ***Provisions designed to protect the SPE from dissolution risks:***

- a. Prohibition of dissolution. If the entity is a limited partnership and a general partner withdraws or becomes insolvent, then the limited partnership agreement must require the remaining partners to continue the partnership as long as one solvent general partner exists. If the entity is a limited liability company, then the articles or organization and/or operating agreement must require the remaining members to continue the limited liability company in the event of a termination event, such as a bankruptcy of the managing member.

- b. SPE general partners or SPE members. Typically, a limited partnership is comprised of one general partner and multiple limited partners. Under the Revised Uniform Limited Partnership Act (see *Virginia Code* Sections 50-73.49 and 50-73.28), if a general partner of a limited partnership were to become subject to a bankruptcy proceeding, the partnership would dissolve unless it was otherwise continued or reconstituted by the remaining partners. If the general partner is an SPE, this should greatly reduce the chances that the general partner will become insolvent and the partnership will dissolve. In addition, the organizational

documents of the SPE general partner or SPE members may require it to consider the interests of the creditors of the borrower in connection with all of its actions.

4. *Provisions designed to limit the likelihood of a voluntary bankruptcy filing:*

Unanimous consent of all partners, members and the independent director, as applicable, may be required to undertake certain actions, most importantly, to file a bankruptcy petition with respect to the SPE, and to modify the SPE's organizational documents.

B. NON-RECOURSE CARVE-OUTS

As discussed above, CMBS participants focus primarily on the value of the property (or the cash flow represented by a creditworthy tenant) rather than on the creditworthiness of the borrower. As such, CMBS loans are typically non-recourse or limited recourse. Nonetheless, non-recourse or limited recourse loans often include guarantees (from creditworthy individuals or entities) of non-recourse carve-outs for “bad-boy” acts, such as (i) fraud or misrepresentation, (ii) misappropriation or misapplication of funds, (iii) failure to pay taxes or insurance premiums; (iv) failure to comply with financial reporting requirements; (v) voluntary bankruptcy filing; (vi) waste or neglect of the collateral; (vii) actions to hinder noteholder's exercise of rights to realize on its security; or (viii) violation of environmental laws. Some loan provisions provide

for the lender to recover its losses or damages upon these “bad boy” acts, while other provisions result in the entire loan becoming a recourse obligation. Note the following sample provision:

Exculpation.

(a) Except as otherwise provided herein, in the Deed of Trust or in the other Loan Documents, Lender shall not enforce the liability and obligation of Borrower to perform and observe the obligations contained in this Note or the Deed of Trust by any action or proceeding wherein a money judgment shall be sought against Borrower, except that Lender may bring a foreclosure action, action for specific performance or other appropriate action or proceeding to enable Lender to enforce and realize upon this Note, the Deed of Trust, the other Loan Documents, and the interest in the Property, the rents and any other collateral given to Lender created by this Note, the Deed of Trust and the other Loan Documents; provided, however, that any judgment in any such action or proceeding shall be enforceable against Borrower only to the extent of Borrower's interest in the Property, in the rents and in any other collateral given to Lender. The provisions of this Section ____ shall not, however, (i) constitute a waiver, release or impairment of any obligation evidenced or secured by this Note or the other Loan Documents; (ii) impair the right of Lender to name Borrower as a party defendant in any action or suit for judicial foreclosure and sale under the Deed of Trust; (iii) affect the validity or enforceability of any indemnity, guaranty, master lease or similar instrument made in connection with this Note, the Deed of Trust, or the other Loan Documents; (iv) impair the right of Lender to obtain the appointment of a receiver; (v) impair the enforcement of any Assignment of Leases and Rents executed in connection herewith; (vi) impair the right of Lender to obtain a deficiency judgment or judgment on the Note against Borrower to the extent necessary to obtain any insurance proceeds or condemnation awards to which Lender would otherwise be entitled under the Deed of Trust, provided however, Lender shall only enforce such judgment against the insurance proceeds and/or condemnation awards; or (vii) impair the right of Lender to enforce the due on sale provisions of Section ____ of the Deed of Trust and the Special Purpose Entity provisions of Section ____ hereinabove.

(b) Notwithstanding the provisions of this Section ____ to the contrary, Borrower and Borrower Principals shall be personally and jointly and severally liable to Lender for the loss or damage it incurs due to (i) fraud or intentional misrepresentation by Borrower, its agents or principals in connection with the execution and the delivery of this Note, the Deed of Trust or the other Loan Documents; (ii) Borrower's application or appropriation of income for any purpose other than debt service to Lender and other approved operating expenses in strict accordance with the budget approved by Lender, as

amended from time to time, of (A) rents, profits or sales proceeds received by Borrower, (B) tenant security deposits or rents, if any, collected in advance, or (C) insurance proceeds or condemnation awards; (iii) Borrower's failure to pay taxes or insurance premiums (except to the extent that sums sufficient to pay such amounts have been deposited in escrow with Lender pursuant to the terms of the Deed of Trust), charges for labor or materials or other charges that can create liens on the Property, provided that Borrower's liability under this clause (iii) shall not exceed an amount equal to the net operating income of the Property for the twelve (12) month period preceding the related failure to pay, less the amount of all installment payments and any required reserve payments made by Borrower in accordance with this Note, the Deed of Trust and the other Loan Documents during such twelve (12) month period; (iv) Borrower's failure to comply with the provisions of the Deed of Trust which require Borrower and any other obligors to furnish financial reports or records; (v) Borrower's or any other obligor's failure to comply with any environmental provisions in the Deed of Trust, that certain Hazardous Materials Certificate and Indemnification Agreement of even date herewith and the other Loan Documents; (vi) Borrower's, Borrower Principals or their respective agents' or principals', or any other obligor's assertion, pursuit or joinder in any claim or proceeding against Lender (or any defense against any collection or enforcement action pursuant to this Note or any other Loan Document) in the nature of lender liability or equitable subordination; (vii) waste of the Property; (viii) any personal property or fixtures constituting part of the collateral being removed or disposed of by Borrower, any partner or member of Borrower, or any other person or entity, other than in accordance with the terms of the Loan Documents unless (A) such personal property or fixtures were disposed of for their fair market value and the proceeds thereof were directly used for the benefit of the Property, or (B) insurance proceeds equal to the fair market value of such collateral are paid to Lender; (ix) any action of Borrower, any member or partner of Borrower or any other guarantor or obligor under the Loan Documents to hinder foreclosure of any collateral securing this Note; (x) if, without obtaining Lender's prior written consent (A) a transfer (except a sale of a Lot as permitted by the Loan Documents) shall occur which, pursuant to Section ___ of the Deed of Trust, gives Lender the right, at its option, to declare all sums secured by the Deed of Trust to be immediately due and payable; (B) Borrower shall encumber the Property with the lien of any subordinate instrument in connection with any financing by Borrower; (C) Borrower shall fail to perform its obligations to provide full access to all of its books and records to Lender as provided for in the Loan Documents; or (D) Borrower shall violate Section 15 hereinabove, any of such events shall constitute a default by Borrower under this Note, the Deed of Trust and the other Loan Documents, and if such event shall continue for thirty (30) days after notice, paragraph (a) of this Note shall not apply from and after the date which is thirty (30) days after notice of such event and Borrower and each member or partner of Borrower (each individually on a joint or several basis if more than one) shall be personally liable on a joint and several basis for full recourse liability under this Note, the Deed of Trust and the other Loan Documents.

(c) Notwithstanding the foregoing, the agreement of Lender not to pursue recourse liability as set forth in Subsection (a) above SHALL BECOME NULL AND VOID and shall be of no further force and effect in the event of (i) Borrower's default under the Single Purpose Entity requirements of Section _____ of this Note, (ii) if the Property or any part thereof shall become an asset in (y) a voluntary bankruptcy or insolvency proceeding, or (z) an involuntary bankruptcy or insolvency proceeding (A) which is commenced by any party controlling, controlled by or under common control with Borrower (the "Borrowing Group") or (B) in which any member of the Borrowing Group objects to a motion by Lender for relief from any stay or injunction from the foreclosure of the Deed of Trust or any other remedial action permitted hereunder or under the Note or the other Loan Documents; or (iii) Borrower or any person or entity in the Borrowing Group directly or indirectly takes any action to hinder or delay Lender's efforts to realize upon the collateral for the Loan.

(d) Nothing herein shall be deemed to be a waiver of any right which Lender may have under Sections 506(a), 506(b), III I (b) or any other provisions of the U.S. Bankruptcy Code to file a claim for the full amount of the indebtedness or to require that all collateral shall continue to secure all of the indebtedness owing to Lender in accordance with this Note, the Deed of Trust and the other Loan Documents.

In addition, nothing in this Section shall (i) be deemed in any way to be a release of impairment of the Note or of the liens and security interests created pursuant to the provisions of the Deed of Trust or any of the other Loan Documents; (ii) be deemed in any way to be a release or impairment of any of the Lender's rights or remedies set forth in the Loan Documents, at law or in equity; (iii) be deemed to be a waiver of any conditions contained in the Loan Documents; (iv) be deemed to prejudice the rights of the Lender to secure a deficiency judgment against any persons or entities (including partners of the Borrower) who have agreed or who may hereafter agree to be liable for payment of the indebtedness evidenced by the Note; (v) be deemed to prejudice the rights of the Lender to secure a judgment against any parties other than the Borrower; or (vi) be deemed to be a waiver of any right which the Lender may have under Sections 506(a), 506(b) and 1111(b) of the Bankruptcy Code or of any other provisions of bankruptcy law to file a claim for the full amount of the indebtedness owing to the Lender by the Borrower or to require that all collateral shall continue to secure all amounts under the Note in accordance with the Loan Documents.

C. INTEREST CALCULATION

There are several different methods by which interest accrual calculations may be made. The parties may agree to, among other things, the *equal payment method* (based upon twelve 30-day months or based upon a 365-day year), or the *360-actual method* (based upon the actual number of days in a year multiplied by $1/360^{\text{th}}$ of the annual interest).

The equal payment method calculates a per diem interest rate by dividing the annual interest by 360, and then charges 30 days worth of interest in each monthly payment. In the alternative, the equal payment method may arrive at a per diem interest rate by dividing the annual interest by 365 and then charging interest on a monthly basis by the precise number of days in a given month.

The 360-actual method calculates a per diem interest rate by dividing the annual interest by 360 and then charges interest on a monthly basis by the precise number of days in a given month. The important issue here is a fair comparison of the true cost of the credit. Simple math dictates that more days of interest result in higher interest payments, at the same quoted rate. Here is an example:

\$10,000,000.00	Principal amount
\$800,000.00	Annual interest at 8%
\$2,222.22	360 day per diem
\$2,191.78	365 day per diem

If the loan documents call for interest to be calculated on a 360 day year, but interest is then charged on the actual number of days elapsed in any given year, the added cost difference to the borrower in the example above, is approximately \$11,110.30 (5 days at \$2,222.22).

D. DEFEASANCE

Defeasance is becoming a more prominent issue in loans originated for the commercial mortgage backed securities market. Initially, the investors' return from expected cash flow was preserved by requiring yield maintenance provisions in loan documents, triggered by a borrower's prepayment. The trend to replace yield maintenance provisions with defeasance options began in 1995 and by 1997 became commonplace.

Defeasance satisfies various goals of the CMBS participants. The borrower wants to preserve its prepayment option to enable it to refinance the loan or sell the underlying real estate collateral (where assumption of the loan is not desirable or is not an option). CMBS investors want to preserve the predictability of the yield represented by cash flow. The servicer and trustee want to preserve the REMIC's tax status and abide by the terms of the Pooling and Servicing Agreement.

Defeasance is the process whereby a mortgage on real estate is replaced with a pledge of U.S. government obligations (treasuries) as substitute collateral for a loan, provided that the obligations generate sufficient cash flow to match the loan's debt service requirements. Note that the substitute collateral and the loan are transferred by the borrower to an unaffiliated SPE created for the sole purpose of receiving defeased loans.

The defeasance process generally involves the following ten steps:

1. The Borrower delivers a notice of intent to defease to the servicer, at least 30 days prior to the proposed defeasance date.
2. The Borrower purchases U.S. treasuries with a cash flow sufficient to timely meet all scheduled mortgage payments.
3. The Borrower coordinates delivery of a comfort letter from a CPA certifying as to the cash flow of the U.S. treasuries.
4. The Borrower coordinates delivery of legal opinions:

- a. enforceability opinion (validly formed and existing SPE assumptor, assumption agreement enforceable, noteholder has validly perfected security interest in the treasuries).
 - b. REMIC opinion (the assumption and release is not a material modification of a mortgage tantamount to replacement of the mortgage, which would subject the REMIC to taxation).
5. Formation of a new SPE to assume the loan and to hold and pledge the U.S. treasuries.
6. Execution and delivery of an assumption agreement whereby the new SPE assumes the loan obligations and takes title to the treasuries; the original borrower is released from prospective liability and any indemnitors/guarantors (i.e., non-recourse carve-outs) ratify and reaffirm their continuing obligations.
7. The new SPE executes and delivers a pledge agreement pledging the U.S. treasuries to the noteholder (REMIC trustee).
8. The Servicer issues an officer's certificate to the REMIC trustee certifying that the transaction is in compliance with the loan documents and the Pooling and Servicing Agreement requirements.

9. The applicable rating agencies issue no-down-grade letters.

10. The Servicer executes and delivers a release of the lien of the mortgage on the subject real property.

Defeasance is not a panacea for all borrowers who want to sell their property or refinance their loan (for cash-out or for a lower interest rate). The loan documents must expressly provide for defeasance. REMIC rules provide for a two-year lock-out period for any defeasance, from the date of securitization of the loan. The loan must not be in default. Perhaps most limiting - defeasance is currently very expensive – and no costs are to be absorbed by the REMIC trust. As such, defeasance is not likely to be cost effective for loans with an unpaid principal balance of less than \$5 million.

III. CONCLUSION

The real estate industry may benefit greatly from the increased access to capital represented by CMBS market. As CMBS plays an increasingly important role in the formerly “local” realm of real estate, those in the industry must understand the unique issues posed by this form of real estate finance.