

# CALIFORNIA REAL ESTATE JOURNAL

FRONT PAGE STORY

PUBLISHED WEEKLY ■ JUNE 4, 2007

## GUEST COLUMNIST

# How to Defease a Loan on Schedule and Avoid Future Liability

BY KARLA N. MACCARY

Since 1998, loans made with the intent to securitize have prohibited prepayment. Borrowers who desire to sell their property or refinance must “defease” such a loan or request the lender to allow a buyer to assume it.

Defeasance involves purchasing government or other permitted securities, so-called pledged securities, that will generate payments substantially similar to the loan’s payment schedule and will be sufficient to pay the balance on the maturity date. The securities are pledged to the lender then transferred to a single-purpose bankruptcy remote entity, the so-called successor borrower, who assumes the borrower’s obligations under the note. The deed of trust is then reconveyed, and the borrower is released of its obligations under the note and most of its obligations under the related loan documents. A defeasance closing generally takes three days.

A borrower facing a defeasance has two primary concerns. First, how can the defeasance happen without jeopardizing the sale or refinance schedule? Second, because the note is not paid off, how can the borrower be assured it will not face future liability as a result of the loan obligations?

### Do No Harm

There are seven main steps the borrower should take to ensure that the defeasance goes smoothly and does not interfere with the closing schedule.

First, in a sale, the seller should make sure the purchase agreement will not hold it responsible or release the buyer of its obligation to purchase if closing is delayed because of a hitch in the defeasance. The purchase agreement could give the seller a right to extend the closing because of a delay in the defeasance or attempt to put the burden of the defeasance, including all costs related thereto, on the buyer.

Second, in a sale, the seller should require the buyer to deposit the purchase price in escrow by 9 a.m. Pacific two business days before the scheduled closing. Because the borrower is responsible for breakage costs if the securities are purchased and the defeasance is not consummated, the seller is advised to wait to reserve or “circle” securities until it is comfortable that the buyer will perform in a timely manner.

Third, early in the defeasance process, confirm that the borrower and its general partner or managing



MACCARY

member are in good standing. If any of these parties has been suspended, the defeasance will be delayed as may be needed to restore the entity to good standing and address the lender’s related concerns.

Fourth, let your defeasance consultant know the proposed deadlines of the sale or refinance before they are agreed to. Defeasance consultants typically claim that the process will take 30 to 60 days, but it can be much quicker, particularly if no rating-agency approval is required. The defeasance process has become much more streamlined during the past several years. A few loan originators have set up related businesses offering defeasance-consulting services, including providing a successor borrower. In such situations, a law firm often represents both the lender and the successor borrower, effectively removing negotiations between those parties from the defeasance process. If attorneys representing the borrower and the lender have worked together on another defeasance, the lender’s counsel often will agree upfront to the same concessions granted to the earlier borrower.

Fifth, find out quickly whether rating-agency approval will be required. That depends in large part on the loan’s size and the terms of the servicing agreement that covers it. Rating-agency approval typically takes 10 days from receipt of a complete approval package, which includes the final form of all documents.

Sixth, order a preliminary title report and verify that all old liens have been released. As part of the defeasance, the lender will require an updated title report, in part to verify that there are no liens other than the loan being defeased. If an old lien appears on the title report, the lender should be satisfied with a title endorsement to the same degree as the new lender or buyer, but lenders have been known to require copies of lien reconveyances and might refuse the comfort provided by a title endorsement.

Last, early in the defeasance process, request that the successor borrower assume all liability should the pledged securities prove insufficient to make all payments under the loan. The most foreseeable way the borrower could have lingering liability for a defeased loan is if the pledged securities are insufficient to pay the loan. The successor borrower might require a few days to respond to such a request but usually will agree.

### How to Limit the Borrower’s Liability

In a defeasance, the loan is not paid off. Rather, the pledged securities are pledged to the lender and transferred to a single-purpose bankruptcy-remote entity that assumes the borrower’s obligations under the note and most of the obligations under the loan documents, and the deed of trust is reconveyed.

While it might appear the borrower could not have future liability related to the loan through such a process, defeasance documents are drafted in such a way that there are risks to the borrower. The most apparent risk is that the pledged securities might be insufficient to make all payments due under the loan. The most important change to defeasance documents that the borrower can negotiate is to release their shortfall liability should the pledged securities prove insufficient to pay the loan.

Related to that, defeasance documents contain a representation and warranty from the borrower that the pledged securities are sufficient to make all payments due under the note. Borrowers must make sure that representation is based solely on the accountant’s report delivered as part of the defeasance.

Second, if a guaranty was delivered as part of obtaining the loan, even if it simply involves recourse carve-outs, the borrower should attempt to negotiate the guarantor’s release as part of the defeasance. The lender will not agree to release liability under environmental indemnity because any such release would not be available were the loan paid in full, but the lender will not be able to make a convincing argument that the guarantor should not be released from nonenvironmental liability related to the loan.

Next, standard defeasance documents state that the borrower’s release is contingent on satisfying all conditions to the defeasance set forth in the loan documents. The borrower should negotiate a change to that provision, typically found in the Modification, Waiver and Consent, so that reconveyance of the deed of trust is evidence of the borrower’s satisfaction or lender’s waiver of all conditions to the defeasance.

Finally, the borrower should limit its liability relating to the pledged securities to claims relating to the acquisition and initial perfection of the security interest in the pledged securities. Any other liability relating to the pledged securities should be the responsibility of the successor borrower, who will hold title to the pledged securities after closing.

**Karla N. MacCary** is a partner at Nossaman Guthner Knox & Elliott.