

# Defeasance Provisions in Securitized-Loan Documents

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## Introduction

The asset-based commercial-paper market currently consists of \$708 billion in assets (up from \$517 billion in 1999), and is by far the most rapidly growing segment of the U.S. credit markets. Between 1987 and 2002, Standard & Poor's rated \$270 billion worth of U.S. commercial mortgage-backed securities ("CMBS"). Higher levels of Treasury-rate and corporate-bond-spread volatility make CMBS very attractive to investors. CMBS investments provide spread stability, as well as liquidity and strong collateral performance relative to the corporate sector. In 2002, investment-grade CMBS yielded a fixed-income return of almost 15.5%, significantly higher than the second-place Treasury market (with a return of just under 12%). *See* Lisa Pendergast and Eric Jenkins, *2002 Review and 2003 Outlook*, CMBS Quarterly (2003).

In CMBS pool transactions, each borrower customarily is prohibited from prepaying its mortgage but may be permitted (provided there is no default under the loan) to execute a collateral defeasance. In a collateral defeasance, the real estate security for the loan is released from the lien and replaced with U.S. government obligations. Since the early 1990s, defeasance has been an effective means of making the pricing on CMBS more attractive by eliminating the prepayment risks associated with fixed-rate loans. As a result of the boom in the conduit market, defeasance has become the overwhelmingly preferred alternative to yield-maintenance prepayment premiums in securitized mortgage financing. As one rating agency has stated, "Today, loan defeasance has become

widely accepted and is a structural characteristic in the majority of loans originated for purposes of securitization.” See Mary MacNeil, Erin Stafford, and Lee Green, *Defeasance by Design Update*, Commercial Mortgage Special Report (Fitch Ratings, Feb. 14, 2001), at p. 1.

### **Benefits of Defeasance**

Lenders and investors in securitized loan transactions prefer defeasance to yield-maintenance prepayment provisions because the certificate holders receive “call protection,” making pricing of the CMBS more attractive (by providing “tighter” spreads and cheaper financing) and providing substitute collateral that is safer and easier to realize on than real estate collateral (which may involve fluctuations in value and expensive and time-consuming foreclosure proceedings), thereby virtually eliminating the default risk for the loan being defeased (although a yield-maintenance prepayment premium may still apply if a loan default occurs). Defeasance also enhances yield predictability by reducing the risk of reinvesting prepayment proceeds in an uncertain interest-rate environment, and reduces costs and the use of intermediaries. Unlike yield-maintenance prepayment provisions, defeasance provides for continuing payments over the remaining term of the loan. A defeased loan secured by U.S. government obligations (which are considered less risky collateral than commercial real estate) is viewed as a positive event by the rating agencies and may result in a ratings upgrade if a sizable portion of the CMBS pool is defeased.

Typically, the costs to the borrower of defeasance are equal to or less than the costs of a yield-maintenance prepayment of the loan. The master servicer calculates the cost of a yield-maintenance prepayment by the borrower in accordance with the yield-maintenance formula in the mortgage loan documents. On the other hand, defeasance is a

“process” and the cost is calculated by combining transaction costs and the securities cost along a yield curve. The borrower customarily will seek to defease its loan in connection with a sale or refinance of the real property collateral, to take advantage of lower interest rates or higher yields (or to refinance for more money and for a longer term). Defeasance costs to the borrower generally decrease the closer the loan is to its maturity date, because the property may have experienced significant appreciation and the loan balance has decreased (thus resulting in a lower cost of the defeasance deposit). The overall cost to the borrower will be less with defeasance than a yield-maintenance prepayment obligation if the defeasance occurs at a time when interest rates have risen in relation to the stated loan rate, i.e., the borrower will be able to purchase treasury instruments (or certain other permitted “government securities”) with a face value less than the outstanding loan balance. The borrower can effectively “hedge” its risk and will not pay any minimum prepayment premium regardless of the interest-rate environment (usually one percent in a yield-maintenance scenario). The borrower in a securitized loan transaction often will seek to gain flexibility by requesting the ability to release collateral from the mortgage, so that it can sell or refinance the real property collateral at any time. Therefore, a provision may be inserted in the mortgage granting the borrower a limited right to substitute collateral subject to rating agency approval and other requirements (generally based on new underwriting criteria, with all costs of compliance to be paid for by the borrower).

### **Nature and Scope of Defeasance**

According to the *Glossary of Terms: Commercial Mortgage-Backed Securities (CMBS)*, published by the Commercial Mortgage Securitization Association (cmbs.org), 2003, “Defeasance” is defined as:

The act of making an investment whole. The supplementing of existing investment terms available (typically through a cash payment) to make the currently available market yield equivalent to that of a pre-existing investment that is being terminated. Most commonly used in bond finance. Synonymous with **yield maintenance**. A common **prepayment option**.

Defeasance transactions in bond transactions generally involve changes in the form of security with respect to debt instruments. The issuer of the debt instruments (usually in the form of bonds) typically deposits into escrow, or a grantor trust account, a pool of U.S. Treasury obligations having an income stream (principal and interest) sufficient to meet the payment obligations on all or a portion of the bonds, i.e., a portfolio is selected that will provide a revenue stream of interest and/or principal payments sufficient to pay, when due, each scheduled principal and interest payment on the defeased loan through the maturity date or such specified payment date. The loan principal due at maturity cannot vary and the government securities selected are not subject to prepayment, call, or early redemption. Neither legal nor beneficial ownership of the government securities is transferred to the bondholders. The transaction is treated for accounting purposes as an extinguishment of the debt in which, for reporting purposes, the issuer is entitled to remove both the debt and the Treasury obligations from its balance sheet. Actual or “true” defeasance occurs when all liens on assets, as well as all covenants (other than covenants to repay the loan) and security interests created pursuant to the bond indenture or other evidence of indebtedness, are released (or “defeased”); however, the debt instrument itself is not retired or satisfied.

In connection with securitized real-estate-financing transactions, one commentator has described defeasance as follows:

Defeasance is a device originally developed in the corporate bond market, which has been adapted in recent years for the mortgage securities market. In this arrangement, the loan documents permit no prepayment at all throughout the term. However, defeasance provides the borrower with liquidity and flexibility, similar to that which would exist with prepayment, even though the loan itself remains outstanding. Defeasance entails the delivery by the borrower of substitute collateral for the bonds, such that no prepayment occurs from the bond holders' perspective. This substitute collateral replaces the mortgage, and accordingly the real property is released from the lien of the mortgage. Such collateral usually consists of U.S. Treasury bills, purchased by the borrower, not subject to prepayment, call or early redemption, with a maturity closest to the loan maturity date in an amount which will generate sufficient principal and interest to pay debt service on the loan. If the loan bears interest at a rate higher than then-current Treasury bills (which would be common in a normal interest-rate environment), the borrower must purchase Treasury bills in a higher principal amount than the

loan principal in order to meet the loan debt service. Defeasance in this context thereby provides some surplus collateral for bond holders. From the borrower's perspective defeasance functions much like prepayment subject to yield maintenance. Typically, the borrower either sells or refinances the mortgaged property and uses the proceeds to purchase the required amount of Treasury bills. Due to REMIC requirements, defeasance cannot be used within two years of loan securitization; prior to this time, the borrower is subject to a lockout.

Steven G. Horowitz, *Key Elements of Securitized Loan Documentation*, Commercial Real Estate Financing, 225 PLI/Real 773, 781-82 (2000).

Another commentator has described mortgage-loan defeasance as follows:

Modeled after an arrangement used by corporations to remove bonds from their books, defeasance requires the borrower to purchase U.S. government obligations for the mortgagee's benefit precisely matching the interest and principal payments on the scheduled mortgage. The mortgagee accepts the Treasury obligations as substitute security, and releases its lien on the security property . . . Compared to yield maintenance clauses, defeasance only marginally disadvantages mortgagors prepaying when rates have fallen. Instead

of paying a yield maintenance fee plus the balance due on the debt, they purchase government securities in an equivalent sum. When rates are significantly above their contract rates, borrowers who would have been entitled to prepay without charge under yield maintenance clauses, will be shopping for Treasuries, if defeasance-burdened. The defeasance borrower's only consolation is that if interest rates have risen enough to offset the spread between the borrower's interest rate and current Treasury yields, the borrower will be able to defease with Treasuries presently worth less than the loan balance. All defeasance-burdened borrowers are penalized by having to finance the spread between Treasury and mortgage rates.

George Lefcoe, *Prepayment Disincentives in Securitized Commercial Loans*, 224 PLI/Real 239, 246 (1999).

Defeasance is a highly technical and complex process and involves numerous parties, including the following: borrower; borrower's counsel; master servicer; master servicer's counsel; accountants; rating agencies; successor borrower; securities broker-dealer; escrow agent; purchaser; purchaser's counsel; new lender (trustee); new lender's counsel; securities intermediary; securities intermediary's counsel, and special servicer. Companies such as Newman & Associates and Commercial Defeasance, LLC now offer, for a fee, to act as consultants and perform and manage the full range of services involved in defeasing a CMBS loan, and to interact with all necessary parties to effect a valid defeasance. Each of these companies maintains a "defeasance calculator"

on its website, which enables a party considering defeasance to calculate the “defeasance cost” to defease the loan by inputting the amount and certain financial terms of the loan. The online calculator provides security costs as well as transaction costs. Also, if the loan is still in the lockout period, the borrower can make future projections on interest rates and perform a “sensitivity analysis.” There are also a number of companies that will offer to serve solely as a “Broker Dealer” and purchase the securities required to defease a CMBS loan.

It may be possible for the borrower in a defeasance transaction to use the proceeds from the sale or refinance of the mortgage loan to purchase the required defeasance securities. However, in a securitized loan, REMIC rules prohibit the payment of cash to the lender to purchase the required U.S. government obligations. Trades to acquire securities require at least two days to settle before the transferee is considered the owner of the securities. The borrower may be able to obtain a bridge loan in the amount of the required defeasance collateral, with the purchased securities serving as collateral for the loan, but the lender may require additional cash or other collateral to cover market-fluctuation risks. One commentator has suggested that the borrower may be able to structure the following escrow arrangement with a title insurance company that would be satisfactory to the lender and the rating agencies, and that would comply with REMIC rules relating to defeasance:

Where defeasance is being pursued in connection with a sale or refinance of the mortgaged property, the borrower may be able to work an escrow arrangement with the title company conducting the closing. The arrangement would work as follow: (a)

the lender delivers the release documents for the mortgage collateral to the title company in escrow and agrees to release these documents once all of the enumerated escrow conditions are satisfied; (b) the title company insures over the lender's mortgage lien in favor of the buyer or new lender on the basis of such commitment, thereby allowing the sale or refinance of the property to close; and (c) at closing, the portion of the sales proceeds sufficient to purchase the defeasance securities is wired to the investment adviser to purchase the securities.

Once the securities are purchased with these funds and transferred to the securities intermediary (and all other conditions are satisfied), the title company receives its authorization to record the mortgaged collateral releases. The success of getting the title company's cooperation with such an arrangement is more likely when the title company is knowledgeable about defeasance and the only remaining defeasance conditions to be satisfied are payment and delivery of the securities.

Robin L. Litwa, *Defeasance – A Practical Overview*, Mortgage Banking (July 2000), at p.3.

Attached hereto as **Exhibit “A”** a sample form of a prepayment/defeasance provision in a mortgage-loan

commitment (or generic term sheet) for a securitized transaction. See Steven G. Horowitz, *Co-Lending Arrangements (Generic Term Sheet for Portfolio Financing)*, Tab 9 at 5 (April 4-5, 1997) (American College of Real Estate Lawyers Midyear Meeting on Finance Topics). Attached hereto, as Exhibits “B,” “C,” and “D” are sample forms of specialized mortgage prepayment/defeasance provisions for use in securitized financing transactions. (Although Fannie Mae offers a defeasance option for multifamily CMBS, defeasance currently is only available for fixed-rate loans of 10.5 years or less including Multifamily Fannie Mae MBS, REMIC, and Cash executions. See *Specifics of Multifamily MBS*, Fannie Mae, <http://fanniemae.com/mbs/multifamily/defeasance> (visited August 25, 2003)).

### **Enforceability of Defeasance Clauses**

Defeasance clauses are becoming the "norm" in securitized mortgage transactions, including CMBS and REMIC financings, and surely there will be case law dealing with mortgage defeasance in the not-too-distant future. As noted by Professor Lefcoe, "they [defeasance clauses] are just as vulnerable [as yield-maintenance clauses] since defeasance calls for prepaying borrowers to substitute Treasury obligations for mortgages, instead of providing a substitute property of equivalent risk. Defeasance is also objectionable since it applies even to borrowers prepaying below market notes." George Lefcoe, *Prepayment Disincentives in Securitized Commercial Loans*, *supra*, PLI/Real at 254. See also John C. Murray, *Enforceability of Prepayment-Premium Provisions in Mortgage Loan Documents*, John C. “Jack” Murray Reference Library (First American Title Insurance Company), <http://www.firstam.com/faf/html/cust/jm-articles.html> (visited August 25, 2003).

There are only a few reported cases (either bankruptcy or non-bankruptcy) that have discussed the enforceability of defeasance clauses in commercial loan documents. In *Baybank Middlesex v. 1200 Beacon Properties, Inc.*, 760 F.Supp. 957, 967-68 (1991), which arose out of the financing of the renovation and addition to a hotel located in Brookline, Massachusetts, the bond indenture provided for defeasance (termination) of the lien securing the bonds after the trustee had received all the outstanding principal, premium and interest due from the borrower. The defeasance provision in the indenture also provided that the bonds would be deemed paid in full at such time as there was irrevocably delivered to the trustee sufficient cash or U.S. obligations with maturities and interest rates sufficient to produce cash “(1) to prepay the Bonds in whole at the earliest date permitted or required by [other sections of the agreement]; or (2) to pay any principal and premium, if any, and interest on the Bonds which may be due, or overdue and to make all remaining payments or principal and premium, if any, and interest on the Bonds as they come due.” *Id.* at 968. The court found that this provision, together with other provisions in the loan documents, demonstrated the parties’ intent that, upon default, the lender’s recovery would be limited to those damages specifically provided under the terms of the agreements. The court ruled that acceleration of the amount due under the mortgage and trust indenture as the result of a default when the bonds used to finance the real estate development became taxable, precluded the lender and trustee from seeking unearned interest on the bonds as additional damages. This was so, the court found, because the trust indenture clearly indicated the parties’ intention that upon the occurrence of such a default, the trustee was required to declare the outstanding principal, accrued interest and premiums immediately due and payable. *See also Fidelity Nat’l Title Ins. Co. v. Intercounty Nat’l Title Ins. Co.*, 2001 U.S. Dist. LEXIS 478 (Jan. 22, 2001), at \*7-8

(describing the hazards of title-insurance agents participating in a mortgage defeasance program where buyers' funds in connection with title conveyances and refinancings were invested in "high-yield junk bonds").

*See generally* Neil D. Baron, *Mortgage and Asset-Backed Securities in Conservatorship or Receivership*, Counseling Creditors of Banks and Thrifts: Dealing with the FDIC and RTC, 561 PLI/Comm 313, 323 (1991); Roger D. Turner, *Selected Issues Relating to Domestic Private Placements and Public Offerings in Europe of Mortgage-Backed Obligations*, Securitization of Commercial Real Estate, 283 PLI/Real 247, 283 (1986); *American Bar Association Section of Taxation Task Force Report on Prop. Regs. § 1.001-3: Modifications of Debt Instruments [Parts VI-VII]*, 48 Tax L. 177, 191 (1994); James M. Johnson, Robert A. Pari, and Leonard Rosenthal, *The Impact of In-Substance Defeasance on Bondholder and Shareholder Wealth*, 44 J. Fin. 1049 (1989); George Lefcoe, *Yield Maintenance and Defeasance: Two Distinct Paths to Commercial Mortgage Payment*, 28 Real Est. L. J. (Winter 2000).

### **“In-Substance” Defeasance**

Although defeasance of underlying loan obligations in asset-backed transactions is a relatively recent phenomenon, bond defeasance has been common for many years in public finance transactions. In a typical “in-substance” defeasance, a pool of Treasury instruments is dedicated by the issuer of bonds as a segregated source of payment of the obligations due; but (unlike a true defeasance) the bondholders are usually not granted a pledge or any lien or other security interest in the Treasuries, the borrower remains fully liable under the loan and indenture covenants, and no other existing security interests are released.

In order to offer call protection for investors, some mortgage-backed bond indentures provide that, upon certain defaults, the trustee must liquidate the collateral and use the proceeds to purchase U.S. Treasury securities that will generate the remaining cash flow on the bonds when and as due. This is a variation of an in-substance defeasance transaction, as described above.

The in-substance defeasance concept has been implemented in connection with prepayment-premium provisions in securitized mortgage-loan transactions, where the borrower seeks a release of portions of the collateral at some future date. Portfolio transactions typically permit prepayment in connection with the sale of collateral. The mortgage lien on a particular property will generally be released upon payment of the loan amount allocated to that property, plus payment of a premium that will be applied to proportionally reduce the principal for the allocated loan amounts for the other properties in the portfolio. (Lenders typically will insist that casualty and condemnation proceeds are not exempt from application of the prepayment-premium formula).

Where defeasance is permitted and a single mortgage loan is secured (and cross-collateralized) by multiple properties, and only a portion of the real property collateral is being defeased, Standard & Poor's has issued the following guidelines with respect to requests for partial defeasance:

If the mortgage is secured by multiple properties and only a portion of the real estate is being defeased, Standard & Poor's expects that the defeasance collateral be sufficient to pay when due a portion of all scheduled debt service payments through the maturity date calculated on a principal amount

equal to 125% of the loan amount allocated to the mortgaged properties defeased or such other partial defeasance premium as may be specified in the original loan documents so long as the stipulated loan to value and debt service coverage ratios are maintained for the undefeased real estate collateral.

Don Petrow and Ron Chun, *Standard & Poor's Confirmation: CMBS Defeasance Criteria*, Standard & Poor's, Jan. 12, 2001), at p. 1.

The loan documents should state that the defeased amount on cross-collateralized pools must equal 125% of the allocated loan balance for the specific real property collateral being defeased, and that all other requirements necessary to effect a defeasance are applicable with respect to any partially defeased loan. See Mary MacNeil, Erin Stafford, and Lee Green, *Defeasance by Design Update*, Commercial Mortgage Special Report (Fitch Ratings, Feb. 14, 2001), at p. 3.

### **REMICs and FASITs**

Specialized forms of prepayment/defeasance provisions are commonly utilized in connection with real estate mortgage investment conduits ("REMICs"), financial asset securitization investment trusts ("FASITs") and other sophisticated forms of securitized mortgage-financing transactions. These provisions generally permit the borrower to elect to obtain a release of a particular property from the loan pool by substituting "defeasance collateral" sufficient to generate the income stream that would otherwise have been generated by the loan collateral being released. REMIC rules require that the defeasance collateral (usually Treasury

securities) consist of direct, noncallable and nonredeemable securities or certificates of deposit issued (or guaranteed) by the U.S. government or one of its instrumentalities. Eligible substitute collateral must constitute “government securities” as defined in the Investment Company Act of 1940, and include U.S. Treasury Obligations, direct obligations of Fannie Mae or Freddie Mac and interest-only strips issued by the Resolution Funding Corp. (RFC).

Typically, the borrower is required by the original loan documents to provide the master servicer with at least 30-60 days prior written notice of the date it intends to defease the loan. (A typical defeasance transaction may take 30 days to close). The defeasance collateral is substituted as collateral security for the note, and the borrower is required to execute a pledge and security agreement (and any other necessary documents) creating a first priority lien therein. The borrower is also required to deliver to the lender, among other things, written confirmation from the applicable rating agency (or agencies) that the substitution of collateral will not result in the withdrawal, downgrade, or qualification of the current rating. A non-consolidation opinion from the borrower’s counsel may also be required. The borrower (because it has effectively prepaid the loan) customarily is released from all obligations under the note and other security documents (except those that expressly survive payment of the loan, and any misrepresentations in connection with the defeasance or failure to provided the requested defeasance documentation), but as part of the transaction the borrower is required to create a special-purpose, “bankruptcy remote” successor entity (“SPE”), unaffiliated with the original borrower, to which it will irrevocably assign all of its obligations, rights and duties under the loan documents (including the pledged defeasance collateral), usually for a nominal consideration. The successor SPE borrower will not be permitted to own any other property other than the defeasance collateral or incur any additional debt. This insulates the borrower from

personal liability while allowing the loan obligation, and the documents evidencing and securing the same, to remain in place. This structure also enables the trust to distance itself from the credit risk of the original borrower. It may be feasible in some instances for the trustee or master servicer to create a specific bankruptcy-remote SPE “accommodation borrower” for each pool of securitized loans, with the note and defeasance collateral for each defeased loan being held by the same entity. The benefits of this specific structure include lower defeasance costs; easier administration; greater probability of legal and regulatory compliance with respect to fees, taxes, and entity requirements; and minimization or avoidance of substantive-consolidation or other bankruptcy risks with respect to the original borrower (or related persons or entities).

There is normally a longer “lockout” period (during which the borrower is prohibited from prepaying the loan) in connection with the defeasance provision. Under REMIC rules, to protect the REMIC tax status of a CMBS transaction, defeasance cannot occur before the second anniversary of commencement of the REMIC, i.e., the first day that the REMIC securities are issued. In anticipation of securitization (even if the loan is not initially securitized), lenders usually permit defeasance upon the earlier to occur of the required two-year REMIC lockout period or three (or sometimes four) years after the date of the loan. In the event of default by the borrower under any of the loan documents, the borrower may be required to pay a form of “make whole” payment calculated by determining the amount sufficient to purchase the defeasance collateral as of the date of acceleration of the loan (with a minimum payment of, e.g., 1% of the default prepayment amount).

The borrower may be permitted to revoke its defeasance request if revocation occurs before the release of the original real property collateral. However, the borrower may be

required to submit a “defeasance deposit” to the lender at the time of the initial request, to cover the costs incurred by the servicer in connection with the request (including internal review and approvals and anticipated costs of third-party reviews, certifications, opinions, and approvals).

### **Rating Agency Requirements**

In the past, rating agencies (such as Standard & Poor’s, Moody’s, and Fitch) reviewed every defeasance transaction in order to affirm the existing rating. However, Fitch has stated that it intends to review defeasance requests only of any of the top 10 remaining loans in the CMBS pool or for any loans representing a top-10 borrower concentration. (Fitch also may require that the borrower be organized as an SPE if the loan is one of the 10 largest loans in the pool at the time of securitization). *See* Mary MacNeil, Erin Stafford, and Lee Green, *Defeasance by Design Update*, Commercial Mortgage Special Report (Fitch Ratings, Feb. 14, 2001), at pp. 2 and 4. Standard & Poor’s permits the servicer to complete the defeasance without obtaining confirmation from Standard & Poor’s if the servicer delivers an approved form of certification within 10 days after completion of the defeasance, and the following conditions are satisfied:

1. The loan is not one of the 10 largest loans in the pool;
2. The loan has a principal balance at the time of the defeasance of less than \$20 million and 5% of the pool principal balance; and;
3. Where a successor borrower assumes the loan, the successor borrower and its affiliates do not hold loans (whether fully or partially defeased) in such pool that in the aggregate (i) total more than \$20 million or (ii) comprise more than 5% of the pool principal balance.

*See Standard & Poor's Structured Finance Criteria: CMBS Defeasance Criteria*, Standard & Poor's, April 10, 2003, at p. 58.

The rating agency, upon completion of its review of the required defeasance documentation, will send a confirmation letter to the master servicer stating that the defeasance will not result in a suspension, withdrawal, downgrade, or qualification of any of the current ratings assigned to the investor certificates.

Issuers in securitized loan transactions customarily will include the following defeasance provisions on their loan documents in order to comply with rating agency requirements: (i) defeasance must occur in accordance with the requirements of and with the time permitted by, applicable REMIC rules and regulations, (ii) the borrower must provide U.S. government securities as replacement collateral in an amount sufficient to pay the note in accordance with its terms, (iii) an independent accounting firm should certify that the collateral is sufficient to pay the note in accordance with its terms, (iv) the loan must be assumed (and collateral owned) by an entity meeting single-purpose bankruptcy-remote (SPE) criteria and (v) counsel must provide an opinion that the trustee has a perfected security interest in the new collateral.

If required, the master servicer also will submit the defeasance request and related documents to each rating agency that rated the CMBS to obtain a "no downgrade" letter (which may take two weeks or longer to procure). The master servicer is charged with seeing that all rating agency requirements are met, and all costs in connection therewith are customarily borne by the borrower (including the cost of acquiring the substitute collateral and fees for the legal opinions, the independent certified public accountant's "comfort letter," and the rating agency's confirmation letter).

See Don Petrow and Ron Chun, *Standard & Poor's Confirmation: CMBS Defeasance Criteria*, Standard & Poor's, Jan. 12, 2001). See also Robin L. Litwa, *Defeasance – A Practical Overview*, Mortgage Banking (July 2000), at p.1.

### **Bankruptcy Issues**

It is possible that the giving of substitute collateral could constitute a potential preference under § 547 of the Bankruptcy Code. As noted above, the defeasance collateral will consist of U.S. government obligations, which generally are the safest form of security available. The real estate, even if security for a very conservative mortgage loan, is always subject to value fluctuations, while the government obligations, if held to maturity (as intended) are not. Hopefully, the most a bankruptcy court would say is that the difference in value between the real estate and the pledged securities (and not the whole defeasance collateral) is a preference. However, mortgage debt obligations rarely are defeased when the property is worth less than the debt, so the defeasance collateral almost always will be worth less than the property released. Therefore, no bankruptcy preference would occur in this situation because a preference, to be voidable under § 547, must result in the transferee receiving more than it would receive in a Chapter 7 liquidation of the debtor/mortgagor's assets if the transfer had not occurred. If the real property collateral was worth more than the defeasance collateral, the creditor would not have received a preference as a result of the defeasance.

The lender may seek one or more opinions of counsel for the borrower, in form and substance and

delivered by counsel that would be satisfactory to a “prudent lender,” stating among other things that (i) the lender has a perfected first priority security interest in the defeasance collateral and that the defeasance security agreement is enforceable against the borrower in accordance with its terms, (ii) in the event of a bankruptcy proceeding or similar occurrence with respect to the borrower, none of the defeasance collateral nor any proceeds thereof will be property of the borrower’s estate under § 541 of the Bankruptcy Code or any similar statute and the grant of security interest therein to the lender will not constitute an avoidable preference under § 547 of the Bankruptcy Code or applicable state law. (It may be problematic to give a “clean” perfection opinion because of the preference issue unless the defeasance collateral was obtained at least 90 days in advance of the release of the real property collateral.)

If an express defeasance provision is not included in the mortgage loan documents, a REMIC compliance opinion may be required by the rating agency as a condition to granting a release of any portion of the collateral. According to one commentator, “These [REMIC compliance] opinions can be difficult and relatively expensive to render.” Carl J. (Kim) Seneker, *How to Document Securitized Commercial Real Estate Mortgage Loans*, *The Practical Real Estate Lawyer*, May 1999, at 53. With respect to defeasance transactions in general, at least one rating agency requires the following types of legal opinions:

To mitigate the risk of bankruptcy of the successor borrower, the depositor must give the servicer a nonconsolidation opinion with respect

to any transaction SPE as successor borrower.

The borrower delivers a security interest opinion to the servicer confirming that the trust has a legal and valid first-priority perfected security interest in the substitute collateral and all proceeds thereof under the appropriate applicable state law.

An attorney should prepare an enforceability opinion concluding that the subsequent assignment and assumption of the substitute collateral and obligations of the original borrower to the successor borrower do not affect the validity, enforceability, or priority of the first-priority perfected security interest granted to the trust.

The borrower's counsel must produce a REMIC opinion confirming that defeasance will not adversely affect the status of any REMIC in the transaction or impose a tax (there is typically a two-year lockout period for any defeasance).

Mary MacNeil, Erin Stafford, and Lee Green, *Defeasance by Design Update*, Commercial Mortgage Special Report (Fitch Ratings, Feb. 14, 2001), at p. 4.

The respective legal and enforcement rights and obligations of the parties customarily are set forth in a

Defeasance Pledge and Security Agreement (“Pledge Agreement”) executed by the borrower (as “Pledgor”), the securitization trustee (as “Pledgee,” by virtue of the its rights as assignee of the original lender’s interest in the loan) and the securities intermediary who holds the securities (as “Intermediary”). By virtue of the executed Pledge Agreement, and the proper filing of a UCC-1 financing statement with the Secretary of State in the jurisdiction where the Pledgor is organized, a valid first-priority UCC security interest attaches to and is perfected in the defeasance collateral. To enable the Pledgee to enforce its rights in a subsequent bankruptcy proceeding by or against the Pledgor, it is imperative that counsel for the Pledgee carefully review the Pledge Agreement (and, with respect to certain matters, the related UCC-1 Financing Statement), for completeness and accuracy in connection with such matters as the nature and scope of the security interest granted, the collateral description, the name and address of the Pledgor, the warranties, representations and covenants of the Pledgor, remedies for Pledgor default, the solvency of the Pledgor, governing law, and the authority of the Pledgor (and certain designated individuals or entities on its behalf) to execute the documents and bind the Pledgor. If the borrower defaults under the loan, the Pledge Agreement should grant the trustee (as Pledgee) the immediate right to enforce and collect payments or proceeds from the pledged collateral, and direct the securities intermediary to receive and send all redemption proceeds directly to the Pledgee and to comply only with orders and directions from the Pledgee. The Pledge Agreement also customarily will prohibit any subordinate liens against the defeasance collateral.

Standard & Poor's has set forth the following requirements with respect to maintaining a perfected first-priority security interest in the pledged defeasance collateral:

**First Priority Perfected Security Interest**

The trustee must have a valid first priority perfected security interest in the defeasance collateral and in all proceeds thereof. This is generally affected [*sic*] by the pledge of the defeasance collateral through a securities intermediary to the trustee for the benefit of the holders of the rated securities. The defeasing borrower should deliver an opinion of counsel to the effect that the defeasance collateral, all securities entitlements for the defeasance collateral, and all proceeds have been duly and validly pledged to the trustee for the benefit of the holders of the rated securities; and the security interest of the trustee is a valid first priority perfected security interest.

Don Petrow and Ron Chun, *Standard & Poor's Confirmation: CMBS Defeasance Criteria*, Standard & Poor's, Jan. 12, 2001).

**Conclusion**

Defeasance provisions have become the overwhelmingly preferred alternative to yield-maintenance prepayment provisions in CMBS loans. Although defeasance offers definite benefits for both

lenders and borrowers compared to yield-maintenance prepayment premiums, defeasance is a highly technical, complicated and cumbersome process, and the parties must fully comply with the strict requirements of the master servicer and, where applicable, the rating agencies. Furthermore, the defeasance must be carefully documented, with special attention paid to the required attorney's opinions and accountant's certifications, as well as the proper attachment, perfection, and priority of the trustee's security interest in the defeasance collateral and in all proceeds thereof.

## **EXHIBIT “A”**

### **PREPAYMENT/DEFEASANCE (LOAN COMMITMENT)**

#### **Prepayment/Defeasance:**

Senior Note: Closed to voluntary prepayment until the earlier of the second anniversary of the securitization of the Senior Note and [2+] years from the Closing. Thereafter, except as provided under “Release Price,” voluntary prepayment in whole through defeasance only through purchase of appropriate US Treasury Strips providing for a payment stream with respect to principal prepaid and all interest payable thereon. A yield maintenance premium (to be based on Treasuries flat) would be payable in the event of any prepayment, including on an acceleration of the Senior Note by reason of Borrower’s default.

Junior Note: Open to prepayment in whole or in part without penalty or premium.

**Release Price:** 125% of Lender-allocated amounts of Senior and Junior notes, plus yield maintenance premium. In the event of a casualty or condemnation giving rise to prepayment, whether at Borrower’s or Lender’s election, then Borrower may prepay the applicable allocated loan amount at the greater of (i) 100% of the allocated loan amount and (ii) the amount of the casualty/condemnation proceeds, but in no event in excess of 125% of the allocated loan amount.

## EXHIBIT “B”

### ARTICLE \_\_: PREPAYMENT; DEFEASANCE

(a) The principal balance of this Note may not be prepaid in whole or in part prior to the Maturity Date except as expressly permitted pursuant to Section \_\_\_ hereof.

(b) Subject to compliance with and satisfaction of the terms and conditions of this Article \_\_\_ and provided that no Event of Default exists under this Note, Borrower may elect on any Monthly Payment Date (defined below) after the Lockout Period Expiration Date (defined below), to release (the “Release”) the Property from the lien of the Security Instrument by delivering to Lender (a “Defeasance”), as security for the payment of all interest and principal due and to become due pursuant to this Note throughout the term hereof, Defeasance Collateral (defined below) sufficient to generate Scheduled Defeasance Payments (defined below). “Monthly Payment Date” shall mean the tenth day of each calendar month prior to the Maturity Date. “Lockout Period Expiration Date” shall mean the earlier to occur of (A) \_\_\_\_\_, \_\_\_\_\_ **[INSERT DATE WHICH IS \_\_\_ YEARS AFTER PAYMENT DATE IN SECTION \_\_\_ (a) ABOVE]**, or (B) the second anniversary of the “startup day” within the meaning of Section 860G(a)(9) of the IRS Code (defined below) of a REMIC Trust (defined below).

(c) As a condition precedent to a Defeasance, and prior to any Release, Borrower shall have complied with all of the following:

- (i) Borrower shall provide not less than sixty (60) days prior written notice to Lender of the Monthly Payment Date upon which it intends to effect a

Defeasance hereunder (the “Defeasance Date”).

- (ii) All accrued and unpaid interest and all other sums due under this Note, the Security Instrument and the Other Security Documents up to the Defeasance Date shall be paid in full on or prior to the Defeasance Date.
- (iii) Borrower shall have delivered to Lender all necessary documents to reflect that the principal balance of this Note has been defeased. This Note shall thereafter be secured by the Defeasance Collateral delivered in connection with the Defeasance. After Defeasance, this Note cannot be prepaid in whole or in part or be the subject of any further Defeasance.
- (iv) Borrower shall execute and deliver to Lender any and all certificates, opinions, documents or instruments required by Lender in connection with the Defeasance and Release, including, without limitation, a pledge and security agreement satisfactory to Lender creating a first priority lien on the Defeasance Collateral (a “Defeasance Security Agreement”).
- (v) Borrower shall have delivered to Lender an opinion of Borrower’s counsel in form and substance satisfactory to Lender stating (A) that the Defeasance Collateral and the

proceeds thereof have been duly and validly assigned and delivered to Lender and that Lender has a valid, perfected, first priority lien and security interest in the Defeasance Collateral delivered by Borrower and the proceeds thereof, and (B) that if the holder of this Note shall at the time of the Release be a REMIC (defined below), (1) the Defeasance Collateral has been validly assigned to the REMIC Trust which holds this Note (the "REMIC Trust"), (2) the Defeasance has been effected in accordance with the requirements of Treasury Regulation 1.860(g)-2(a)(8) (as such regulation may be amended or substituted from time to time ) and will not be treated as an exchange pursuant to Section 1001 of the IRS Code and (3) the tax qualification and status of the REMIC Trust as a REMIC will not be adversely affected or impaired as a result of the Defeasance. The term "REMIC" shall mean a "real estate mortgage investment conduit" within the meaning of Section 860D of the IRS Code. "IRS Code" shall mean the United States Internal Revenue Code of 1986, as amended, and the related Treasury Department regulations, including temporary regulations.

- (vi) Borrower shall have delivered to Lender written confirmation from the Rating Agencies (defined in the Security Instrument ) that such

Defeasance will not result in a withdrawal, downgrade or qualification of the then current ratings by the applicable Rating Agencies of the Securities (defined in the Security Instrument). If required by the Rating Agencies, Borrower shall, at Borrower's expense, also deliver or cause to be delivered a non-consolidation opinion with respect to the Defeasance Obligor (as defined below) in form and substance satisfactory to Lender and the Rating Agencies.

- (vii) Borrower shall have delivered to Lender a certificate satisfactory to Lender given by Borrower's independent certified public accountant (which accountant shall be satisfactory to Lender) certifying that the Defeasance Collateral shall generate monthly amounts equal to or greater than the Defeasance Payments required to be paid under this Note through and including the Maturity Date.

(d) In connection with any Defeasance hereunder, Borrower shall (unless otherwise agreed to in writing by Lender), at Borrower's expense, establish or designate a successor entity, which shall be a single purpose, bankruptcy remote entity approved by Lender, as such term is described in Section \_\_\_ [**SPE Covenants**] of the Security Instrument (the "Defeasance Obligor") and Borrower shall transfer and assign all obligations, rights and duties under and to this Note together with the pledged Defeasance Collateral to such

Defeasance Obligor. Such Defeasance Obligor shall assume the obligations under this Note and any Defeasance Security Agreement, and Borrower shall be relieved of its obligations under such documents and, except with respect to any provisions of the Note, the Security Instrument or the Other Security Documents which by their terms expressly survive payment of the Debt in full, the Note, the Security Instrument or the Other Security Documents.

(e) Each of the obligations of the United States of America that is part of the Defeasance Collateral shall be duly endorsed by the holder thereof as directed by Lender or accompanied by a written instrument of transfer in form and substance wholly satisfactory to Lender (including, without limitation, such instruments as may be required by the depository institution holding such securities or by the issuer thereof, as the case may be, to effectuate book-entry transfers and pledges through the book-entry facilities of such institution) in order to perfect upon the delivery of the Defeasance Collateral a first-priority security interest therein in favor of Lender in conformity with all applicable state and federal laws governing the granting of such security interests. Borrower shall authorize and direct that the payments received from such obligations shall be made directly to Lender or Lender's designee and applied to satisfy the obligations of Borrower or, if applicable, the Defeasance Obligor, under this Note.

(f) The Defeasance Collateral shall generate payments on or prior to, but as close as possible to, the Business Day (defined below) prior to each successive Monthly Payment Date after the date of the Defeasance upon which payments are required under this Note and in amounts equal to or greater than the payments due on such dates (including, without limitation scheduled payments of principal, interest, servicing fee (if any) and any other regularly scheduled amounts due under this Note, the Security Instrument or the

Other Security Documents on such dates) together with the outstanding principal amount of this Note which would be due on the Maturity Date (the “Scheduled Defeasance Payments”). The term “Business Day” shall mean a day upon which commercial banks are not authorized or required by law to close in New York, NY.

(g) Notwithstanding any release of the Security Instrument granted pursuant to this Article \_\_\_ or any Defeasance hereunder, the Defeasance Obligor shall, and hereby agrees to be, bound by and obligated under Sections \_\_\_, \_\_\_, \_\_\_, \_\_\_, \_\_\_ and \_\_\_ Articles \_\_\_ and \_\_\_ of the Security Instrument; provided, however, that all references therein to “Property” or “Personal Property” shall be deemed to refer only to the Defeasance Collateral delivered to Lender.

(h) Any costs or expenses incurred or to be incurred in connection with the Defeasance and any revenue, documentary stamp or intangible taxes or any other tax or charge due in connection with the transfer of this Note, or otherwise required to accomplish the Defeasance shall be paid by Borrower simultaneously with the occurrence of any Defeasance.

(i) The term “Defeasance Collateral” as used herein shall mean non-callable and non-redeemable securities evidencing an obligation to timely pay principal and interest in a full and timely manner that are direct obligations of the United States of America for the payment of which its full faith and credit is pledged.

(j) Upon Borrower’s compliance with all of the conditions to Defeasance and a Release set forth in Article \_\_\_ through \_\_\_, Lender shall release the Property from the lien of the Security Instrument and the Other Security Documents. All costs and expenses of Lender incurred in

connection with the Defeasance and Release, including, without limitation, Lender's counsel's fees and expenses, shall be paid by Borrower simultaneously with the delivery of the Release documentation.

(k) If a Default Prepayment (defined below) occurs, Borrower shall pay to Lender the entire Debt, including, without limitation, an amount (the "Default Consideration") equal to the greater of (i) the amount (if any) which, when added to the outstanding principal amount of the Note will be sufficient to purchase Defeasance Collateral providing the required Scheduled Defeasance Payments assuming Defeasance would be permitted hereunder, or (ii) one percent (1%) of the Default Prepayment. For purposes of this Note, the term "Default Prepayment" shall mean a prepayment of the principal amount of this Note made after the acceleration of the Maturity Date under any circumstances, including, without limitation, a prepayment occurring after an Event of Default or in connection with reinstatement of the Security Instrument provided by statute under foreclosure proceedings or exercise of a power of sale, any statutory right of redemption exercised by Borrower or any other party having a statutory right to redeem or prevent foreclosure, any sale in foreclosure or under exercise of a power of sale or otherwise.

(l) Notwithstanding anything to the contrary herein, provided no Event of Default exists under this Note, the Security Instrument or the Other Security Documents, (i) Borrower may prepay the principal balance of this Note in whole during the [**three (3) months**] prior to the Maturity Date and no prepayment consideration shall be due in connection therewith, but Borrower shall be required to pay all other sums hereunder together with all interest which would have accrued on the principal balance of this Note after the date of prepayment to the next Monthly Payment Date (the "Interest Shortfall Payment"), if such prepayment occurs on a date which is not a Monthly Payment Date; and

(ii) if a complete or partial prepayment results from the application of insurance proceeds or condemnation awards pursuant to Sections \_\_\_\_, \_\_\_\_ or \_\_\_\_ of the Security Instrument, no prepayment consideration or Default Consideration shall be due in connection therewith, but Borrower shall be required to pay all other sums due hereunder, including, without limitation, the Interest Shortfall Payment, if applicable.

## **EXHIBIT “C”**

### **PREPAYMENT/DEFEASANCE (SECURITIZED MORTGAGE; REMIC –ALTERNATIVE)**

Defeasance.

- (i) Notwithstanding any provisions of this Section \_\_\_\_ to the contrary, including, without limitation, subsection (a) of this Section \_\_\_\_, at any time other than during a REMIC Prohibition Period (as such period is defined in clause (iv) below), but in no event should such a period limit Borrower’s right beyond three years from the date hereof, the Borrower may cause the release of the Premises and any escrowed funds from the lien of the Security Instrument and the other Loan Documents upon the satisfaction of the following conditions:
  - (A) not less than 60 (but not more than 90) days prior written notice shall be given to the Lender specifying a date on or before which the Defeasance Collateral (as hereinafter defined) is to be delivered (the “Release Date”), such date being on a Scheduled Payment Date;
  - (B) all accrued and unpaid interest and all other sums due under this Note and under the other Loan Documents up to the Release Date, including, without limitation, all fees, costs and expenses incurred by the Lender and its agents

in connection with such release (including, without limitation, legal fees and expenses for the review and preparation of the Defeasance Security Agreement (as hereinafter defined) and of the other materials described in subsection \_\_\_\_ (b)(i)(C) below and any related documentation, and any servicing fees or costs related to such release), shall be paid in full on or prior to the Release Date;

(C) the Borrower shall deliver to the Lender on or prior to the Release Date:

(1) a pledge and security agreement, in form and substance that would be satisfactory to a prudent lender, creating a first priority security interest in favor of the Lender in the Defeasance Collateral, as defined herein (the “Defeasance Security Agreement”), which shall provide, among other things, that any excess amounts received by the Lender from the Defeasance Collateral over the amounts payable by the Borrower hereunder shall be refunded to the Borrower promptly after each Scheduled Payment Date;

(2) direct, non-callable obligations of the United States of America

that provide for payments prior and as close as possible to (but in no event later than) all successive Scheduled Payment Dates occurring after the Release Date, with each such payment being equal to or greater than the amount of the corresponding Monthly Payment Amount required to be paid under this Note (including all amounts due on the Maturity Date) for the balance of the term hereof (the "Defeasance Collateral"), each of which shall be duly endorsed by the holder thereof as directed by the Lender or accompanied by a written instrument of transfer in form and substance that would be satisfactory to a prudent lender (including, without limitation, such certificates, documents and instruments as may be required by the depository institution holding such securities or the issuer thereof, as the case may be, to effectuate book-entry transfers and pledges through the book-entry facilities of such institution) in order to perfect upon the delivery of the Defeasance Security Agreement the first priority security interest therein in

favor of the Lender in conformity with all applicable state and federal laws governing granting of such security interests;

- (3) a certificate of the Borrower certifying that all of the requirements set forth in this subsection \_\_\_\_ (b)(i) have been satisfied;
- (4) one or more opinions of counsel for the Borrower in form and substance and delivered by counsel that would be satisfactory to a prudent lender stating, among other things, that (i) the Lender has a perfected first priority security interest in the Defeasance Collateral and that the Defeasance Security Agreement is enforceable against the Borrower in accordance with its terms, (ii) in the event of a bankruptcy proceeding or similar occurrence with respect to the Borrower, none of the Defeasance Collateral nor any proceeds thereof will be property of the Borrower's estate under Section 541 of the U.S. Bankruptcy Code or any similar statute and the grant of security interest therein to the

Lender shall not constitute an avoidable preference under Section 547 of the U.S. Bankruptcy Code or applicable state law, and (iii) the release of the lien of the Security Instrument and the pledge of Defeasance Collateral will not directly or indirectly result in or cause any REMIC (as defined in clause (iv) below) that then holds this Note to fail to maintain its status as a REMIC;

- (5) a certificate of the Borrower's independent certified public accountant certifying that the Defeasance Collateral will generate monthly amounts equal to or greater than the Monthly Payment Amount required to be paid under this Note up to and including the Maturity Date; and
  - (6) such other certificates, documents and instruments as the Lender may reasonably require; and
- (D) in the event the Loan is held by a REMIC, the Lender has received written confirmation from any rating agency rating any mortgage pass-through certificates or other securities evidencing a beneficial interest in the Loan in a public offering or private

placement (the “Securities”) that substitution of the Defeasance Collateral will not result in a downgrade, withdrawal, or qualification of the ratings then assigned to any of the Securities.

- (ii) Upon compliance with the requirements of subsection \_\_\_\_ (b)(i), the Premises and any escrowed funds shall be released from the lien of the Security Instrument and the other Loan Documents, and the Defeasance Collateral shall constitute collateral which shall secure this Note and all other obligations under the Loan Documents. The Lender will, at the Borrower’s expense, execute and deliver any agreements reasonably requested by the Borrower to release the lien of the Security Instrument and the other Loan Documents from the Premises.
  
- (iii) Upon the release of the Premises in accordance with this Section \_\_\_\_ (b), the Borrower shall (at the Lender’s sole and absolute discretion) or at Borrower’s election assign all its obligations and rights under this Note, together with the pledged Defeasance Collateral, to a successor entity designated by the Borrower and which would be satisfactory to a prudent lender. Such successor entity shall execute an assignment and assumption agreement in form and substance that would be satisfactory to a prudent lender pursuant to which such successor entity shall assume the Borrower’s obligations under this Note and the Defeasance Security Agreement. As conditions to such assignment and assumption, the Borrower shall (A) deliver to the Lender one or more opinions of counsel in form and substance and delivered by counsel that would be satisfactory to a prudent lender

stating, among other things, that such assignment and assumption agreement is enforceable against the Borrower and such successor entity in accordance with its terms and that this Note, the Defeasance Security Agreement and the other Loan Documents, as so assigned and assumed, are enforceable against such successor entity in accordance with their respective terms, and opining to such other matters relating to such successor entity and its organizational structure as the Lender may reasonably require, and (B) pay all fees, costs and expenses incurred by the Lender or its agents in connection with such assignment and assumption (including, without limitation, legal fees and expenses and for the review of the proposed transferee and the preparation of the assignment and assumption agreement and related certificates, documents and instruments). Upon such assignment and assumption, the Borrower shall be relieved of its obligations hereunder, under the other Loan Documents and under the Defeasance Security Agreement, except as expressly set forth in the assignment and assumption agreement.

(iv) For purposes of this Section \_\_\_\_, “REMIC Prohibition Period” means the two-year period commencing with the “startup day” within the meaning of Section 860G(a)(9) of the Internal Revenue Code of 1986, as amended from time to time or any successor statute (the “Code”) of any “real estate mortgage investment conduit,” within the meaning of Section 860D of the Code (any such conduit, a “REMIC”) that holds this Note. In no event shall the Lender have any obligation to notify Borrower that a REMIC Prohibition Period is in effect with respect to the Loan, except that the Lender shall notify the Borrower if any REMIC Prohibition Period is in effect with respect to the Loan after receiving any notice described in Section \_\_\_\_ (b)(i)(A); provided, however, that the failure of

the Lender to so notify the Borrower shall not impose any liability upon the Lender or grant the Borrower any right to defease the Loan during any such REMIC Prohibition Period. In no event, however, may any REMIC prohibition period exist beyond three years after initial funding of the loan.

## EXHIBIT "D"

### PREPAYMENT/DEFEASANCE (SECURITIZED MORTGAGE)

#### Defeasance.

- (a) With respect to a release of the Lien of this Mortgage pursuant to Section \_\_\_ hereof, but only in connection with the defeasance of the Allocated Loan Amount for one (1) or more properties through the Maturity Date (a "Defeasance"), the Grantor shall deposit Defeasance Collateral in accordance with subsection (b) below to the Defeasance Collateral Account. In no event shall the delivery of Defeasance Collateral cause the Grantor to be released from its obligations to make payments of principal and interest on the Note.
- (b) The Defeasance shall be permitted at such time as all of the following events shall have occurred:
  - (i) the Defeasance Collateral Account shall have been established pursuant to Section \_\_\_ hereof;
  - (ii) if the Loan is held by a REMIC [or a FASIT], a period of more than two (2) years shall have elapsed since the date on which the Loan is deposited into such REMIC [or FASIT];
  - (iii) Grantor shall have delivered or caused to have been delivered to Beneficiary the Defeasance Collateral for deposit into the Defeasance Collateral Account such that it

will satisfy the Minimum Defeasance Collateral Requirement with respect to a release of one (1) of the Properties or the Total Defeasance Collateral Requirement with respect to a release of all of the Properties, as the case may be, at the time of delivery and all such Defeasance Collateral, if in registered form, shall be registered in the name of Beneficiary or its nominee (and, if registered in nominee name, endorsed to Beneficiary or in blank) and, if issued in book-entry form, the name of Beneficiary or its nominee shall appear as the owner of such securities on the books of the Federal Reserve Bank or other party maintaining such book-entry system;

(iv) Grantor shall have granted or caused to have been granted to Beneficiary a valid perfected first-priority security interest in the Defeasance Collateral and all proceeds thereof;

(v) Grantor shall have delivered or caused to be delivered to Beneficiary an Officer's Certificate, dated as of the date of such delivery, (x) that sets forth the aggregate face amount or unpaid principal amount, interest rate and maturity of all such Defeasance Collateral, a copy of the transaction journal, if any, or such other notification, if any, published by or on behalf of the Federal Reserve Bank or other party maintaining a book-entry system advising that Beneficiary or its nominee is the owner of such securities issued in book-entry form, and (y) to the following effect:

(A) Grantor owns the Defeasance Collateral being delivered to Beneficiary free and clear of any and all Liens, security interests or other encumbrances, and has not assigned any interest or participation therein (or, if any such interest or participation has been assigned, it has been released), and Grantor has full power and authority to pledge such Defeasance Collateral to Beneficiary;

- (B) such Defeasance Collateral consists solely of Defeasance Eligible Investments;
- (C) such Defeasance Collateral satisfies the Minimum Defeasance Collateral Requirement or the Total Defeasance Collateral Requirement, as the case may be, determined as of the date of delivery;
- (D) the Defeasance contemplated hereby will not give rise to an Event of Default; and
- (E) the information set forth in the schedule attached to such Officer's Certificate is correct and complete as of the date of delivery (such schedule, which shall be attached to and form a part of such Officer's Certificate, shall demonstrate satisfaction of the requirement set forth in clause (C) above, in a form reasonably acceptable to Beneficiary);
- (vi) Grantor shall have delivered or caused to be delivered to Beneficiary (A) the Required Opinion with respect to Beneficiary's interest in such Defeasance Collateral, (B) a Tax Opinion, (C) if the Mortgage Loan at such time is included in a REMIC or a FASIT, a Nondisqualification Opinion, and (D) in the event the aggregate of amounts previously defeased and currently subject to a Defeasance equals or exceeds in the aggregate \_\_\_% of the Loan Amount, and additional Opinion of Counsel to the effect that Beneficiary will not be required to be registered under the Investment Company Act as a result of such Defeasance; and
- (vii) No Default or Event of Default shall have occurred and be continuing on either the date of such deposit or at any time during the 120 day period following the date of such deposit (it being understood that this condition shall not be deemed satisfied until the expiration of such period).

(viii) Grantor shall have delivered or caused to be delivered to Beneficiary such other documents and certificates as Beneficiary may reasonably request in connection with demonstrating that Grantor has satisfied the provisions of this Section \_\_\_\_.

(c) For purposes of determining whether sufficient amounts are on deposit in the Defeasance Collateral Account, there shall be included only payments of principal and predetermined and certain income on the Defeasance Collateral (determined without regard to any reinvestment of such amounts) that will occur on a stated date for a stated payment on or before the next Payment Date.

#### **Defeasance Collateral Amount**

(a) On or before the date on which Grantor delivers Defeasance Collateral to Beneficiary pursuant to Section \_\_\_\_ or \_\_\_\_ hereof, Grantor shall open at any Approved Bank or Banks at the time and acting as custodian for Beneficiary, a defeasance collateral account (the “Defeasance Collateral Account”) which shall at all times be an Eligible Account (as defined in the Cash Collateral Agreement), in which Grantor shall grant to Beneficiary or reconfirm the grant to Beneficiary of a security interest as part of the Trust Estate hereunder. Should Grantor open the Defeasance Collateral Account at a bank or banks other than

an Approved Bank, such Defeasance Collateral Account must be maintained as a segregated trust account. The Defeasance Collateral Account shall contain (i) all Defeasance Collateral delivered by Grantor pursuant to Sections \_\_\_ and \_\_\_ hereof, (ii) all payments received on Defeasance Collateral held in the Defeasance Collateral Account and (iii) all income or other gains from investment of moneys or other property deposited in the Defeasance Collateral Account; provided, however, that (x) any sums earned on any Defeasance Collateral which were not included in the determination of the Minimum Defeasance Collateral Requirement or the Total Defeasance Collateral, as the case may be, shall be paid monthly by Beneficiary into the Operating Account to be held in accordance with the Cash Collateral Agreement, and (y) any sums earned on any Defeasance Collateral representing the difference between the assumed interest on the Note at the Default Rate and the lesser, if applicable, of the actual interest on the Note for the quarter prior to the preceding Due Date shall be paid quarterly to the Operating Account. All such amounts, including all income from the investment or reinvestment thereof, shall be held by Beneficiary as part of the Trust Estate, subject to withdrawal by Beneficiary for the purpose set

forth in this Section \_\_\_\_\_. Grantor shall be the owner of the Defeasance Collateral Account and shall report all income accrued on Defeasance Collateral for federal, state and local income tax purposes in its income tax return.

(b) Beneficiary shall withdraw, draw on or collect and apply the \_\_\_\_\_ amounts that are on deposit in the Defeasance Collateral Account to pay when due the principal and all installments of interest and principal on the Note and other amounts due under the Loan Documents.

(c) Funds and other property in the Defeasance Collateral Account shall not be commingled with any other monies or property of Grantor or any Affiliate of Grantor.

(d) Beneficiary shall not in any way be held liable by reason of any insufficiency in the Defeasance Collateral Account.

### **Prepayment**

(a) Maker shall have no right to prepay the Principal Amount in full or in part at any time prior to the Maturity Date except as hereinafter set forth in this Section \_\_\_\_\_ and in Section \_\_\_\_\_ of the Mortgage.

(b) At any time on or before \_\_\_\_\_, \_\_\_\_\_ (the "Cut-Off Date"), Maker may prepay the Principal Amount in whole

or in part on a Payment Date (or, in connection with a Defeasance in compliance with requirements of Section \_\_\_ of the Mortgage, on a date other than a Payment Date). Prepayments in respect of the Notes made on or before the Cut-Off Date that result in the aggregate principal amount of the Loan being reduced to an amount greater than or equal to \$\_\_\_,000,000 may be made without penalty or premium (except that if so prepaid in connection with refinancing other than an Excluded Refinancing (as defined below), a prepayment premium of 0.5% of the principal amount of the Loan so prepaid will be payable by Maker to Payee). Prepayments on or before the Cut-Off Date that result in the principal amount of the Loan being reduced to an amount less than \$\_\_\_,000,000 (after giving effect to any prepayments covered by the preceding sentence) will require payment of a prepayment premium in an amount equal to 1% (or, in the case of a prepayment in connection with a refinancing other than an Excluded Refinancing, 1.5%) of the difference between (x) \$\_\_\_,000,000 (or, after the principal amount of the Loan has been reduced to an amount below \$\_\_\_,000,000, the then current principal amount of the Loan) and (y) the principal amount of the Loan after such prepayment; provided, however, that each of the

foregoing references to \$\_\_\_\_,000,000 shall be reduced by the amount of any prepayments of the principal amount of the Loan pursuant to subsection (d) below. "Excluded Refinancing" means any refinancing of the principal amount of the Loan with respect to the Properties identified as \_\_\_\_\_ or \_\_\_\_\_.

(c) After the Cut-Off Date, the Principal Amount may be prepaid in whole or in part without premium or penalty, except that any prepayment during the period from the Cut-Off Date through and including \_\_\_\_\_, \_\_\_\_\_ in connection with a refinancing (other than an Excluded Refinancing) will require payment of a prepayment premium in an amount equal to 0.5% of the Principal Amount so prepaid.

(d) The Principal Amount may be prepaid in whole or in part without any penalty or premium as a result of Lender's election to apply any Proceeds to reduce the Principal Amount.

In the event that any prepayment of the Principal Amount is made by maker or received by Payee on a date other than a Payment Date, then such prepayment shall be accompanied by interest on the Principal Amount being prepaid at the Class A Interest Rate through the immediately following Payment Date. In connection with any such prepayment, interest on the Principal Amount being repaid may be paid either (i) in Cash or (ii) with respect to the unaccrued interest for the period from (and including) the date of the prepayment to (but not including) the immediately following Payment Date, by providing Payee with U.S. Government Obligations maturing on or before the immediately following Payment Date in an amount sufficient to pay on the

immediately following Payment Date the unaccrued interest on the Principal Amount being prepaid for the period from (and including) the date of the prepayment to, but not including, the immediately following Payment Date.