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Partial Defeasance & Release Issues in Multi-Property Loans *Written by* ***Charlie Marshall*** *at 214.659.4509 and* ***Patrick Sargent*** *at 214.659.4430*

Defeasance suits the needs of CMBS investors seeking to manage prepayment risk, but loan parties must be alert to additional complications if multiple properties are involved.

The concept of defeasance is straightforward enough: the exchange of one type of collateral (real estate) for another (US Government securities, typically, and for purposes of this discussion, Treasuries).

In a typical single property transaction, the SPE borrower transfers the real property securing the loan to the buyer and replaces it with new collateral consisting of Treasuries in an amount (the "Defeasance Amount") that will be sufficient to pay monthly debt service on the loan and the final payment at maturity (frequently a balloon payment, which corresponds nicely to available Treasuries).

For multi-property or cross-collateralized loans, if a borrower desires the flexibility to sell one or more of the properties during the term of the loan, lenders typically assign an allocated loan amount to each property based on underwriting considerations, and require a release premium for prepayment (usually 25% over the allocated loan amount) and other covenants to prevent "cherry-picking" and to preserve the underwriting benefits of aggregating the properties.

The 25% excess can be spread over the remaining loan balances and properties on a pro rata basis, thus giving immediate benefit from the prepaid loan (or a portion thereof).

To accomplish the release in a defeasance loan that does not involve a prepayment , is it sufficient to release the property upon receipt of the Defeasance Amount for the allocated loan amount?

The Treasuries are AAA security for repayment of the defeased portion of the loan, but what about the credit support for the undefeased portion (i.e., the additional loan-to-value afforded by each property, and the available excess cash flow after debt service that could be used for the weaker units)?

Use the same approach as with prepayments: calculate the Defeasance Amount for the allocated loan amount, and multiply by 125%. You end up with both excess cash flow each month (the Treasuries should pay an amount roughly 25% greater than monthly debt service, the excess available to the borrower after making the loan payment) and the balloon amount at the maturity of the Treasuries should also be roughly 25% greater than the allocated loan amount. Remember: the terms concerning defeasance must conform to those relating to partial releases.

The guiding principle is to maintain the benefit of excess monthly cash flow and collateral value.

Since defeasance involves merely replacing collateral (and there is no prepayment), there is no need to change loan balances or note terms. If the transaction involves multiple SPE borrowers where both the property and the related SPE borrower will be released, then the defeasance collateral should be conveyed to a new SPE in consideration for the new SPE`s assuming the related loan.

Otherwise just release the dirt, pledge the new collateral perfected in the name of the trustee, and go on about your business. Not terribly problematic, unless this was not contemplated when the loan closed.

Legal Aspects of Mortgage Lending The Coming Revolution ***GUEST FEATURE - TECHNOLOGY***
Charles J. Altman*, President Tikon Mortgage Technologies 212.697.8484*

Editor`s Note: We continue to be intrigued by efforts to reshape the legal function in securitized lending transactions. Charlie Altman and his company, Tikon Mortgage Technologies, are part of that effort, and we have asked Charlie to share his thoughts on the trends that are driving change in the delivery of CMBS-related legal services. Charlie was previously in-house counsel at Lehman Brothers, with responsibility for conduit lending operations.

While the boundless enthusiasm for all things Internet may have receded, the technology necessary to automate various legal and other loan processing functions is rapidly being developed. The dramatic benefits of that technology for the commercial real estate finance industry are within reach.

Our industry has seen a succession of innovations that have changed how we work. What technological adaptations will we see when we look back several years from now? My company is involved in technology solutions for the legal aspects of commercial mortgage lending and, in developing our applications, we have observed a number of emerging trends and products that will impact lenders and legal services for them. Loan Documents

Commercial real estate lending is document-intensive. Until recently, word processing with merge capabilities was considered the state of the art for document creation at most law firms. But this still requires significant manual review. Document automation programs such as HotDocsÒ have been available that are faster, but acceptance in commercial lending has been slow.

Internet based document creation tools are just now becoming available that are tailored to commercial lending and its variety of negotiated or structural document changes. For example, Tikon has recently developed LegalDocsNow!Ô, an Internet document creation application that enables attorneys to easily design complex legal documents that are accessible to all deal parties via a web browser. The output is both a text-locked Adobe PDF file as well as an XML-compliant database of the document’s legal provisions. Due Diligence Documents

Documents such as leases, surveys and title documents can now be more readily managed. The technologies of scanning and Internet-based document management are now available to allow anyone with internet access and a low cost scanner to use Internet document “filing cabinets” where different parties can upload and review documents. Access can be controlled. Data Capture

Legal information embodied in loan documents can now be systematically retrieved, minimizing labor-intensive document review. New technologies can automate the process of capturing that data with impressive precision. This can be done using Extensible Mark-up Language (“XML”). XML is an Internet protocol that enables the tagging and extraction of information from documents regardless of what computer application was used to create the document. XML has received considerable attention in the context of quantitative data elements in mortgage origination. The legal world will also benefit from XML and the resulting ability to zero-in on information within documents. Knowledge Management

Technology can be used to transfer institutional knowledge in ways that can dramatically affect employee training and productivity, as well as reinforcing consistent best practices. In loan document preparation, for example, knowledge management would take the shape of including explanatory annotation with drafting precedent with tie-ins to other reference sources. Tikon has incorporated this approach into its documentation products.

Application Service Providers ("ASP"s)
Finally, we are seeing a change in the manner in which legal technology is provided. In the past, software was generally licensed for installation and use on the lender`s or law firm`s computers, and the customer was responsible for installing, maintaining and supporting the application. The ASP model relieves the customer of those responsibilities. The customer uses software applications that reside on the ASP`s computers (typically, Internet based servers), and it is the ASP that takes care of upgrades, backups and customer support. Having adopted the ASP model, we at Tikon think that low-cost, seamless product enhancement is the ASP`s biggest benefit. A lender or law firm could not otherwise get the benefit of low-cost, specialized software products that are focused on commercial origination and developed for multiple lenders because they would be too expensive or cumbersome to develop, roll-out and maintain in a traditional licensed software

approach for a single lending institution or law firm. © Charles J. Altman

Zoning Matters Zoning Issues***Peter McKee*** *at 214.659.4507*

There are essentially 4 assurances or comforts that the lender`s zoning due diligence should establish: No Violations Comfort

(No evidence of any material zoning violation). Look for (i) a corroborated comfort letter from the applicable zoning authority; (ii) an ALTA 3.1 zoning endorsement; (iii) site plan approval that matches the as-built survey; or (iv) certificates of occupancy and/or material building permits. Any nonconformity (i.e., where use or improvements vary from current ordinance) must be categorized as either a zoning violation or legally nonconforming feature. Any material zoning violation should be cured prior to loan closing. Rebuild Comfort

(Following major casualty, use can be continued and improvements can be fully rebuilt). If use or improvements are legally nonconforming, look for (i) "full rebuild" provisions in the zoning ordinance; (ii) law and ordinance coverage (particularly the loss of use component); or (iii) facts that support determination that probability of a casualty`s exceeding the damage threshold set by the zoning ordinance (and triggering compliance with current code) is remote. Partial casualties (greater than the damage threshold requiring current compliance) are the problem for lenders. The sizing of the coverage should consider the extent and nature of the nonconformity as well as the damage threshold specified by the zoning ordinance. Licenses and Permits Comfort

(Certificates of occupancy and, for hotels and nursing homes in particular, applicable operating permits have been obtained). If C/O`s cannot be obtained, look for (i) confirmation from locality that the absence of the permit will not result in any enforcement action; and (ii) supporting evidence that there are no zoning or other local law violations. For temporary C/O's, assure that any conditions remaining to be satisfied must be susceptible of being timely performed (and check leases to confirm that rent obligations are not impacted if the permanent C/O is delayed).

Special Issues Comfort
(Property-specific zoning approvals or other land use regulations do not impose additional obligations or restrictions upon intended use and operation of property). Look for confirmation from the zoning comfort letter that there are no property-specific land use approvals or other matters that would impact loan underwriting. Proffers, impact fees, off-site construction obligations, or other requirements that conflict with current operations can accompany any zoning approval, and, being unrecorded for the most part, will not be picked up by title searches. But they`re still binding.

Lenders Lose Protection on Subordinated Debt *Written by* ***Patrick Sargent*** *at 214.659.4430*

Senior lenders` reliance on subordination / standstill agreements to mitigate subordinate debt risks must now be guarded.

A recent bankruptcy decision has held that one of the chief protections intended by such an agreement—the assignment of the junior creditor`s voting rights in bankruptcy to the senior creditor—is not permitted under the Bankruptcy Code.

In Re 203 North Lasalle Street Partnership, 246 B.R. 325 (Bankr. N.D. Ill. 2000), involved a first mortgage loan on a Chicago office building where the senior lender had agreements with a junior lender calling for (i) subordination of the junior loan and (ii) an assignment of the junior lender`s voting rights in bankruptcy.

The court sided with the senior lender in concluding that the subordination provision was enforceable. But the junior lender, which also happened to be the general partner of the borrower, prevailed on the assignment of voting rights claim.

The court held that the junior lender would be allowed to vote its claim in the confirmation proceeding, notwithstanding the contractual language assigning those rights to the senior lender.

The critical difference for the court was that Section 1126(a) of the Bankruptcy Code expressly provides that "the holder of a claim . . . may accept or reject a [confirmation] plan" and that waiver of this voting right is not covered by Section 510(a), which permits subordination agreements.

The court cited several decisions supporting the general rule that pre-bankruptcy agreements may not override contrary provisions of the Bankruptcy Code; those cases, however, typically found that a debtor could not waive or contract away its rights under the Bankruptcy Code.

Here, the issue is the relative rights and bargaining power between creditors, and not any rights of the common debtor. Nevertheless, this decision adversely impacts the senior lender`s ability to accept or reject a reorganization plan or control enforcement of remedies against a common borrower over the junior lender`s objections in the future.

Lenders in CMBS transactions have historically allowed subordinated debt where the junior lender has signed a subordination/standstill agreement to the following effect:

- the junior loan and all claims thereunder are subordinated to the senior loan;
- payments on junior loan may be made only from excess cash after senior loan debt service and reserves have been paid;
- the junior lender agrees neither to file nor consent to the filing of an involuntary bankruptcy proceeding involving borrower;
- the junior lender waives the right to declare default or pursue remedies so long as the senior loan is outstanding, and for applicable preference period thereafter; and
- the junior lender assigns its voting rights in bankruptcy of borrower to the senior lender.

These provisions have given senior lenders comfort that the junior lender will not interfere with the senior lender in the event of a bankruptcy of the borrower, so that the junior debt is considered "soft" or almost like equity.