

MORTGAGES SECURING SWAPS

Ernest A. Goetz, Jr. and Kenneth A. Hoffmann

Swap Mortgages Generally. In addition to securing the repayment of principal and interest, a mortgage encumbering real property may secure a borrower's obligations under an interest rate "swap agreement". However, there are some special concerns a lender should have with a mortgage that secures "swap" obligations, especially in New York State, because of mortgage recording tax issues.

Swap agreements are usually entered into between a commercial or investment bank ("counterparty") and a borrower that desires to purchase the swap to shift to the counterparty the risk of interest rate fluctuations on a variable rate loan. A fixed rate for floating rate swap has become a common financing vehicle. In a fixed rate for floating rate swap, the borrower agrees to pay an amount equal to a specified fixed interest rate applied to an amount (the "notional amount") and the counterparty agrees to pay an amount determined by reference to a specified floating interest rate (e.g., LIBOR) as applied to the same notional amount for identical periods. Although the notional amount and term of the swap can be less than the corresponding principal amount and term of the loan, for purposes of this discussion we will assume that they are identical. The party with the larger obligation on any payment date during the term of the swap agreement pays the net amount by which its obligation exceeds the other party's obligation.

If rates rise, a swap will function like an interest rate cap, but if rates drop the borrower may find it wishes it had not entered into the swap, because the swap agreement can become a burdensome obligation. The borrower must continue to pay fixed interest even though the floating rate of interest on the borrower's loan has turned out to be lower. The swap agreement becomes a monetary obligation that the borrower has to pay to the counterparty during any period of declining interest rates.

Termination Payments. If the borrower does not perform its obligations under a swap agreement, or if other specified events occur (e.g., a borrower bankruptcy or other financial problems), then the counterparty can require the borrower to immediately pay an amount that in most cases has the effect of either (i) giving the counterparty the benefit of the swap agreement for its remaining term, or (ii) causing the borrower to lose the benefit of the swap and the further obligations of the counterparty. This liquidated payment, called a

“termination payment,” is similar to a “make whole” prepayment penalty on a fixed rate loan and is calculated based on a complicated formula. Although not determined based on an actual loss, the termination payment on a fixed rate for floating rate swap will approximate the price that the counterparty would need to pay in the swap market, taking into account the then current interest rate environment, to buy from another person the same fixed rate payment stream that the borrower had contractually agreed to pay under the swap agreement. It reflects, in part, a discounting to present value of the likely future differences between the floating rate that the counterparty agreed to pay and the fixed rate that the borrower agreed to pay. If rates have dropped significantly, the borrower in this scenario may find itself obligated to pay a very substantial termination payment.

When a counterparty initially considers entry into a swap agreement, the counterparty will be concerned with the creditworthiness of the purchaser of the swap, in this case the borrower, since the borrower might be called upon to make a termination payment if and when required under the swap agreement. The counterparty may therefore ask for security for the termination payment in the form of a mortgage, typically on the same real estate that will secure the borrower's floating rate loan, that is, the loan which created the demand or the requirement (if imposed by the lender) of the swap in the first instance. When the counterparty is the same institution that is making the floating rate loan, a single mortgage can secure both the floating rate loan and the borrower's obligation to make any termination payment if the swap turns out to be “out-of-money,” i.e., a loss for the borrower/swap purchaser.

Mortgage Recording Tax. To record a mortgage in New York securing a swap termination payment, the parties might quantify the amount of the termination payment which the mortgage secures. The borrower could then pay mortgage recording tax on the principal amount of the loan as well as the amount attributable to the termination amount so that the mortgage secures a possible termination payment in an amount up to that maximum amount. If the termination payment turned out to exceed the maximum secured amount, then the mortgage would not secure any of such excess. However, if the mortgage uses an alternative structure, the parties do not need to specify the amount of the termination payment in the mortgage itself and pay the mortgage recording tax on a separately specified termination payment amount.

In situations where a mortgage secures a swap termination payment relating to the same loan that the mortgage secures, it is commonly thought that the parties can avoid paying additional mortgage recording tax on the termination payment amount. This is because

the obligation to pay a termination payment may be structured as an obligation to pay additional interest on the same loan. Although the New York mortgage recording tax applies, the tax is applicable only to principal indebtedness. It does not apply to any secured obligation to pay interest, even “additional interest” arising under a swap. Therefore, to the extent that the mortgage secures a swap termination payment, preferably by describing that obligation as additional interest, no further mortgage recording tax is incurred.

Documentation Provisions. When using a mortgage to secure swap obligations, lenders should follow these suggestions:

Definition of “Additional Interest”. In the mortgage note or loan agreement, the borrower should agree to pay any termination payment arising under the swap agreement. The mortgage note or loan agreement should define that payment as “Additional Interest.”

Identification of the swap. When the mortgage identifies the secured obligations, those obligations should also be defined to include the swap obligations, for example, “all of the Borrower's obligations to pay any Additional Interest as provided for under the [Mortgage Note or Loan Agreement, as appropriate].”

Maximum Secured Amount. Where the mortgage defines the mortgage amount or the maximum secured amount, the principal amount of the mortgage should not be increased to cover the swap obligations, but the reference to the “interest” secured should be modified to read: “interest (including Additional Interest as defined in the [Mortgage Note or Loan Agreement, as appropriate]).”

Qualifications. Although the preceding points accurately describe current industry practices and understandings, any lender that relies on a mortgage securing swap termination payments on this basis should note the following: (i) the New York State taxation authorities have never officially approved this structure; and (ii) this structure works only to the extent that (a) the swap relates to the same loan that the mortgage secures (and not, for example, to a loan that is unsecured), and (b) the notional amount of the swap does not exceed the principal amount secured by the mortgage on the New York real property*. By satisfying the last two conditions, the parties support the argument that any swap payment is really nothing more than additional interest on the same loan.

Title Insurance. For any mortgage that secures swap obligations, the lender should also obtain a “swap” endorsement as part of its mortgagee title insurance

* See, Joshua Stein, *New York Commercial Mortgage Transactions* Section 6.14 (Aspen Publishing 2003)

policy. If a lender obtains such an endorsement, the title insurance company agrees to provide additional title insurance coverage for the mortgage, up to an agreed amount reflected in the endorsement, to cover possible swap termination obligations that the mortgage secures. Although the endorsement requires the lender to specify a particular dollar amount of coverage, e.g., \$1,000,000 of additional title coverage for swap exposure, the title insurer does not require a corresponding fixed dollar increase in the secured amount under the mortgage. Lenders can anticipate title company requests for the prior review of the draft mortgage documents in order for the title company to confirm the “Additional Interest Structure”. Of course, it should be remembered that title insurance covers loss or damage resulting from defects or failure of title in connection with the insured real property or from enforcement of superior liens in the insured property. It is not credit insurance and will not help if the real property does not possess the value necessary to support the loan and the swap obligations.

This article is not intended to provide legal advice for a specific transaction. If you require further information on any matter contained in this article or would like to discuss a specific transaction, please feel free to contact either Mr. Goetz or Mr. Hoffmann at (516) 296-7000.