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DIRT LAWYERS AND DIRTY REMICS

Bradley T. Borden & David J. Reiss*

The day-to-day practice of real estate law does not touch on the intricacies of the securitization of mortgages, let alone the tax laws that apply to mortgage-backed securities. And that is okay. What is not okay is that securitization professionals did not account for the day-to-day practices of dirt lawyers as they relate to the transfer and assignment of mortgage notes and mortgages when structuring mortgage-backed securities. The consequences of this may turn out to be severe for investors, underwriters, and securitization professionals.

But of equal gravity is the responsibility that this imposes on dirt lawyers, as members of society with specialized knowledge, to help shape policy. As the business cycle turns and the mortgage markets rise from the depths of the Bust, dirt lawyers should be sure to make their views known about the role that law should play in the business of real estate finance. In particular, they should make clear how formalistic legal rules protect the parties to a real estate finance transaction and that these rules should be treated with appropriate deference. That formalism can protect the borrower from paying the debt more than once or to the wrong party. It can also protect the owner of the note from disputes over whether the underlying debt should be paid.

Take, for example, the negotiability of mortgage notes, which is governed by the Uniform Commercial Code (UCC). Notes can be sold by the thousands in run of the mill secondary market transactions. Negotiable notes are much better for lenders than non-negotiable ones, so lenders are incentivized to properly negotiate them. Trusts are bulk purchasers of negotiable instruments which put the "security" in mortgage-backed securities (MBS). These trusts are best protected if they are holders in due course of the negotiable instruments and are

thusly incentivized to ensure that the note was properly negotiated. The rules of negotiability are quite clear, designed as they were for a broad swath of the commercial world. Negotiation of a typical mortgage note requires delivery and the payee's signature or endorsement. Notwithstanding these incentives and clear rules, a mountain of recently revealed evidence indicates that many notes in secondary market transactions were not properly negotiated.

One of the consequences of the sale of a negotiable note not done in accordance with the requirements of the holder in due course doctrine is that the purchaser of the note may not be free of the personal defenses that the note maker (borrower) would have had against the original lender. (The personal defenses include lack of consideration; non-performance; actual payment of the debt; and fraud in the inducement. UCC § 3-302.) Another consequence of the sale of a note that is not done properly is that the beneficial owner (as opposed to the legal owner) may not be able to collect on the debt if the borrower is in default. And a third – and until recently hidden -- consequence of an improper sale of a note to a secondary market participant is that the purchaser may fail to comply with requirements necessary to obtain favorable tax treatment as a Real Estate Mortgage Investment Conduit, a REMIC.

Modern Residential Real Estate Finance

Before 1986, complex mortgage-backed securities had various tax-related inefficiencies. First amongst them, these securities were taxable at the entity level and so investors faced double taxation. Wall Street firms successfully lobbied Congress to do away with double taxation in 1986. This legislation created the Real Estate Mortgage Investment Conduit (REMIC), which was not taxed at the entity level. This one change automatically boosted its yields over other forms of mortgage-backed securities that would otherwise be taxed. Unsurprisingly, REMICs

displaced these other types of mortgage-backed securities and soon became the dominant choice of entity for such transactions.

A REMIC allows for the pooling of mortgage loans that can then be issued as a multiple-tranche mortgage-backed security. A REMIC is intended to be a passive investment in a static pool of mortgages. Because of its passive nature, a REMIC is limited as to how and when it can acquire mortgages. In particular, a REMIC must in most cases acquire its mortgages within three months after its start-up. 26 U.S.C. § 860G(a)(3), (9). The Internal Revenue Code provides for draconian penalties for REMICs that fail to comply with applicable legal requirements, the REMIC rules.

In the 1990s, the housing finance industry, still faced with the patchwork of state and local laws relating to real estate, sought to streamline the process of assigning mortgages from the loan originator to a mortgage pool. Industry players, including Fannie and Freddie and the Mortgage Bankers Association, advocated for The Mortgage Electronic Recording System ("MERS"), which was up and running by the end of the decade. A MERS mortgage contains a statement that "MERS is a separate corporation that is acting solely as nominee for the Lender and Lender's successors and assigns. MERS claims to be the mortgagee under this Security Instrument." MERS is not, however, named on any note endorsement. This new system saved lenders small but not insignificant amounts of money in recording fees and administrative costs every time a mortgage was transferred. But the legal status of this private recording system was not clear and had not been ratified by Congress. Notwithstanding that fact, nearly all of the major mortgage originators participated in MERS and it registered millions of mortgages within a couple of years. By 2009 MERS claimed to be the nominal mortgagee on approximately two-thirds of all newly-originated residential loans.

Beginning in the early 2000s, MERS and other parties in the mortgage securitization industry began to relax many of the procedures and practices they originally used to assign mortgages among industry players. Litigation documents and decided cases reveal how relaxed the procedures and practices became. Hitting a crescendo right before the global financial crisis, loan origination and securitization practices became egregiously negligent.

The Rule of Law in the Business of Real Estate

Even though some securitizers may have followed the terms contained in the applicable Pooling and Servicing Agreements that governed REMIC mortgaged-backed securities, the very low tolerance for deviation in the REMIC rules suggests that partial compliance could result in a finding that individual REMICs fail to comply with the strict requirements of the Internal Revenue Code. This would cause those REMICs to lose their preferred tax status. Surprisingly, however, the IRS appears to be unresponsive to this issue so far, and its failure probably contributed to the financial crisis to some extent. *See* Bradley T. Borden, *Did the IRS Cause the Financial Crisis?*, HUFFINGTON POST (Oct. 18, 2012), *available at* http://www.huffingtonpost.com/bradley-t-borden/did-the-irs-cause-the-fin_b_1972207.html.

To obtain REMIC classification, a trust must satisfy several requirements. Of particular interest is the previously mentioned requirement that within three months after the trust's startup date substantially all of its assets must be qualified mortgages. *See* IRC § 860D(a)(4). The regulations provide that substantially all of the assets of a trust are qualified mortgages if no more than a *de minimis* amount of the trust's assets are not qualified mortgages. Treas. Reg. § 1.860D-1(b)(3)(i). A "qualified mortgage" is an obligation that is principally secured by an interest in real property. *See* IRC § 860G(a)(3)(A). Thus, to be a qualified mortgage, an asset

must satisfy both a timing requirement (be acquired within three months after the startup date) and definitional requirement (be an obligation principally secured by an interest in real property).

Industry practices raise questions about whether trusts satisfied either the timing requirement or the definitional requirement. The general practice was for trusts and loan originators to enter into Pooling and Servicing Agreements, which required the originator to transfer the mortgage note and mortgage to the trust. Nonetheless, reports and court documents indicate that originators and trusts frequently did not comply with the terms of the Pooling and Servicing Agreements and originators often retained possession of the mortgage notes as MERS became the nominee of record on the mortgage.

The failure to properly transfer the mortgage note and mortgage may cause the trusts to fail both the timing requirement and the definitional requirement that are necessary to qualify for REMIC status. They fail the timing requirement because they do not acquire the requisite interests within the three-month prescribed time frame. They fail the definition requirement because they do not legally own the proper obligations, and what they do legally own does not appear to be secured by interests in real property.

Wall Street Rules or Legal Rules?

While Wall Street treated the REMIC rules with disregard, they are actually pretty straightforward in broad outline. Federal tax law does not rely upon the state-law definition of ownership, but it looks to state law to determine parties' rights, obligations, and interests in property. *See, e.g.*, Burnet v. Harmel, 287 U.S. 103, 110 (1932). The tax definition of ownership would apply to the mortgage notes. *See* Bradley T. Borden & David J. Reiss, *Beneficial Ownership and the REMIC Classification Rules*, 28 TAX MGMT. REAL EST. J. 274 (Nov. 7, 2012). Tax law can also disregard the transfer (or lack of transfer) of formal title where the

transferor retains many of the benefits and burdens of ownership. *See* Bailey v. Comm'r, 912 F2d 44, 47 (2d Cir. 1990). Courts focus on whether the benefits and burdens of ownership pass from one party to another when considering who is the owner of property for tax purposes. Grodt & McKay Realty, Inc. v. Comm'r, 77 T.C. 1221, 1237 (1981). The analysis of ownership does not merely look to the agreements the parties entered into because the label parties give to a transaction does not determine its character. *See* Helvering v. Lazarus & Co. 308 U.S. 252, 255 (1939). The analysis must examine the underlying economics and the attendant facts and circumstances to determine who owns the mortgage notes for tax purposes. *See id.*

Courts in many states have considered the legal rights and obligations of REMICs with respect to mortgage notes and mortgages they claim to own. Courts are split, with some ruling in favor of MERS as nominee for the REMIC and others ruling in favor of other parties whose interests are adverse to the REMIC and to MERS. Apparently, no court has considered how significant these rules are with respect to REMIC classification for tax purposes. Standing to foreclose and participate in a bankruptcy proceeding will likely affect the tax analysis of whether REMIC trust assets are secured by an interest in real property, but they probably do not affect the tax analysis of whether the REMIC trusts own obligations. (The lack of standing should result in a finding that the mortgage note is not secured by an interest in real property.) This analysis turns on the ownership of the mortgage notes.

The practices at Countrywide Home Loans, Inc. (one of the nation's largest loan originators in terms of volume during the Boom and now part of Bank of America) illustrate the outrageous behavior of mortgage securitizers during that period of time. The court in *In re Kemp* documents in painful detail how Countrywide failed to transfer possession of a note to the pool backing a MBS so that Countrywide failed to comply with the requirements necessary for that

mortgage to comply with the REMIC rules. *See* In re Kemp, 440 F.R. 624 (Bkrtcy D.N.J. 2010). Numerous other filings and reports suggest that Countrywide's practices were typical of many major lenders during the early 2000s. A suit filed by the New York Attorney General also details in its allegations how loan originators and REMIC sponsors colluded to populate REMICs with mortgages that did not comply with the REMIC rules. *See* Complaint, New York v. J.P. Morgan Securities LLC, NO. 451556/2012 (County of New York, Oct. 10, 2012). A suit filed on behalf of Freddie Mac and Fannie Mae also alleges the practices of loan originators that have negative implications for REMICs' tax-advantaged status. *See* Complaint, Federal Housing Finance Agency v. JPMorgan Chase & Co., No. 11 Civ. 6188 (DLC) (S.D.N.Y. June 13, 2012).

The practices of loan originators and REMIC sponsors have caused severe losses and have undermined the American property system. Significant litigation has grown out of those losses. To date, hundreds of suits have been filed that allege a range of behaviors in the securitization industry that have consequences for the REMIC rules. *See Developments in Real Estate Finance*, available at http://refinblog.com/ (tracking changes in the law and practices of the real estate finance industry). The resulting tax consequences for REMICs that failed to comply with the REMIC rules may be staggering.

Kemp addressed the issue of enforceability of a note under the UCC for bankruptcy purposes. *See* In re Kemp, 440 B.R. 624 (Bkrtcy D.N.J. 2010). The court in that case held that a note was unenforceable against the maker of the note and the maker's property under New Jersey law on two grounds. The court held that because the beneficial owner of the note, the Bank of New York (the trustee of a pool of mortgages that backed an MBS that included the mortgage at issue in the case), did not have possession and because the note lacked proper endorsement upon sale, the note was unenforceable. Recognizing that the mortgage note came within the UCC

definition of negotiable instrument, the court then considered who is entitled to enforce a negotiable instrument but held that no such person was a party in *Kemp*.

The flaws that the opinion documents are shocking to even a modestly competent lawyer, even after the revelations regarding industry practices that have come to light since the Subprime Bust. These flaws include

- The originator failing to convey possession of the note to the intended assignee, the trustee of the pool
- The originator failing to endorse the note to the intended assignee
- The originator failing to affix an allonge to the note
- The originator producing a Lost Note Certification in the same filing in which it claims to have located the original note
- The originator transferring the note to the trustee after filing its proof of claim
- The originator failing to maintain corporate formalities to distinguish it from its affiliates, as those formalities relate to the issue of possession of the note

The consequences of these flaws play out for i) the borrower, ii) the legal owner of the debt and iii) the trustee (the beneficial owner) of the pool of mortgages securing the MBS that includes the mortgage at issue in the case.

As the *Kemp* court notes, "[f]rom the maker's standpoint,"

> it becomes essential to establish that the person who demands payment of a negotiable note, or to whom payment is made, is the duly qualified holder. Otherwise, the obligor is exposed to the risk of double payment, or at least to the expense of litigation incurred to prevent duplicative satisfaction of the instrument. These risks provide makers with a recognizable interest in demanding proof of the chain of title.

440 B.R. at 631 (quoting Adams v. Madison Realty & Dev., Inc., 853 F.2d 163, 168 (3d Cir. N.J. 1988). And because the originator did not comply with the legal niceties, the beneficial owner of the debt, the trustee, cannot file its proof of claim either.

The *Kemp* court does not address the third type of consequence (for the trustee) because it is not an issue that is before the court. Nonetheless, the *Kemp* court's analysis illustrates how courts may reach results that undercut arguments that REMICs were the owners of the mortgage notes and mortgages that were purportedly sold to them for REMIC rules purposes.

Even if the majority of jurisdictions issue foreclosure and bankruptcy rulings that have favorable consequences for REMICs, the few that do not can destroy the REMIC classification of many mortgage-back securities that were structured to be—and promoted to investors as—REMICs. This is because rating agencies require that REMICs be geographically diversified in order to spread the risk of defaults caused by local economic conditions. Most, if not all, REMICs will own mortgage notes and mortgages from states governed by laws that the courts determine do not support REMIC eligibility for the mortgages from those jurisdictions. This diversification requirement makes it very likely that REMICs will have more than a *de minimis* amount of mortgages that do not come within the definition of qualified mortgage under the REMIC regulations. Professionals who helped structure these securitizations may face liability if the IRS were to find that a purported REMIC was just purported and not a REMIC.

As lawsuits arising from the Subprime Boom allocate liability and damages arising from faulty securitizations – dirty REMICs -- among investors, underwriters and securitization professionals, lawyers may feel no more empowered to take corrective action than homeowners do. We might feel as if we do not have much leverage over lenders, over title companies, over Wall Street firms. And indeed, we don't. But as members of bar associations and trade associations, as informed constituents of elected officials, as wielders of the pen, we can attempt to influence policy and industry practices that we believe to be harmful to a well-ordered real estate market.

If you look back to the Subprime Boom in the early 2000s, do you recollect saying that things can't keep going on like this? Well, you were right and we are now suffering the serious consequences. Let us now commit to speaking out in real-time to reduce the chances that history repeats itself, at least in our lifetimes.

Summary: Real estate lawyers have a duty to explain how legal rules protect the parties to a real estate finance transaction and should advocate that these rules be treated with appropriate deference in order to protect the financial system from irrational exuberance.

Keywords: mortgage-backed securities, MBS, Real Estate Mortgage Investment Conduit, REMIC, dirt lawyers

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* Brad and David are professors at Brooklyn Law School. © 2012 Bradley T. Borden and David J. Reiss. This brief article is drawn from a forthcoming study by the authors and builds on an earlier discussion of these issues in Bradley T. Borden & David J. Reiss, *Wall Street Rules Applied to REMIC Classification*, THOMSON REUTERS NEWS & INSIGHT (Sep. 13, 2012), available at http://newsandinsight.thomsonreuters.com/Securities/Insight/2012/09_-_September/Wall_Street_Rules_Applied_to_REMIC_Classification/ and Bradley T. Borden & David J. Reiss, 30 *Once a Failed REMIC, Never a REMIC*, CAYMAN FIN. REV. __, (forthcoming 2013), *available at* http://ssrn.com/abstract=2185420.