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Once a Failed REMIC, Never a REMIC

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Investors in mortgage-backed securities, built on the shoulders of the tax-advantaged Real Estate Mortgage Investment Conduit ("REMIC"), may be facing extraordinary tax losses because of how bankers and lawyers structured (or failed to structure) these securities. This calamity is compounded by the fact that those professional advisors should have known that the REMICs they created were flawed from the start.

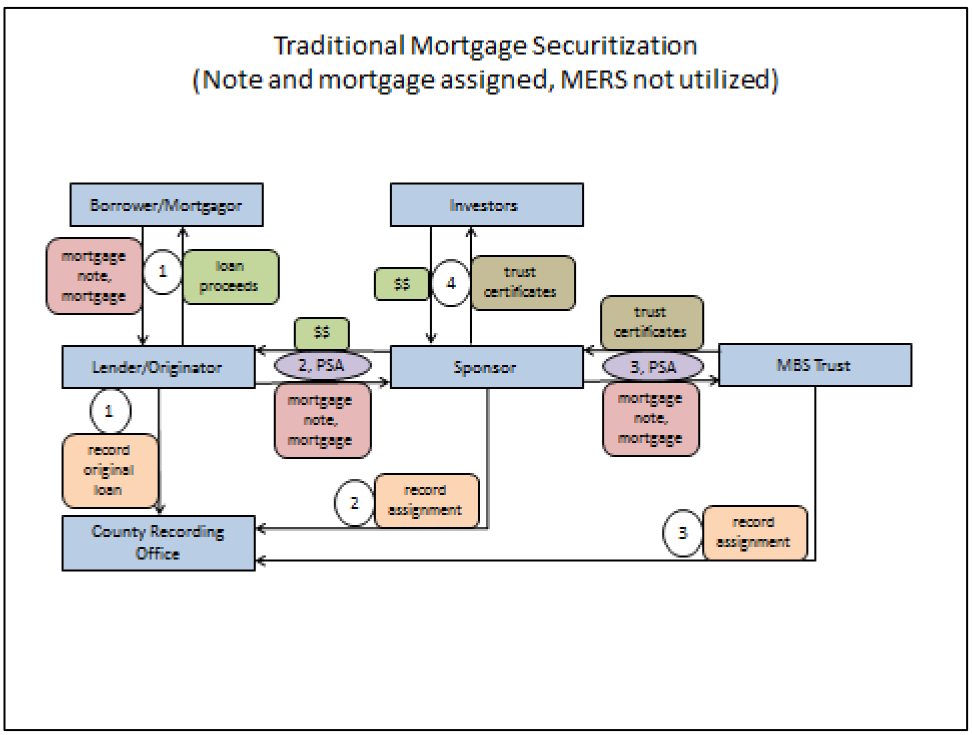
A History of REMIC-able Growth

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 REMIC, which was not taxed at the entity level. This one change automatically boosted its yields over other mortgage-backed securities that would otherwise be taxed. Unsurprisingly, REMICs displaced other types of mortgage-backed securities and soon became the dominant choice of entity for such transactions.

The process for creating a REMIC can be fairly complex, but a simple diagram of the original process provides sufficient framework for discussion and analysis. Loan originators lend

* 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/.

money to borrowers who use the proceeds to purchase a residence.[1] The borrowers execute a mortgage notes in favor of the originator for the amount of the loan and grant the originator a mortgage on the residence. The originator records the mortgages in the county clerk's office. The originator sells the mortgage notes and assigns the mortgage to a REMIC sponsor. The sponsor records assignments of mortgages in the county clerk's office. The sponsor transfers the mortgages notes and assigns the mortgage to a REMIC trust in exchange for beneficial interests in the trust. The REMIC trustee records the assignment of the mortgage, and the sponsor sells the beneficial interests to investors. The following diagram depicts the traditional securitization process.



[1] A REMIC may include mortgages secured by real estate other than a home, but this article focuses on residential mortgage-backed REMICs.

A REMIC allows for the pooling of mortgage loans that can then be issued as a multiple-tranche mortgage-backed security.[2] 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.[3] In particular, a REMIC must in most cases acquire its mortgages within three months after its start-up.[4] The Internal Revenue Code provides for draconian penalties for REMICs that fail to comply with applicable legal requirements.

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."[5] 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

[2] *See* JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 411 (H.R. 3838, 99th Cong; P.L. 99-514) (hereinafter "THE 1986 BLUEBOOK") ("[T]he Congress believed that the provisions of the Act should apply to any multiple class entity used for packaging interests in mortgages, regardless of the legal form used, *provided that the interests satisfy the specified substantive requirements*." (emphasis added)).
[3] *See* THE 1986 BLUEBOOK at 411 ("The Congress believed that there should be some relief from two levels of taxation (i.e., at the entity level and at the shareholder level) where an entity with multiple classes of interests holds only a pool of real estate mortgages and related assets, *has no powers to vary the composition of its mortgage assets*, and has other powers generally consistent with the preservation of trust status, provided that satisfactory rules are prescribed for the taxation of the multiple interests." (emphasis added)), 412 ("In general, a REMIC is *a fixed pool of mortgages* with multiple classes of interests held by investors." (emphasis added)).
[4] 26 U.S.C. § 860G(a)(3), (9).
[5] *See, e.g.*, BROOK BOYD, REAL ESTATE FINANCING § 14.05[9] (2005).

a couple of years. By 2009 MERS claimed to be the nominal mortgagee on approximately two-thirds of all newly-originated residential loans.[6]

Beginning in 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 hit, the loan origination and securitization practices became egregiously negligent, perhaps criminal.

The practices at Countrywide Home Loans, Inc. (then one of the nation's largest loan originators in terms of volume 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 the note to the pool backing the securities so that Countrywide failed to comply with the requirements necessary to obtain REMIC status for that mortgage.[7] Numerous other filings and reports suggest that Countrywide's practice was typical of many major lenders during the early 2000s.[8] In fact, in addition to failing to transfer mortgage notes, the parties often failed to assign and record the mortgages. Prior to the 2008 Financial Crisis, the REMIC securitization process had devolved into something depicted by the following diagram—notice that the originator does not transfer the mortgage note, and recording of the mortgage assignment often occurred long after the purported transfer, if at all.

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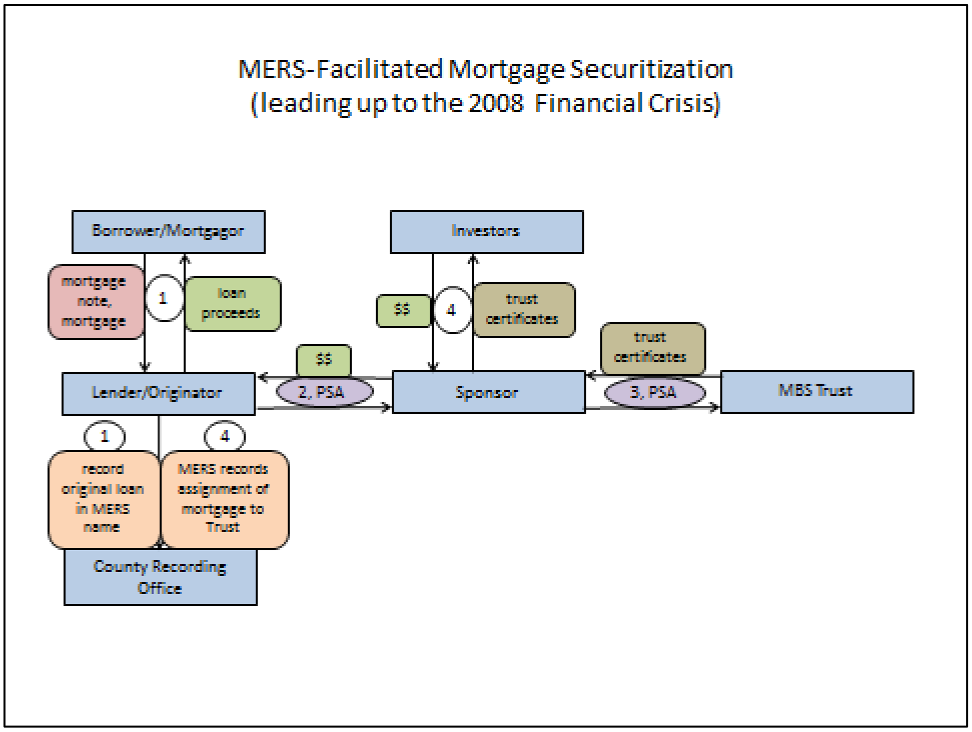
[6] *See* Jackson v. Mortgage Electronic Registration Systems, Inc., 770 N.W. 2d 487, 490–92 (Minn. 2009).

[7] *See* In re Kemp, 440 F.R. 624 (Bankr. D.N.J. 2010). *See also* Cutler v. U.S. Bank National Association, No. 2D10-5709 (Fla. App. 2d Dist. Sep. 21, 2012) (holding that if a bank was the holder of a note at the time it brought a foreclosure action, it did not have standing to bring the action).

[8] *See Developments in Real Estate Finance*, available at http://refinblog.com/ (tracking changes in the law and practices of the real estate finance industry).



A suit filed by the New York Attorney General (the Schneiderman Complaint) also details in its allegations how loan originators and REMIC sponsors colluded to populate REMICs with faulty mortgages.[9] A suit filed on behalf of Freddie Mac and Fannie Mae (the Fannie Complaint) also alleges the corrupt practices of loan originators that have implications for REMICs' tax-advantaged status.[10] The practices of loan originators and REMIC sponsors have causes severe losses and have undermined the U.S. property system. Significant litigation has grown out of those losses and damage to the property system. Investors who purchased beneficial interests in REMIC trusts are suing the parties who put the REMICs together and promoted them.[11] State and federal prosecutors are also bringing actions for fraud and

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[9] *See* Complaint, New York v. J.P. Morgan Securities LLC, NO. 451556/2012 (County of New York, Oct. 10, 2012).
[10] *See* Complaint, Federal Housing Finance Agency v. JPMorgan Chase & Co., No. 11 Civ. 6188 (DLC) (S.D.N.Y. June 13, 2012).
[11] *See, e.g.*, Consolidated Complaint at 20–22, HSH Nordbank AG v. Barclays Bank PLC, No. 652678/2011 (County of New York Apr. 2, 2012) (claiming REMIC promoters misrepresented information about the pooled mortgages and committed fraud); The Western and Southern Life Insurance Company v. Residential Funding Company, No. A1105042 (Hamilton County Ohio June 6, 2012) (denying motions to dismiss claims against

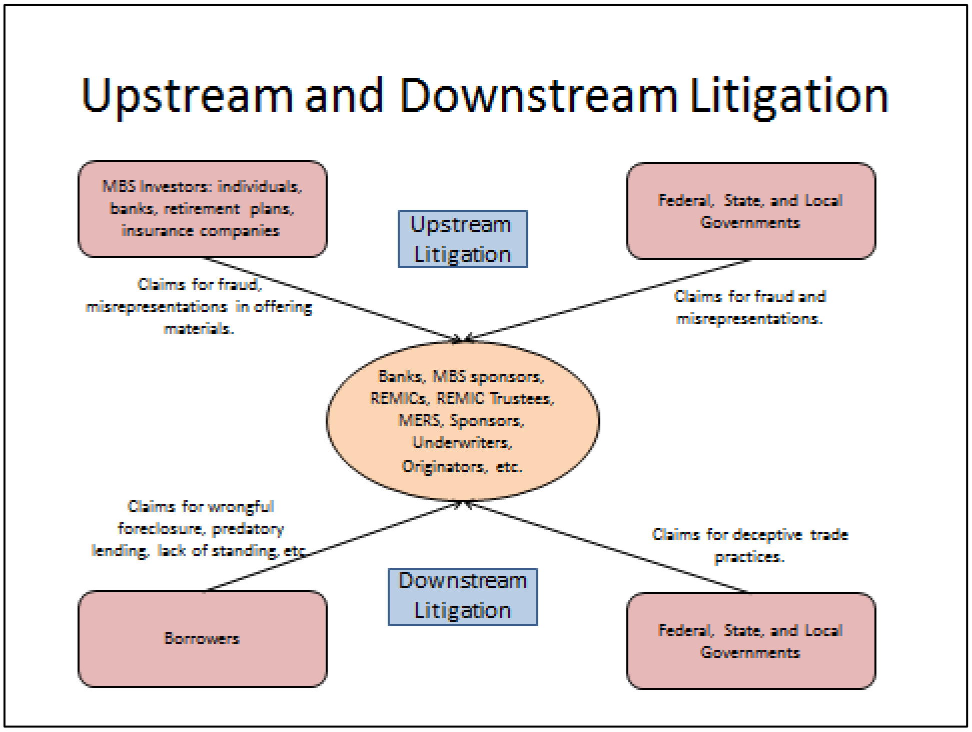
misrepresentation against the sponsors.[12] This body of litigation is depicted as upstream litigation in the diagram below. MERS, banks, and REMIC trustees are involved in litigation with homeowners and borrowers regarding the legal rights that the banks and trustees have to enforce mortgage notes and foreclose on property.[13] Counties have also brought lawsuits against MERS and banks seeking recording fees for purported transfers of the mortgage notes.[14] The diagram depicts this body of legal action as downstream litigation.

organizers of residential mortgage-backed securities (RMBS)); Pennsylvania Public School Employees' Retirement System v. Bank of America Corporation, No. 11 Civ. 733 (S.D.N.Y. 2012) (denying Bank of America's motion to dismiss the Section 10(b) and Rule 10b-5 claim against it because the plaintiff's allegations concerning Bank of America's "misstatements and omissions concerning its reliance on MERS, vulnerability to repurchase claims, internal controls, and compliance with GAAP and SEC regulations" satisfied the requisite standard to raise a strong inference of the bank's misconduct and scienter regarding the misconduct).

[12] *See, e.g.*, Complaint, New York v. J.P. Morgan Securities, *supra* note 9; Complaint, New York v. Credit Suisse Securities, No. 451802/2012 (County of New York, Nov. 20, 2012); Amended Complaint at 32–33, Federal Housing Finance Agency v. JPMorgan Chase & Co. et al, No. 11 CV. 6188 (DLC) (S.D.N.Y. June 13, 2012) (describing origination practices of some notes); Complaint-in-Intervention of the United States of America, United States v. Bank of America, 12 Civ. 1422 (JSR) (S.D.N.Y. Oct. 24, 2012) (claiming that Countrywide, as originator, eliminated checkpoints, resulting in fraud and loan defects while Countrywide represented it had tightened its underwriting standards).

[13] *See, e.g.*, Fowler v. Recontrust Companay, N.A., 2011 WL 939863 (D. Utah Mar. 10, 2011) (holding that MERS is the beneficial owner under Utah law); Jackson v. Mortgages Electronic Registration Systems, Inc., 770 N.W. 2d 487 (Minn. 2009) (holding that MERS, as nominee, could institute a foreclosure by advertisement, i.e., a nonjudicial foreclosure, based upon Minnesota "MERS statute" that allows nominee foreclosure); Gomes v. Countrywide Home Loans, Inc., 192 Cal.App.4th 1149 (Cal. App. 2011) (finding that MERS had authority to foreclose on behalf of the note holder because of the authority granted to it under the deed of trust); Bain v. Metropolitan Mortgage Group, Inc., 285 P.3d 34 (Wash. 2012) (holding that MERS was not a beneficiary under Washington Deed of Trust Act because it did not hold the mortgage note); Eaton v. Federal National Mortgage Association, 462 Mass. 569 (Mass. 2012) (holding that mortgagee must hold the note to foreclose or act with the authority of the note holder); Ralph v. Met Life Home Loans, No. CV 2010-0200 (5th D. Idaho Aug. 10, 2011) (holding that MERS was not the beneficial owner of a deed of trust, so its assignment was a nullity and the assignee could not bring a nonjudicial foreclosure against the borrower); Landmark National Bank v. Kesler, 289 Kan. 528, 216 P.3d 158 (Kan. 2009) (holding that MERS had no interest in the property and was not entitled to notice of bankruptcy or to intervene to challenge it). Litigation in this area is moving quickly, so even work done a few years ago is not up to date. Nonetheless, an early article with a nice overview of cases that consider state-law issues associated with MERS recording is John R. Hooge & Laurie Williams, *Mortgage Electronic Registration Systems, Inc.: A Survey of Cases Discussing MERS' Authority to Act*, NORTON BANKRUPTCY LAW ADVISOR 1 (Aug. 2010)..

[14] *See, e.g.*, Margaret Cronin Fisk & Tom Korosec, *Bank of America, MERS Lose Bid to Dismiss Texas Fee Suit*, BLOOMBERG BUSINESSWEEK (May 24, 2012), *available at* http://www.businessweek.com/news/2012-05-23/bank-of-america-mers-lose-bid-to-dismiss-texas-fee-suit.



To date, hundreds of such suits have been filed, and there appears to be no immediate end in the number that will be filed.[15] Courts are still struggling to determine the legal fallout of the mess that banks and MERS have created.

Sloppiness and REMICs Rules Don't Mix Well

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

[15] *See Developments in Real Estate Finance*, available at http://refinblog.com/ (tracking changes in the law and practices of the real estate finance industry).

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.[16]

To obtain REMIC classification, a trust must satisfy several requirements. Of particular interest is the requirement that within three months after the trust's startup date substantially all of its assets must be qualified mortgages.[17] 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.[18] The regulations do not define what constitutes a *de minimis* amount of assets, but they provide that substantially all of the assets are permitted assets if no more than one percent (1%) of the aggregate basis of all of the trust's assets is attributed to prohibited assets.[19] If the aggregate basis of the prohibited assets exceeds the 1% threshold, the trust may nonetheless be able to demonstrate that it owns no more than a *de minimis* amount of prohibited assets.[20] Nonetheless, an amount significantly greater than 1% would appear to exceed the *de minimis* exception. Thus, almost all of a REMIC's assets must be qualified mortgages.

A "qualified mortgage" is an obligation that is principally secured by an interest in real property.[21] The trust must also acquire the obligation by contribution on the startup date or by purchase within three months after the startup date.[22] Thus, to be a qualified mortgage, an asset must satisfy both a definitional requirement (be an obligation principally secured by an interest in real property) and a timing requirement (be acquired within three months after the startup date).

[16] 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.
[17] *See* IRC § 860D(a)(4).
[18] *See* Treas. Reg. § 1.860D-1(b)(3)(i).
[19] *See* Treas. Reg. § 1.860D-1(b)(3)(ii).
[20] *See id.*
[21] *See* IRC § 860G(a)(3)(A).
[22] *See* IRC § 860G(a)(3)(A)(i), (ii).

Industry practices raise questions about whether trusts satisfied either the definitional requirement or the timing 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, as in Kemp, reports and court documents indicate that originators and trusts frequently did not comply with the terms of the Pooling and Servicing Agreements and the originator typically retained possession of the mortgage notes and MERS became the nominee of record on the mortgage.

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

Even if the trusts acquired some obligations principally secured by interests in real property, many of their assets would not satisfy the REMIC requirements. The Schneiderman Complaint and Fannie Complaint allege that the loan origination practices and underwriting standards become were severely flawed. If these allegations proved to be true, many of the mortgages in REMIC pools will fail to be principally secured by interests in real property. This would result in the trusts owning more than a *de minimis* amount of prohibited assets. If more than a *de minimis* amount of a trust's assets are prohibited assets, then it would not be eligible for REMIC status.

The Un-MERS-iful Stringency of the REMIC Regulations

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.[23] 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.[24] 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.[25] 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.[26] The analysis must examine the underlying economics and the attendant facts and circumstances to determine who owns the mortgage notes for tax purposes.[27]

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 and others ruling in favor of other parties whose interests are adverse to MERS. Apparently, no court has considered how significant these rules are with respect to REMIC classification. 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.[28] This analysis turns on the ownership of the mortgage notes.

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[23] *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).
[24] *See* Bailey v. Comm'r, 912 F2d 44, 47 (2d Cir. 1990).
[25] Grodt & McKay Realty, Inc. v. Comm'r, 77 T.C. 1221, 1237 (1981).
[26] *See* Helvering v. Lazarus & Co. 308 U.S. 252, 255 (1939).
[27] *See id.*
[28] The lack of study should result in a finding that the mortgage note is not secured by an interest in real property.

Kemp addressed the issue of enforceability of a note under the Uniform Commercial Code (UCC) for bankruptcy purposes.[29] 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.[30] The court held that because the owner of the note, the Bank of New York, did not have possession and because the note lacked proper endorsement upon sale, the note was unenforceable.[31] Recognizing that the mortgage note came within the UCC definition of negotiable instrument,[32] the court then considered who is entitled to enforce a negotiable instrument but held that no such person was a party in *Kemp*.[33]

This analysis illustrates how courts may reach results that undercut arguments that REMICs were the owners of the mortgage notes and mortgages for tax purposes. But even if the majority of states rule in favor of 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, REMICs hold notes and mortgages from multiple jurisdictions. Most, if not all, REMICs own mortgages 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 notes that do not come within the definition of qualified mortgage under the REMIC regulations.

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[29] *See* In re Kemp, 440 B.R. 624 (Bkrtcy.D.N.J. 2010). A claim in bankruptcy is disallowed after an objection "to the extent that . . . such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured." *See id.* at 629 (citing 11 U.S.C. § 502(b)(1). This article cites to the UCC generally instead of specifically to the New Jersey UCC to illustrate the general applicability of the holding.

[30] *See id.* at 629–30.

[31] *See id.*

[32] *See id.* at 630.

[33] *See id.*

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.