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David Reiss
Brooklyn Law School, david.reiss@brooklaw.edu

Bradley T. Borden
Brooklyn Law School, bradley.borden@brooklaw.edu

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Bradley T. Borden
David Reiss

WALL STREET RULES

Bradley T. Borden & David Reiss*

> "They take aggressive positions, and they figure that if enough of them take an aggressive position, and there's billions of dollars at stake, then the IRS is kind of estopped from arguing with them because so much would blow up. And that is called *the Wall Street Rule*. That is literally the nickname for it."[1]

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 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. If these losses are realized, those professionals will face suits for damages so large that they could put them out of business. That is, unless the Wall Street Rule is applied.

The issue of REMIC failure for tax purposes is important in at least three contexts: (1) in any potential effort by the IRS to clean up this industry; (2) in civil lawsuits brought by REMIC investors against promoters, underwriters, and other parties who pooled mortgages and sold mortgage-backed securities; and (3) state and federal prosecutors and regulators who consider bringing criminal or civil claims against promoters, underwriters, and other parties who pooled mortgages and sold MBSs.

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* Brad and David are professors at Brooklyn Law School. This brief article is drawn from a forthcoming study by the authors.

[1] Lee Shepard, Bain Capital Tax Documents Draw Mixed Reaction, ALL THINGS CONSIDERED, (NPR Business broadcast Aug. 28, 2012) (discussing taxation of private equity management compensation), available at http://www.npr.org/player/v2/mediaPlayer.html?action=1&t=1&islist=false&id=160196045&m=160201502 (emphasis added).

A History of REMIC-able Growth

The first mortgage-backed securities ("MBS") were issued by entities related to the federal government, like Fannie Mae and Freddie Mac, in the early 1970s. These MBS paid out investors from their proportional share of ownership of a securitized pool of mortgages' cash flow. Starting in the late 1970s, private issuers such as commercial banks and mortgage companies began to issue residential mortgage-backed securities. These "private label" securities are issued without the governmental or quasi-governmental guaranty that a federally related issuer would give. Private label securitization gained momentum during the savings and loan crisis in the early 1980s, when Wall Street firms were able to expand market share at the expense of the beleaguered thrift sector.

Before 1986, 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 types of mortgage-backed securities. 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 mortgage-backed security. A REMIC is a pass-through entity for tax purposes, meaning that unlike corporations they do not pay income tax and their owners thereby avoid the double taxation they would face from receiving corporate dividends. A REMIC is intended to be a passive investment. Because of its passive nature, a REMIC is limited as to how and when it can acquire mortgage. In particular, a REMIC must in most cases acquire its mortgages within 90 days of its start-up.[2] 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 mortgage from one mortgage pool to another. 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 is the mortgagee under this Security Instrument."[3] MERS is not named on any note endorsement. This new system saved lenders a small but not insignificant amount of money 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 MERS registered millions of mortgages within a couple of years of being up and running.

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 practices became egregiously negligent.

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

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[2] 26 U.S.C. § 860G(a)(3), (9).
[3] *See, e.g.*, BROOK BOYD, REAL ESTATE FINANCING § 14.05[9] (2005).

behavior of mortgage securitizers during that period of time. Consider an arrangement that was typical of that period.

Kemp-temptable Practices

Kemp demonstrates that securitizers did not follow the rules applicable to REMICs when issuing mortgage-backed securities. We outline the facts here and discuss the consequences in the following sections.

On May 31, 2006, Countrywide Home Loans, Inc., lent $167,000 to John Kemp.[4] At that time, Mr. Kemp signed a note listing Countrywide Home Loans, Inc., as the lender; no indorsement appeared on the note. An unsigned allonge (a piece of paper attached to a negotiable note that allows for the memorialization of additional assignments if there is not sufficient room on the note itself to do so) of the same date accompanied the note and directed Mr. Kemp to "Pay to the Order of Countrywide Home Loans, Inc., d/b/a America's Wholesale Lender." On the same day, Mr. Kemp signed a mortgage in the amount of $167,000, which listed the lender as America's Wholesale Lender. The mortgage named MERS as the mortgagee and authorized it to act solely as nominee for the lender and the lender's successors and assigns. The mortgage referenced the note Mr. Kemp signed, and it was recorded in the local county clerk's office on July 13, 2006.

On June 28, 2006, Countrywide Home Loans, Inc., as seller, entered into a Pooling and Servicing Agreement (PSA) with CWABS, Inc., as depositor; Countrywide Home Loans Servicing LP as master servicer; and Bank of New York as trustee. The PSA provided that Countrywide Home Loans, Inc., sold, transferred, or assigned to the depositor "all the right, title and interest of [Countrywide Home Loans, Inc.] in and to the Initial Mortgage Loans, including

[4] *See* In re Kemp, 440 B.R. 624, 627 (Bkrtcy D.N.J. 2010).

all interest and principal received and receivable by" Countrywide Home Loans, Inc.. The PSA provided that the depositor would then transfer the Initial Mortgage Loans, which include Mr. Kemp's loan, to the trustee in exchange for certificates referred to as Asset-backed Certificates, Series 2006-8. The depositor apparently then sold the certificates to investors.

The PSA also provided that the depositor would deliver "the original Mortgage Note, endorsed by manual or facsimile signature in blank in the following form: 'Pay to the order of ________ without recourse', with all intervening endorsements from the originator to the Person endorsing the Mortgage Note." Although Mr. Kemp's note was supposed to be subject to the PSA, it was never endorsed in blank or delivered to the depositor or trustee as required by the PSA. At that time, no one recorded a transfer of the note or the mortgage with the county clerk.

On March 14, 2007, MERS assigned Mr. Kemp's mortgage to Bank of New York as trustee for the Certificate Holders CWABS, Inc. Asset-backed Certificates, Series 2006-8. The assignment purported to assign Mr. Kemp's mortgage "[t]ogether with the Bond, Note or other obligation described in the Mortgage, and the money due and to become due thereon, with interest." That assignment was recorded on March 24, 2008.

On May 9, 2008, Mr. Kemp filed voluntary bankruptcy. On June 11, 2008, Countrywide Home Loans, Inc., identifying itself as servicer for the Bank of New York, filed a secured proof of claim noting Mr. Kemp's property as collateral for the claim. In response, Mr. Kemp filed an adversary complaint on October 16, 2008, against Countrywide Home Loans, Inc., seeking to expunge its proof of claim.

At trial, Countrywide Home Loans, Inc., produced a new undated Allonge to Promissory Note, which directed Mr. Kemp to "Pay to the Order of Bank of New York, as Trustee for the Certificate-holders CWABS, Inc., Asset-backed Certificates, Series 6006-8." A supervisor and operational team leader for the apparent successor entity of Countrywide Home Loans Servicing LP testified that the new allonge was prepared in anticipation of the litigation and was signed weeks before the trial. That same person testified that the Mr. Kemp's original note never left the possession of Countrywide Home Loans, Inc., but instead, it went to its foreclosure unit. She also testified that the new allonge had not been attached to Mr. Kemp's note and that customarily, Countrywide Home Loans, Inc., maintained possession of the notes and related loan documents. In a later submission, Countrywide Home Loans, Inc., represented that it had the original note with the new allonge attached, but it provided no additional information regarding the chain of title of the note. It also produced a Lost Note Certificate dated February 1, 2007, providing that Mr. Kemp's original note had been "misplaced, lost or destroyed, and after a thorough and diligent search, no one has been able to locate the original Note."

The court therefore concluded that at the time of the filing of the proof of claim, Mr. Kemp's mortgage had been assigned to the Bank of New York, but Countrywide Home Loans, Inc., had not transferred possession of the associated note to the Bank of New York.

By failing to transfer possession of the note to the pool backing the securities, Countrywide failed to comply with the requirements necessary to obtain REMIC status. Numerous other filings and reports suggest that Countrywide's practice was typical of many major lenders during the early 2000s. Thus, although we rely on the facts in the Kemp case in this brief article, it has very broad application.

Sloppiness and REMICs Rules Don't Mix Well

Even though a minority of securitizers may have followed the terms contained in the applicable Pooling and Servicing Agreements, the very low tolerance for deviation in the REMIC rules suggests that compliance in a minority of situations would not prevent the IRS from finding that individual REMICs fail to comply with their strict requirements in an overwhelming number of cases. And the failure of a very small number of mortgages to comply with the rules would be sufficient to cause a putative REMIC to lose its preferred tax status.

Federal tax treatment of REMICs is important in two respects. First, it treats regular interests in REMICs as debt instruments.[5] Second, federal tax law specially classifies REMICs as something other than tax corporations, tax partnerships, or trust and generally exempts them from federal income taxation.[6] These two aspects of REMICs work hand in hand to provide REMICs favorable tax treatment. REMICs must compute taxable income, but because the regular interests are treated as debt instruments, REMICs deduct amounts that constitute interest payments to the holders of residual interests.[7] Without these rules, a REMIC could be a tax corporation and the regular interests could be equity interests. If that were the case, the REMIC would not be able to deduct payments made to the regular interest holders and would owe federal income tax on its taxable income. That is how the REMIC classification provides significant tax benefits.

To obtain REMIC classification, a trust must satisfy several requirements. Of particular interest is the requirement that within three months after the trusts startup date substantially all of its assets must be qualified mortgages.[8] The regulations provide that substantially all of the assets

[5] *See* IRC §§ 860B(a), 860C(b)(1)(A).
[6] *See* IRC § 860A(a).
[7] *See* IRC §§ 163(a), 860C(b)(1)(A).
[8] *See* IRC § 860D(a)(4).

of a trust are qualified mortgages if no more than a *de minimis* amount of the trust's assets are not qualified mortgages.[9] 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.[10] 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.[11] 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.[12] The trust must acquire the obligation by contribution on the startup date or by purchase within three months after the startup date.[13] 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).

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 PSAs, which required the originator to transfer the mortgage note and mortgage to the trust. Nonetheless, as with Kemp, reports and court documents indicate that originators and trusts frequently did not comply with the terms of the PSAs and the originator typically retained the mortgage notes and mortgages.

That failure appears to cause the trusts to fail both the definitional requirement and the timing requirement that are necessary to elect REMIC status. They fail the definition requirement

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[9] *See* Treas. Reg. § 1.860D-1(b)(3)(i).
[10] *See* Treas. Reg. § 1.860D-1(b)(3)(ii).
[11] *See* Treas. Reg. § 1.860D-1(b)(3)(ii).
[12] *See* IRC § 860G(a)(3)(A).
[13] *See* IRC § 860G(a)(3)(A)(i), (ii).

because they do not own obligations, and what they do 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. And even if the trusts acquired some obligations principally secured by interests in real property, many of their assets would not satisfy the REMIC requirements. 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.

<u>The Un-MERS-iful Stringency of the REMIC Regulations</u>

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.[14] 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.[15] 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.[16] As the Tax Court has stated, to "properly discern the true character of [a transaction], it is necessary to ascertain the intention of the parties as evidenced by the written agreements, read in light of the attending facts and circumstances."[17] If, however, the transaction does not coincide with the parties' bona fide intentions, courts will ignore the stated intentions.[18] Thus, the analysis of ownership cannot merely look to the agreements the parties entered into because the label parties give to a transaction does determine its character.[19] Consequently, the

[14] *See, e.g.*, Burnet v. Harmel, 287 U.S. 103, 110 (1932).
[15] *See* Bailey v. Comm'r, 912 F2d 44, 47 (2d Cir. 1990).
[16] Grodt & McKay Realty, Inc. v. Comm'r, 77 T.C. 1221, 1237 (1981).
[17] *See* Haggard v. Comm'r, 24 T.C. 1124, 1129 (1955), *aff'd* 241 F.2d 288 (9th Cir. 1956).
[18] *See* Union Planters National Bank of Memphis v. United States, 426 F.2d 115, 117 (6th Cir. 1970).
[19] *See* Helvering v. Lazarus & Co. 308 U.S. 252, 255 (1939).

analysis must examine the underlying economics and the attendant facts and circumstances to determine who owns the mortgage notes for tax purposes.[20]]

Courts in many states have considered the legal rights and obligations of REMICs with respect to mortgage notes and mortgages they claim to own. The range of issues state courts have considered with respect to REMIC mortgage notes and mortgages range from standing to foreclose,[21] entitlement to notice of bankruptcy proceeding against a mortgagor,[22] to ownership of a mortgage note under a state's commercial code.[23] As these cases indicate, at least with respect to the question of security interest, the 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 analysis of whether REMIC trust assets are secured by an interest in real property, but they probably do not affect the analysis of whether the REMIC trusts own obligations. This analysis turns on the ownership of the mortgage notes.

In re Kemp addressed the issue of enforceability of a note under the uniform commercial code (UCC) for bankruptcy purposes.[24] The court in that case held that a note was unenforceable

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[20] *See* Helvering v. F.&R. Lazarus & Co., 308 U.S. 252, 255 (1939).
[21] *See* Bain v. Metropolitan Mortgage Group, Inc. ____ (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); Ralph v. Met Life Home Loans, ____ (5th D. Idaho August 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); Fowler v. Recontrust Company, N.A., 2011 WL 839863 (D. Utah March 10, 2011) (holding that MERS is the beneficial owner under Utah law); Jackson v. Mortgage 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 to foreclose).
[22] *See* 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).
[23] *See* In re Kemp, 440 B.R. 624 (Bkrtcy.D.N.J. 2010).
[24] *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

against the maker of the note and the maker's property under New Jersey law on two grounds.[25] The court held that because the owner of the note, the Bank of New York, did not have possession and the lack of proper indorsement upon sale made the note unenforceable.[26] Recognizing that the mortgage note came within the UCC definition of negotiable instrument,[27] the court then considered who is a party entitled to enforce a negotiable instrument.[28]

Only the following three types persons are entitled to enforce a negotiable instrument: (1) "the holder of the instrument, [2] a nonholder in possession of the instrument who has the right of a holder, [3] or [3] a person not in possession of the instrument who is entitled to enforce the instrument pursuant to [UCC § 3-309 or 3-301(d)."[29] The court then explained why the Bank of New York did not come within the definition of a party entitled to enforce the negotiable instrument.

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 MBS that were structured to be – and promoted to investors as -- REMICs. Because rating agencies require that REMICs be geographically diversified in order to spread the risk of default 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 ensures

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U.S.C. § 502(b)(1). New Jersey adopted the UCC in ____. *See* ____. This article cites to the UCC generally instead of specifically to the New Jersey UCC to illustrate the general applicability of the holding.

[25] *See* In re Kemp at 629–30.

[26] *See* In re Kemp at 629–30.

[27] *See* In re Kemp at 630.

[28] *See* In re Kemp at 630.

[29] *See* Unif. Commercial Code § 3-301.

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.

IRS-ponsible Industry Regulation

Law firms issued opinions that MBS transactions would qualify as REMICs. They did so even though they knew or should have known that an insufficient percent of trust assets would satisfy the definition of qualified mortgage under the REMIC rules. Nonetheless, the IRS does not appear to be engaged in auditing REMICs. Its reasons for not challenging REMIC status at this time may be justified as they study the issue and observe the outcome of the numerous actions against REMICs and originators. Because REMICs did not file the correct returns and may have committed fraud, the statute of limitations for earlier years will remain open indefinitely, giving the IRS adequate time to pursue REMIC litigation after it obtains the information it needs. If the IRS's does not take action at the appropriate time, however, it will be a serious failure and will result in the loss of billions of dollars of tax revenue for the federal government.

More troubling still is the IRS's failure to address the wide-scale abuse and problems that existed during the years leading up to the financial meltdown. The IRS's failure to adequately police REMICs is one more reason that the mortgage industry was able to overly inflate the housing market. And that, inexorably, led to the crash and our tepid recovery from it.

More generally, by overlooking the serious defects in the transactions, courts and governmental agencies encourage the type of behavior that led to the financial crisis. Lawmakers, law enforcement agencies and the judiciary cede their governing functions to private industry if they allow players to disregard the law and stride to create law through their own practices. If we allow the Wall Street Rule to apply, then Wall Street rules. If the rule of law is respected, then Main Street can look forward to the equal protection of the law and returned prosperity without fear of bubbles inflating because powerful special interests can flout the law that applies to the rest of us.