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Dirt Lawyers and Dirty REMICs: A Debate

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DIRT LAWYERS AND DIRTY REMICS: A DEBATE

In mid-2013, Professors Bradley T. Borden and David J. Reiss published an article in the American Bar Association's *Probate & Property* journal (May/June 2013, at 13), about the disconnect between the securitization process and the mechanics of mortgage assignments. The Borden/Reiss article discussed potential legal and tax issues caused by sloppiness in mortgage assignments.

Joshua Stein responded to the Borden/Reiss article, arguing that the technicalities of mortgage assignments serve no real purpose and should be eliminated. That article appeared in the November/December 2013 issue of the same publication, at 6.

Stein's response was accompanied by a commentary from Professors Borden and Reiss, which also appeared in the November/December 2013 issue, at 8.

To follow the Borden/Reiss/Stein debate, click on the links in the left margin or on any paragraph in the summary above.

For more information on the three authors, including contact information, click on these links:

- Professor Bradley T. Borden
- Professor David J. Reiss
- Joshua Stein

For more information on ABA's *Probate & Property* Journal, click here.

Dirt Lawyers and Dirty REMICs

The day-to-day practice of real estate law typically 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 when structuring mortgaged-backed securities, securitization professionals did not account for the day-to-day practices of lawyers as they relate to the transfer and assignment of mortgage notes and mortgages. This disregard may result in severe consequences for investors, underwriters, and securitization professionals.

Of equal gravity is the responsibility to help shape policy that this state of affairs imposes on "dirt," or real estate, lawyers, as members of society with specialized knowledge. 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 law should play in the business of real estate finance. In particular, they should make clear, first, how formalistic legal rules protect the parties to a real estate finance transaction and, second, that these rules should be treated with appropriate deference. That formality can protect the borrower from paying the debt more than once or to the wrong party. It also can 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. Lenders much prefer negotiable notes to nonnegotiable ones, so lenders are incentivized to properly negotiate them. Trusts are bulk purchasers of negotiable instruments, which put the "security" in a mortgage-backed security (MBS). These trusts are best protected if they are holders in due course of the negotiable instruments and thus are incentivized to ensure that the notes were properly negotiated. The rules of negotiability are quite clear and designed 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 carried out 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 (the borrower) would have had against the original lender. These personal defenses include lack of consideration, nonperformance, actual payment of the debt, and fraud in the inducement. See UCC § 3-302. Another consequence of the sale of a note 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 the requirements necessary to obtain favorable tax treatment as a Real Estate Mortgage Investment Conduit (REMIC).

By Bradley T. Borden and David J. Reiss

Tim Bower

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Before 1986, mortgage-backed securities had various tax-related inefficiencies.

This article builds on earlier discussions of these issues by the authors. See Bradley T. Borden & David J. Reiss, *Wall Street Rules Applied to REMIC Classification*, Thomson Reuters News & Insight (Sept. 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, *Once a Failed REMIC, Never a REMIC*, 30 Cayman Fin. Rev. 65 (1st Quarter 2013), available at http://ssrn.com/abstract=2185420.

Modern Residential Real Estate Finance

Before 1986, MBSs had various tax-related inefficiencies. Most importantly, these securities were taxable at the entity level, so investors faced double taxation. Wall Street firms successfully lobbied Congress to eliminate double taxation in 1986. This legislation created the REMIC, which is not taxed at the entity level. This one change automatically boosted REMIC yields over other forms of MBSs that would still be taxed. Unsurprisingly, REMICs larglely displaced these other types of MBSs 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 multiple-tranche MBSs. A REMIC is intended to be a passive investment in a static pool of mortgages. Because of its passive nature, a REMIC is limited on how and when it can acquire mortgages. In most cases, a REMIC must acquire its mortgages within three months of its start-up. IRC § 860G(a)(3)(ii), (9). The IRC contains 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 Mae, Freddie Mac, 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. The legal status of this private recording system was not clear, and it 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 had 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 complied with all of the terms contained in the applicable Pooling and Servicing Agreements that govern REMIC MBSs, the very low tolerance for deviation in the REMIC rules suggests that even a small degree of noncompliance could result in a finding that individual REMICs have violated the strict requirements of the IRC. 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 this 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 www.huffingtonpost.com/bradley-t-borden/did-the-irs-cause-the-fin_b_1972207.html.

To obtain the REMIC classification, a trust must satisfy several requirements. Of particular interest is the requirement that within three months after the trust's start-up 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 start-up date) and a 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 can cause a trust to fail both the timing requirement and the definitional requirement that are necessary to qualify for REMIC status. The trust fails the timing requirement because it does not acquire the requisite interests within the three-month prescribed time frame. It fails the definition requirement because it does not legally own the proper obligations, and what the trust does legally own does not appear to be secured by interests in real property.

Wall Street Rules or Legal Rules?

Although Wall Street treated the REMIC rules with disregard, they are actually pretty straightforward in broad outline. Federal tax law does not rely on 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 also can disregard the transfer (or lack of transfer) of formal title when the transferor retains many of the benefits and burdens of ownership. See *Bailey v. Commissioner*, 912 F.2d 44, 47 (2d Cir. 1990).

Courts focus on whether the benefits and burdens of ownership pass from one party to another when considering who the owner of property is for tax purposes. *Grodt & McKay Realty, Inc. v. Commissioner*, 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. F. & R. 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. Thus, even if a trust owns a mortgage under Article 9 of the UCC, it would not appear to be the tax owner.

Courts in many states have considered the legal rights and obligations of REMICs with respect to mortgage notes and mortgages that the REMICs 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 for the 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 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 behavior of mortgage securitizers during that period of time. The court in *In re Kemp*, 440 B.R. 624 (Bankr. D.N.J. 2010), documents in painful detail how Countrywide failed to transfer possession of a note to the pool backing a MBS, and thus failed to comply with the requirements necessary for that mortgage to comply with the REMIC rules. 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 inadvertently 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. 1, 2012). A suit filed on behalf of Freddie Mac and Fannie Mae also alleges that the practices of loan originators have negative implications for the REMICs' tax-advantaged status. See Complaint, *Federal Hous. Fin. Agency v. JPMorgan Chase & Co.*, No. 11 Civ. 6188 (DLC), 2012 WL 5395646 (S.D.N.Y. Sept. 2, 2011).

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. For reports on such litigation, see Bradley T. Borden & David J. Reiss, REFinBlog (Feb. 26, 2013, 5:00 p.m.), http://refinblog.com. 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

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UCC for bankruptcy purposes. See 440 B.R. at 626. 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 on 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 in the opinion documents are shocking, 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 only after the filing of the proof of claim; and
- 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 flaws in the opinion documents are shocking, even after the revelations regarding industry practices that have come to light since the subprime bust.

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

As the *Kemp* court notes:

> From 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. 1988)). 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 did not address the third type of consequence (for the trustee) because it was not an issue before the court. Nonetheless, the analysis in *Kemp* illustrates how courts can 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 with negative consequences can destroy the REMIC classification of many mortgage-backed securities that were structured to be—and promoted to investors as—REMICs. This is because rating agencies require that REMICs be geographically diversified to spread the risk of defaults caused by local economic conditions. Most, if not all, REMICs own mortgage notes and mortgages from states governed by laws that the courts may 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 a 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 truly a REMIC.

Conclusion

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

Looking back to the housing boom in the early 2000s, at the time some said that things could not keep going on like this. They were right, and the United States is 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. ■

Dirt Lawyers versus Wall Street: A Different View

In the securitization boom that preceded the financial crisis, people became sloppy about the technical details of transferring residential mortgages from the originator to intermediaries and ultimately to real estate mortgage investment conduit (REMIC) entities for securitization. Bradley T. Borden and David J. Reiss described the magnitude of the mess, and its possible legal, tax, and practical consequences, in the cover article of the May/June 2013 issue of this publication.

Notes were not properly endorsed. Lenders lost them. Assignments were never recorded, or were recorded in the wrong order or with gaps. Transfers that should have been made weren't. Notes followed one path of transfers, mortgages another. When the music stopped, enforcement became a problem because servicers couldn't figure out the paper trail. To fill gaps, those in the back room sometimes undertook a goal-oriented creative writing program.

Because of all that sloppiness, transferees of loans sometimes flunked the basic tests to become holders in due course. Borrowers faced the theoretical risk of having to pay their loans twice. REMICs maybe failed to qualify under the tax law, exposing their investors to tax disasters.

One might add that, as a result of all this, mortgage borrowers in default have had a field day delaying or even derailing foreclosures by claiming that the plaintiff lacked standing because it couldn't prove ownership of the note and mortgage. And when loan servicers tried to clean up the files, borrowers cried fraud and robo-signing, while remaining in default.

Next time around, Borden and Reiss argue, we should do it right. Legal technicalities and niceties do matter. When we move mortgages, we should get the notes properly endorsed, the right assignments signed, and everything recorded both promptly and correctly.

Yes, the securitization boom left behind a mess. Yes, messes are bad. But there's more to the discussion. The post-securitization residential foreclosure mess should prompt larger questions about how we evidence, document, and transfer ownership of mortgage loans.

Does our system make any sense at all? Do the technical requirements that Borden and Reiss describe—now creating so much trouble for foreclosures—still serve any purpose in the 21st century? They certainly create tremendous paperwork, complexity, and legal issues, most of which seem entirely spurious and unnecessary.

They also create tremendous opportunities for error. As Borden and Reiss show, the mortgage origination and securitization industries seem to have fully seized all those opportunities. But do those troublesome technical requirements give anyone any protection that matters?

Yes, it's certainly nice for a mortgage holder to be a holder in due course. But how often does holder-in-due-course status matter for today's institutional residential mortgages? How often does the purchaser of such a loan actually benefit by taking free of defenses based on fraud or previous payment? How often has a loan purchaser been able to enforce against the borrower a previously repaid loan just because the purchaser was a holder in due course?

Today's residential mortgages are so wrapped up with consumer protections that any holder of the loan would have trouble enforcing a mortgage loan that was truly subject to, for example, fraud in the inducement. As a practical matter, in the world of residential mortgages all defenses probably travel with the loan, so holder-in-due-course status has no real significance to a mortgage purchaser. It matters for checks and commercial transactions, but not for residential mortgages.

Borden and Reiss point out that traditional requirements for endorsement and delivery of the original promissory note also protect the borrower from the risk of having to pay the loan twice. While that risk may exist in theory, if the borrower had in fact paid the loan, that would typically provide a complete defense against foreclosure.

Any discussion that treats promissory notes as a measure to mitigate the risk of double payment relies on the fantasy that when the borrower repays the loan, he will demand that the lender prove possession of the note and the right string of endorsements.

If any residential borrower actually asked to see the note at the time of payoff, the servicer's first response would consist of confusion and laughter. When his laughter died down, the servicer would explain that the note was lost years ago. Or perhaps the servicer might advise the borrower to speak to someone else in some other department that never answers the phone. The borrower would eventually give up.

Practically speaking, in today's world, the main function of any original promissory note consists of getting lost.

If any mortgage borrower anywhere in the United States had ever actually needed to pay their mortgage loan a second time to keep their house, we would all have heard about it; even one instance would have prompted a tremendous outcry. But has anyone ever heard of that actually happening?

Even if requirements for presentation of the note could prevent the risk of double payment, they wouldn't achieve that goal, for two reasons. First, as mentioned, many notes get lost. Second, residential lenders often require the borrower to sign multiple original notes. In other words, the requirement for a mortgage holder to show possession of the note doesn't actually give the borrower much protection.

Outside of real estate, many loans no longer require promissory notes, nor are they burdened by the technical requirements of the recording system or of negotiable instruments. No one cares about original notes, or holder in due course. Borrowers in those transactions have not faced an epidemic of double payment claims. Purchasers of these loans, or interests in them, haven't suffered great losses for lack of an original piece of paper or holder-in-due-course status.

Unlike mortgage assignments, corporate stock and other financial instruments are transferred electronically with little to no documentation. The transfer system itself keeps track of everything. If corporate stock transfers followed the mortgage model, every corporation would have its own detailed set of rules, requirements, fees, filings, and forms for stock transfer documentation. Every transfer of a single share of stock would require dealing with multiple pieces of paper with numerous signatures and could take weeks, with endless opportunities for problems and mistakes. Transferring 100 shares would require 100 sets of fully compliant documentation. But none of that happens, because the corporate stock transfer system is simple, functional, reliable, and largely electronic.

The 21st century is a great time to revisit the legal principles and practices that drive the complexity and paperwork that led to the mistakes described by Borden and Reiss.

We could start by eliminating promissory notes in mortgage transactions. Instead, we could document real estate loans as contractual promises in which possession of an original piece of paper has no particular significance. A promissory note is not essential to evidencing an obligation to pay, secured or not. Ownership of a loan could be presumptively determined based on an institution's books and records, and a history of loan payments.

We might even go a few steps further and establish a central registrar to keep track of who owns mortgage loans and who has the right to foreclose. Transfers could be confirmed electronically, with no paperwork at all. A registrar's certificate would evidence the right to foreclose.

The Mortgage Electronic Registration System (MERS) seemed like a great move in that direction. MERS contemplated that a lender would record its mortgage once, in favor of MERS, then any future mortgage assignments could take place electronically, without the paperwork, pitfalls, delays, and variations—and now legal issues—entailed by generating and filing documents with thousands of recording systems across the United States.

But the same antiquated legal notions that created so much trouble for mortgage assignments have also created trouble for MERS. County clerks anxious to protect revenue, employment, and the importance of their offices joined forces with the foreclosure defense bar to try to derail the MERS train. Judges seized the opportunity MERS gave them to help defaulting borrowers stay in their homes, and to create new law—and to achieve good consumer protection headlines—in an area that suddenly assumed great public importance. The result: a MERS mess with conflicting decisions from coast to coast, and many more months of borrower defaults with impunity.

That doesn't mean MERS was a bad idea. Our leaders should figure out how real estate law can accommodate and support MERS and move into the 21st century. The idea of a single central registry for mortgage transfers makes sense. It would make even more sense to expand that central registry to cover all property-related transfers, replacing a system that often seems as outdated as quill pens and parchment.

Any proposal to blow up and recreate our system of land records and mortgage loan assignments will face a predictable set of objections. Jobs will be lost, though other jobs created. Tax collectors might have trouble collecting taxes. The transition process won't go perfectly. After the transition, real estate lawyers and paralegals will have less work to do. Will the system adequately protect and preserve online data? Will it invade privacy? And, of course, it might create new opportunities for fraud.

A better system for mortgage assignments would also speed foreclosures. Would that be so bad? If a borrower can no longer afford his house and the market won't let him sell for more than the mortgage balance, then he doesn't really own the house anyway. The mortgage holder does, for all practical purposes. Every month the borrower has the option to keep the house by making that month's payment. If he can't make those payments, or chooses not to, that's unfortunate, but he still doesn't have any equity in the house. He should find a new place to live, just as millions of other Americans do each year.

Foreclosures are part of any mortgage finance system, one possible outcome when someone borrows money and grants security. If we can't stomach residential foreclosures, maybe the federal government should just buy everyone a house.

Commercial real estate is, of course, a different story. It is less fungible than houses. The roles of borrower and lender are more complex, nuanced, and interrelated. The identity of the borrower matters. And commercial foreclosures do not seem to have experienced the same problems as residential foreclosures.

Aside from speeding up residential foreclosures, any attempt to fix loan transfers will also raise well-founded concerns that trying to change anything will just make it worse. But if we take a gradual and careful approach—perhaps moving state by state—to bringing our real estate documentation and security systems into the 21st century, then over time it should be possible to overcome these and other objections. The United States did something like that, though not as dramatic, when Revised Article 9 became effective in 2001. Nothing too disastrous happened.

Some would argue that today's system protects mortgage borrowers by making it hard for mortgage lenders to spuriously enforce a mortgage loan that they don't own or perhaps that isn't even in default. Today's system may do that. Aggressively applied by the courts, it puts mortgage lenders to the test and forces them to prove they own the loan they want to foreclose. When paperwork deficiencies prevent the lender from proving standing, the lender gets thrown out of court.

In these cases, however, the borrower is still in default. And, realistically, lenders don't often try to foreclose on loans they don't own or that aren't in default.

When the court throws lenders out of court because of issues of standing, the defaulting borrower gets to keep her house, at least until the right paperwork gets lined up and submitted. In that time, as long as four years for a residential foreclosure proceeding in New York, the borrower typically doesn't pay debt service, insurance, or real estate taxes. Once in a while the defaulting borrower gets really lucky: the paperwork is so bad that no one actually has the right to foreclose.

All of this produces extraordinarily long, complex residential mortgage foreclosures, destabilizing neighborhoods and preventing property values from recovering. When it isn't clear who owns a property and no one has an incentive to maintain it, and nothing about the foreclosure gets resolved quickly, the mortgage collateral inevitably festers and deteriorates. Today's clumsy system for documenting mortgage loan transfers puts properties into legal limbo for years as a result of paperwork requirements that might be quaint and funny if they didn't create so much trouble.

Let's assume, though, that a genuine risk exists that a mortgage lender might in fact try to foreclose a loan it doesn't own against a borrower who isn't in default. To address that risk, one could say that if a mortgage borrower ever lost his house under any such circumstances, he should be entitled to recover treble (or more) damages, plus attorney's fees, from the originator of his mortgage or whoever wrongfully took his house. The borrower would have the same right if she were forced to pay the same loan twice. Some state laws may already give borrowers rights like these; there, no change in law would be necessary at all.

With suitable safeguards, a streamlined system to track mortgage assignments would give borrowers ample protection.

In a separate discussion, Borden and Reiss also argue that technical glitches in transfers of mortgages may have caused many REMICs to fail the various technical tests established under the Internal Revenue Code. The solution to that problem, if it really is one, would be much easier to adopt than other measures suggested earlier in this article.

Solving the REMIC problem would require nothing more than a technical amendment to the Internal Revenue Code, which is, after all, entirely capable of being amended. The Code should say that as long as a REMIC directly or indirectly holds the risks and benefits of a mortgage loan, and cleans up any technical imperfections in its ownership within a reasonable time after learning of them, that should be just as good as if the REMIC actually owned the loan.

The apparent lack of publicized REMIC disqualifications to date may tell us that the IRS applies the REMIC requirements with the practicality and flexibility suggested in the previous paragraph. If that's true, then perhaps nothing need be done.

The problems Borden and Reiss describe do definitely cry out for action—but not necessarily the action they suggest. Instead of exalting the technicalities of the current system, we should get rid of them. We should massively simplify loan transfers and revise the law as necessary to do that.

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Dirty REMICs, Revisited

Before setting pen to paper to draft our response to Joshua Stein's "Different View," we had to look down to see whether the shoe was on the other foot. A preeminent real estate lawyer was criticizing two law professors for advocating for strict construction of documents and statutes and for thinking too small. And that practitioner was also advocating for a revolution in real estate finance, for sweeping away borrower protections that had been developed over a millennia under our common law system, and for replacing the status quo with an efficient system designed by the financial industry, along the lines of the Mortgage Electronic Recording System (MERS). We expect to find that kind of thinking in law review articles!

Because our different approaches so clearly demonstrate the opposing views in the debate over the future of residential real estate finance, we will first review those differences and then highlight where they converge. In the end, we hope that real estate lawyers of all stripes can come together with an approach to residential real estate finance that is efficient and also provides reasonable protections for homeowners.

Those Troublesome Technical Requirements!

Stein asks whether "those troublesome technical requirements give anyone any protection that matters." Before going to the substance of the question, we would first ask, would Mr. Stein waive a strict notice requirement contained in a commercial lease if doing so would harm his client? If not (and we are pretty sure it is "not"), why would a different rule apply with homeowners? Certainly residential lenders don't routinely waive "troublesome" requirements such as the one that requires monthly payments to be made by a certain date in order to avoid a late penalty.

As to the substance of Mr. Stein's inquiry, we would answer—yes, technical requirements matter. As just one example, only certain parties can foreclose on a mortgage. Technical state law requirements ensure that the plaintiff is one of those parties and protect borrowers from defending actions by parties without standing to foreclose. Again, I am confident that Mr. Stein would insist on such a technical requirement if it were his commercial client who was faced with a foreclosure. What is good for the commercial goose is good for the residential gander as far as we can tell.

Another example: Stein's dismissal of the relevance of the holder-in-due-course status in residential mortgage finance ignores the key role it played in the debate over state anti-predatory lending legislation throughout the boom years in the early 2000s. See generally David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 Fla. St. U. L. Rev. 985 (2006).

And another: Stein argues that payment would "typically provide a complete defense against foreclosure" in the case of a second foreclosure brought by the true owner of the debt. That misstates the real issue. The real issue is whether a borrower would have to defend an action to collect the debt brought by a true owner after another party brought a successful foreclosure action. The clear answer is yes; they would need to pay for the defense of such a suit. And, in Arizona at least, they might be liable for that debt to the true owner under certain circumstances! See William K. Akina, David J. Reiss & Bradley T. Borden, *Show Me the Note!*, Westlaw J. Bank & Lender Liability 3 (June 3, 2013) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2274977 and http://works.bepress.com/david_reiss/63).

And a last one: Stein argues that we are mistaken in calling for the IRS to enforce the REMIC rules as they are written so that the Treasury can collect revenue properly due to it by noncompliant purported REMICs. The general tax enforcement policy is that if you do not comply with the strict requirements for avoiding taxation, you will pay tax on the transaction. We do not understand why Stein would have a special rule for REMICs. It makes us wonder whether he believes that commercial real estate transactions should be generally exempt from strict compliance with the Internal Revenue Code. For instance, the period for identifying properties for like kind exchanges under IRC § 1031 could be a few months instead of 45 days after the transfer of the relinquished property, and the exchange could happen 180 days, give or take, after that transfer. That would be very efficient for investors, too!

Law Professors Thinkin' Small

Stein argues that we should sweep away a lot of the technical requirements relating to mortgages and adds that we might even go a few steps further and establish a central registrar to keep track of who owns mortgage loans and who has the right to foreclose. As Stein acknowledges, this is a lot like the Mortgage Electronic Registration System (MERS). But Stein does not acknowledge any of the controversy surrounding MERS, which was created by private interests such as Fannie, Freddie, and the Mortgage Bankers Association. They did not believe that they needed the approval of federal, state, or local governments, or anyone else for that matter, to dramatically change the recording system for mortgages. Things appeared to go swimmingly for a few years, but the shortcuts MERS took wrought a toll on it. Stein's takeaway: do it again.

Our takeaway: if we do it again, let's remember that process matters. Consult with all of the stakeholders, including those representing borrowers' interests. Promote efficiency, but respect the body of law that has developed around mortgages. Accept that consumer protection is not only the right thing to promote but that consumer protection also promotes responsible lending.

The Future of Residential Real Estate Finance

We have poked fun at Mr. Stein a bit for the double standard we believe he has for residential and commercial real estate finance transactions. But we are grateful that he has taken our argument seriously and agree with him that the stakes are high for borrowers and for the real estate finance industry. We agree that structural reform that would seek to modernize the system of residential real estate finance is called for. But until that reform is in place, we will continue to advocate for the enforcement of procedural protections and for strong tax enforcement.

We would also emphasize that a thoughtful process for adopting proposed reforms is not only important to ensure that all stakeholders are represented but also to ensure the long-term legitimacy of the new system. And we cannot emphasize enough how important we believe consumer protection is to a well-functioning residential real estate finance system. A thousand years of precedents in law and equity back us up on that.

Bradley T. Borden
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2013 RPTE Law Student Writing Contest Winners

Congratulations to the 2013 Law Student Writing Contest winners:

First place—Jessica Beess und Chrostin of Harvard Law School: "Mandatory Arbitration Clauses in Donative Instruments: A Taxonomy of Disputes and Type-Differentiated Analysis."

Second place—Rebecca Gross of Georgetown University Law School: "Intestate Intent: Presumed Will Theory, Duty Theory, and the Flaw of Relying on Average Decedent Intent."

Third place—Kyle Belz of Stetson University College of Law: "No Covenant for Old Men: Restrictive Covenants' Impact on Aging in Place."

The goal of the RPTE student writing contest is to encourage and reward law student writing on the subjects of real property or trust and estate law. The essay contest is designed to attract students to these law specialties and to encourage scholarship and interest in these areas. Articles submitted for judging are encouraged to be on timely topics and have not been previously published.

Jessica Beess und Chrostin, the first place winner, will receive $2,500 cash, a one-year free membership in the Section, and free round-trip airfare and weekend accommodations to attend the Section's Fall Leadership Meeting, November 7–9, 2013, in New Orleans (valued at approximately $1,000). In addition, Jessica's essay will be considered for publication in a future issue of the *Real Property, Trust and Estate Law Journal*. Rebecca Gross, the second place winner, will receive $1,500 cash, and Kyle Belz, the third place winner, will receive $1,000 cash.