REMIC Tax Enforcement as Financial-Market Regulator

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Lawmakers, prosecutors, homeowners, policymakers, investors, news media, scholars and other commentators have examined, litigated, and reported on the role that residential mortgage-backed securities (RMBS) played in the 2008 financial crisis. Big banks create RMBS by pooling mortgage notes into trusts and selling interests in those trusts. Absent from prior work related to RMBS securitization is the tax treatment of RMBS mortgage-note pools and the critical role tax enforcement should play in ensuring the integrity of mortgage-note securitization.

This article examines federal tax aspects of RMBS mortgage-note pools formed in the years leading up to the financial crisis. Tax law provides favorable tax treatment to real estate mortgage investment conduits (REMICs), a type of RMBS pool. To qualify for the favorable REMIC tax treatment, an RMBS pool must meet several requirements relating to the ownership and quality of mortgage notes. The practices of loan originators and RMBS organizers in the years leading up to the financial crisis have jeopardized the tax classification of a significant portion of the RMBS pools. Nonetheless, the IRS appears to believe that there is no legal or policy basis for challenging REMIC classification of even the worst RMBS pools. This article takes issue with the IRS’s inaction and presents both the legal and policy grounds for enforcing tax law by challenging the REMIC classification of at least the worst types of RMBS pools. The article urges the IRS to take action, recognizing that its failure to police these arrangements prior to the financial crisis is partly to blame for the economic meltdown in 2008. The IRS’s continued failure to police RMBS arrangements provides latitude to industry participants to facilitate future economic catastrophes. Even where the IRS does not take action, private parties can rely upon the blueprint set forth in the article to

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bring qui tam or whistleblower claims to accomplish the purposes of the REMIC rules and obtain the beneficial results that would occur if the IRS enforced the REMIC rules.

INTRODUCTION

When real estate mortgage investment conduits (REMICs) operate in the Congressionally-sanctioned manner, they drive capital to residential real estate markets and help provide liquidity to all classes of homeowners. That capital makes homeownership a reality for people who may not otherwise be able to purchase a home. It also fuels economic growth. Unfortunately, in the years leading up to the 2008 financial crisis, REMIC sponsors disregarded Congressional mandates, labeling unqualified
arrangements as “REMICs.” REMIC organizers (including loan originators, underwriters, and sponsors) knowingly originated and pooled problematic mortgage notes to form residential-mortgage backed securities (RMBS). RMBS pools thus included mortgage notes signed by uninformed and unqualified borrowers with insufficient collateral to ensure repayment. Having established these purported REMICs, the organizers then misrepresented their quality to investors.

REMIC organizers’ practices were an integral part of the financial debacle that brought the multi-trillion dollar real estate finance industry to its knees. In fact, the practices literally brought the U.S. Treasury to its knees as Secretary Hank Paulson pled with House Speaker Nancy Pelosi to keep her party on board with the 2008 federal government bailout designed to address the financial crisis. REMIC organizers’ practices also crippled the world economy. If the IRS had enforced the REMIC rules, it would have deterred the unsavory practices of REMIC organizers, which most likely would have helped prevent or at least reduce the magnitude of the financial crisis. Now the IRS must take action and collect the revenues to which the government is legally entitled.

REMICs are the result of mortgage securitization—the process of pooling illiquid assets, such as mortgage notes, into an RMBS pool (often structured as a state-law trust) and selling securities in the pool to investors. The securitization process requires several steps. Loan originators such as local banks lend money in exchange for mortgage notes and mortgages. They then sell the mortgage notes and mortgages to an RMBS sponsor. The RMBS sponsor gathers hundreds of mortgage notes and mortgages from loan originators and transfers them to an RMBS trust in exchange for interests in the trust. The sponsor then sells the RMBS to investors. If an RMBS trust satisfies several requirements, it will qualify as a REMIC and receive favorable tax treatment.

Congress designed the REMIC requirements to ensure that only high-quality mortgage notes enter RMBS pools that seek REMIC classification. By failing to securitize only high-quality mortgage notes in REMICs, RMBS sponsors violated tax law on a wide scale. The IRS would have uncovered such violations if it had audited REMICs. Early detection of violations through tax enforcement would have deterred much of the behavior that is responsible for the financial crisis. The IRS’s failure

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2. See infra Part II (explaining the requirements under the I.R.C. to become an REMIC).
to audit REMICs and enforce the REMIC rules thus allowed practices to deteriorate and helped to cause the financial crisis. The IRS should now take action by challenging the classification of at least certain types of REMICs. Such actions would add to government revenues, put mortgage securitizers on notice that they must comply with congressional mandates, reestablish the IRS’s role as an impartial enforcer of federal tax statutes, and guide the tax bar as it advises financial institutions about the requirements for REMICs.

The significant amount of litigation that followed the RMBS collapse has exposed a number of unsavory lending and securitization practices that led to the financial crisis. In these legal battles, banks and RMBS sponsors have found themselves in the crosshairs of not only RMBS investors and government agencies but also homeowners. Homeowners and borrowers fight foreclosure and bankruptcy claims in downstream litigation; RMBS investors and prosecutors sue RMBS sponsors in upstream litigation. In downstream litigation, homeowners challenge claims of parties who attempt to foreclose on property or bring a claim in bankruptcy. The results of downstream RMBS litigation are mixed both from a legal and contextual perspective. In some jurisdictions, courts rule in favor of homeowners and estop purported mortgage holders from foreclosing on property or participating in bankruptcy proceedings. In other jurisdictions, courts allow purported mortgage holders to proceed with foreclosures or participate in bankruptcy proceedings. States have also filed lawsuits against lenders and other financial institutions in the mortgage industry claiming unfair and otherwise inappropriate lending and foreclosure practices. The results of some of these actions appear in headlines reporting settlements between states and financial institutions.


5. See id. (reviewing the current landscape in upstream and downstream litigation).

6. See id. (recognizing the different treatment of litigation in jurisdictions).

that total many billions of dollars.\textsuperscript{8}

In upstream RMBS litigation, RMBS investors sue for various types of wrongdoing on the part of financial institutions. Investors claim that financial institutions did not properly disclose their liability exposure, that mortgage securitizations did not proceed as represented in offering materials and required by pooling and servicing agreements (PSAs), and that RMBS sponsors misrepresented facts about the ownership and quality of pooled mortgages.\textsuperscript{9} Much of the upstream litigation is in its early stages but involves astronomical sums of money. Figure 1 summarizes the litigation landscape in this area.

The financial crisis has been written about from many angles, but this article is the first to approach it from the perspective of tax policy. It illustrates that law and policy do not support REMIC classification of numerous RMBS pools. The article suggests that had the IRS enforced statutory requirements for REMICs, it could have helped prevent the financial crisis. After analyzing multiple questions of first impression that the courts will face in resolving RMBS litigation, this article concludes that even today the IRS could and should take action against REMICs that clearly violate the REMIC rules.


\textsuperscript{9} See infra Part I.D (citing examples of upstream litigation regarding the misrepresentations made by RMBS sponsors).
Part I of the article recounts the history of the RMBS industry and the role of REMIC classification in that industry. The discussion reveals that policymakers and commentators support mortgage-note securitization because it provides greater liquidity to residential mortgage lenders, reduces the cost of borrowing, and makes homeownership available to a broader cross-section of the population. Congress enacted the REMIC rules to facilitate mortgage securitization by providing tax-favored treatment to RMBS structures that satisfied several requirements. That favorable treatment was tailored to RMBS structures and securitization processes that were common at the time. Following the enactment of the REMIC rules, however, lending and securitization practices began to change. Leading up to the financial crisis, those practices ceased to satisfy the applicable requirements.

Part II provides the legal basis for challenging the REMIC classification of many RMBS arrangements. Comparing the rules of REMIC classification to actual securitization practices in the years leading up to the financial crisis reveals that many RMBS arrangements that held themselves out as REMICs could not satisfy the REMIC requirements. This analysis discredits claims of commentators and government officials who argue that there are no good legal or policy reasons for challenging the tax classification of purported REMICs.10

Part III presents the policy reasons for challenging REMIC classification. Congress enacted the REMIC rules to apply to a very specific type of mortgage-note pool. The requirements are grounded in sound tax policy and the IRS should be duty-bound to enforce the rules. Granting favorable tax treatment to RMBS arrangements that fail to adhere to those rules undermines Congressional intent and the sound policy that supports the rules. Failure to enforce the rules has allowed parties to siphon significant tax revenue from government coffers. The failure to audit purported REMICs has also empowered REMIC organizers to engage in practices that led to the financial crisis. Continued failure to act in this area will provide continued opportunities for such practices. IRS inaction also justifies the tax bar’s poor work in this area, making the call to action all the more urgent. The IRS has an obligation to act to thwart the type of behavior that brought the world economy to its knees.

I. OVERVIEW OF RMBS INDUSTRY AND ROLE OF REMICS

For generations, Americans who wanted to buy a home would typically contact a local thrift institution, like a savings and loan or bank, and speak to a loan officer who would evaluate their applications. Under those conditions, reserve requirements and balance sheet restrictions limited the amount of money institutions could lend. The system stifled growth by limiting the amount of cash available to lend to potential homeowners. Limited amounts of cash drove up interest rates, making homeownership available only to people with prime financial profiles. Thus, traditional financing practice needed innovation to make homeownership possible for a larger segment of society. The solution appeared to lie with Wall Street.

A. Origins of the RMBS Market

Wall Street investors historically viewed home loans as riskier investments than other assets because mortgages are regulated by a patchwork of local and state laws and are tied to local economies. A local recession or natural disaster could increase defaults and decrease the value of a portfolio of geographically concentrated mortgages. These conditions kept Wall Street investors out of the residential mortgage market. To help create more liquidity for lenders and homebuyers, the federal government began considering mortgage securitization as a possible source of greater liquidity in the late 1960s. Securitizations were carefully structured to achieve precise tax, accounting, and regulatory treatment to make them attractive to Wall Street investors. To help reduce risks associated with local economies, the pool of mortgages were drawn from diverse...
locations. Interests in these pools of mortgages were dubbed residential mortgage-backed securities (RMBS).

The most important factor in the development of the RMBS market was the creation of two government-sponsored enterprises (GSEs): Fannie Mae and Freddie Mac. Fannie Mae created a secondary market for certain loans prior to 1970, but the RMBS market began in earnest with the passage of the Emergency Home Finance Act of 1970 (EHFA), which allowed GSEs to purchase and securitize conforming mortgages. Fannie Mae and Freddie Mac set up standardized procedures for the creation and management of RMBS pools, and guaranteed the timely payment of principal and interest on the securities backed by the loans in the pool. GSEs only securitized conforming loans—those meeting strict standards related to the borrower’s creditworthiness and the value of the collateral.

Securitizations in the 1970s involved direct pass-through securities for which investors received a mortgage-note pool’s cash flow in proportion to their ownership of securities in the pool. Thus, a person who owned five percent of the pool’s securities would receive five percent of the cash flow from each mortgage and be taxed accordingly. In the late 1970s, “the primary condition” necessary for the explosion of RMBS securitization came about: “a funding shortfall.” That is, the strong desire for home ownership and the rapid escalation of housing prices created a demand for residential mortgages that the local lending institutions could not meet. Wall Street firms responded.

Starting sporadically in the late 1970s, issuers unrelated to the federal government, such as commercial banks and mortgage companies, began to issue RMBS. These “private label” securities did not have the governmental or quasi-governmental guarantee that a federally-related issuer such as a GSE would give, and they are typically backed by nonconforming loans. Private-label securitization gained momentum during the savings and loan crisis in the early 1980s. Wall Street firms identified “a unique opportunity to profit from the thrift crisis by proffering

17. Reiss, supra note 11, at 1004.
19. See id. at 1032 (outlining the standards that must be met to qualify as a conforming loan).
20. See JOHN FRANCIS HILSON & JEFFREY S. TURNER, ASSET-BASED LENDING: A PRACTICAL GUIDE TO SECURED FINANCING, § 2.6.2 (2000) (presenting different forms of funding practices used by vehicles to purchase or finance receivables, including pass-through funding).
the securitization exit strategy as the solution to the thrifts’ residential portfolio dilemma.”

Issuers of these private-label securities were less regulated and less consistent than Fannie Mae and Freddie Mac when it came to creating and managing their products. Nonetheless, private-label RMBS faced a serious impediment to their growth that arose from their tax treatment.

During the 1970s and early 1980s, the tax classification and treatment of the mortgage-note pools stymied the growth of the RMBS industry. RMBS sponsors could structure mortgage-note pools as investment trusts, which required the pools to remain constant and the investors to have interests in the underlying mortgages that were proportionate to their interests in the trust. Consequently, the trust generally could issue only one class or type of security. If the RMBS pool was an investment trust, the interest income from the loans would flow through to the investors without the trust incurring any tax liability. The proportionate ownership requirement, however, prohibited the RMBS pool from issuing different classes (or tranches) of interests without becoming a taxable entity. Thus, RMBS sponsors had to choose between a single-tranche flow-through mortgage pool and a multiple-tranche taxable mortgage-pool.

Leaving the tax drawbacks aside, the financial benefits of multiple-tranche mortgage-note pools are significant. A multiple-tranche mortgage-note pool creates RMBS interests with different risk profiles. For instance, the mortgage-note pool over-collateralizes the highest-rated tranche and pays the holders of that tranche first. If the trust has sufficient proceeds, it pays the holders of all of the tranches. If borrowers begin to default, however, the trust may not be able to fully pay the obligations of all the tranches. Thus, the lower-rated tranches are riskier and pay a higher interest rate. The ability to provide tranches with different risk profiles makes RMBS attractive to a broader swathe of investors and adds more capital to the residential mortgage market. And most importantly, if rating agencies rate the least risky tranches in a multiple-tranche pool as

22. Id.


24. Id.


“investment-grade,” those tranches can be eligible for purchase by a range of institutional investors.\(^\text{27}\)

As noted, the problem with the multiple-tranche RMBS structure in the 1970s and 1980s was that it would not qualify for flow-through taxation.\(^\text{28}\) Consequently, a multiple-tranche RMBS trust would have been treated as a taxable corporation and subject to tax on interest earned on loans;\(^\text{29}\) interests in such a trust might have been equity and not debt, so payments to holders might not have been deductible,\(^\text{30}\) and RMBS holders would have had to pay tax on payments that they received.\(^\text{31}\) Thus, the tax aspects of multiple-tranche RMBS structures made them unattractive to investors.

Congress was concerned about granting favorable tax treatment to multiple-tranche RMBS structures because the cash inflows and outflows and the interest income and deductions of such structures do not match.\(^\text{32}\) Because the risk profile and date to maturity of the tranches vary, the interest rate for the tranches varies, and the RMBS trust and RMBS investors recognize interest income at different times under the rules governing original issue discount.\(^\text{33}\) Even if the income of RMBS holders and the RMBS trust equalized over time, that durational difference could deprive the federal government of the time-value-of-money related to the delayed tax payments on the interest income of the junior tranche investors.\(^\text{34}\) Congress needed to solve this delay problem before it would grant flow-through treatment to multiple-tranche RMBS trusts.


\(^\text{28}\) 1986 Bluebook, supra note 26, at 407; see also Treas. Reg. § 301.7701-4(c)(1) (as amended in 1996) (stating that “[a]n ‘investment’ trust will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders. . . . An investment trust with multiple classes of ownership interests ordinarily will be classified as a [corporation].”).


\(^\text{30}\) See I.R.C. § 163(a) (2012) (allowing a deduction for interest payment, but no similar deduction exists for dividend payments).


\(^\text{33}\) See Van Brunt, supra note 32, at 211–18 (explaining why investors recognize interest income at different times).

\(^\text{34}\) See id. at 154–56, 184–85 (describing the timing difference).
Congress solved the problem with the REMIC rules by providing that REMICs must have only regular interests and residual interests.\textsuperscript{35} The regular interest holders had to recognize interest income under the accrual method, taking into account any original issue discount in their interests.\textsuperscript{36} The residual interest holders, on the other hand, had to recognize an amount of income (or loss) necessary to account for income not recognized by the regular interest holders, known as phantom income (or loss).\textsuperscript{37} The holders of residual interests generally recognized phantom income early in the life of the RMBS trust and phantom loss in the later years.\textsuperscript{38} Even if the income and loss offset each other, the timing difference gave residual interests negative value.\textsuperscript{39} To account for that income, an RMBS trust had to compute and estimate the performance of the loans on the formation of the RMBS trust, and the trust assets had to remain static throughout the life of the trust to give such computations and estimations meaning.\textsuperscript{40} Figure 2, below, illustrates why the interest of the RMBS trust does not match interest income of the RMBS investors.

\textsuperscript{35} See 1986 Bluebook, supra note 26, at 412 (noting that “[h]olders of ‘regular interests’ generally take into income that portion of the income of the REMIC that would be recognized by an accrual method holder of a debt instrument that had the same terms as the particular regular interest; holders of ‘residual interests’ take into account all of the net income of the REMIC that is not taken into account by the holders of the regular interests”); Bruce Kayle, Where Has All the Income Gone? The Mysterious Relocation of Interest and Principal in Coupon Stripping and Related Transactions, 7 VA. TAX REV. 303, 348 (1987) (providing that “[h]olders of residual interests take into account the difference between the income generated by the REMIC’s assets and the amount of income taken into account by the holders of regular interests”).

\textsuperscript{36} See I.R.C § 860B(b) (2012) (requiring the use of the accrual method); I.R.C § 1272(a)(6) (2012) (applying special accrual rules to regular interest investors).

\textsuperscript{37} See I.R.C. §§ 860C(a), 860E(a) (2012) (requiring that the residual interest holder’s income be no less than the excess inclusion [“phantom income”] for the year).

\textsuperscript{38} See Van Brunt, supra note 32, at 211-14.

\textsuperscript{39} Id. at 203.

\textsuperscript{40} See I.R.C. § 1272(a)(6)(A) (2012) (providing that the daily accruals would derive in part from the present value of remaining payments under a debt instrument—either the RMBS or the mortgage note); Treas. Reg. § 1.860D-1(d)(2)(i)-(iii) (2013) (requiring a REMIC to report the following on the tax return for its first taxable year: information about the terms and conditions of the regular and residual interests and a description about the prepayment and reinvestment assumptions that the REMIC uses for purposes of I.R.C. § 1272); see also 1986 Bluebook, supra note 26, at 426 (“Congress intended that such prepayment assumption will be determined by the assumed rate of prepayments on qualified mortgages held by the REMIC and also the assumed rate of earnings on the temporary investment of payments on such mortgages insofar as such rate of earnings would affect the timing of payments on regular interests. The Congress intended that the Treasury regulations will require these pricing assumptions to be specified in the first partnership return filed by the REMIC.”).
As part of the 1986 Tax Reform Act, Congress provided that RMBS trusts that account for phantom income and loss are not subject to corporate taxation, but qualify for flow-through taxation. The static-asset requirement goes beyond merely limiting the transfer of mortgage notes into and out of an RMBS trust. It also supports a fairly accurate assessment of the value of the mortgage notes in a pool and the likelihood that borrowers will make timely payments on their loans. Factors such as the borrower’s creditworthiness, the value of the borrower’s collateral, the occupancy status of the collateral, and the trust’s right and ability to foreclose on the collateral affect the value of the mortgage notes in a given pool and the likelihood and timeliness of payments. Consequently, Congress imposed strict trust asset requirements that multiple-tranche RMBS trusts must satisfy in order to qualify for REMIC flow-through treatment. RMBS trusts that fail to satisfy these requirements cannot accurately compute the income of the RMBS holders and can thereby siphon revenues from government coffers by using REMIC flow-through

42. See e.g., Griffin & Maturana, supra note 3 (identifying the negative impact on payments of unreported second liens, inflated appraisals, misrepresentation of owner occupancy, and flipping); State-Level Guarantee Fee Pricing, 77 Fed. Reg. 58991, 58991 (proposed Sept. 25, 2012) (noting “the exceptionally high costs” incurred “in cases of mortgage default in [certain] states”).
43. See I.R.C. §§ 860D, 860G (2012) (defining a REMIC); see also infra Part III.
Consequently, any RMBS trust that neither meets the REMIC requirements nor is an investment trust must be taxed as a corporation.

Following the Tax Reform Act of 1986, multiple-tranche mortgage-note pools could take the favored tax status of a REMIC if they satisfied the REMIC requirements. At the time Congress created the REMIC rules, RMBS sponsors appeared to take appropriate measures to ensure that they had satisfied the REMIC requirements. REMIC status revolutionized the RMBS industry. Between 1986 and 2008, REMICs became a significant part of the RMBS market. As of the end of 2011, purported REMICs held more than $3 trillion in assets. That value was about a quarter of all U.S. residential mortgages and a third of all securitized mortgages.

A simplified version of the securitization process in 1986 illustrates how mortgage notes and mortgages moved to REMICs at the time Congress created the REMIC rules. First, an originator lent money to a borrower. The borrower signed a mortgage note for the amount of the loan and a mortgage granting the lender a security interest in the loan. As part of this step, the lender recorded the mortgage with the county clerk.

Second, the originator entered into a PSA with a sponsor and trustee. Pursuant to the agreement, the originator sold the mortgage note and mortgage to a REMIC sponsor for cash.

If the mortgage note was a bearer instrument, the originator transferred it by transferring possession of the mortgage note; otherwise, the originator endorsed the note and transferred possession of it. As part of the second step, the REMIC

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44. Miscalculations may result in understated phantom income of the residual interest holders. This could occur if the fair market value of the mortgage notes in the pool is less than the value that the RMBS organizers claim it is. The overstated value would cause the trust to report less gross income than otherwise required under the rules governing original issue discount. That underreporting would understate the amount of phantom income that the residual interest holders would report in the early years of the RMBS.

45. See I.R.C. § 7701(i) (2012) (treating taxable mortgage pools as tax corporations); 1986 Bluebook, supra note 26, at 411 (stating that “[t]he Congress believed that this vehicle should be the exclusive vehicle (accompanied by exclusive tax consequences) relating to the issuance of multiple class mortgage-back securities, and that availability of other vehicles should be limited to the extent possible.”).


49. See Reiss, supra note 11, at 1003 (describing the securitization process).

50. See Wolf, supra note 48, § 37.27 (describing the transferability of the interests of
sponsor recorded the transfer of the mortgage note and mortgage.\textsuperscript{51} Third, after the REMIC sponsor acquired a pool of mortgage notes and mortgages, it transferred them to a REMIC trust in exchange for the beneficial interests in the trust.\textsuperscript{52} The REMIC trust had no managers, so its trustee recorded the transfer of the mortgage note and mortgages with the county clerk.\textsuperscript{53} Fourth, the sponsor sold the beneficial interests in the REMIC trust to investors.\textsuperscript{54} Figure 3 illustrates the traditional RMBS securitization process from its inception in the 1970s until the 1990s.

\textbf{Figure 3: Traditional Mortgage Securitization (1970s to early 1990s)}

\begin{figure}
\centering
\includegraphics[width=\textwidth]{figure3.png}
\end{figure}

\begin{thebibliography}{99}
\bibitem{1} See \textit{id}.
\bibitem{2} See \textsc{Patrick D. Dolan} \& \textsc{C. VanLeer Davis III}, \textsc{Securitizations: Legal \& Regulatory Issues} § 4.02 (providing a short description of the typical structure of securitization trusts).
\bibitem{3} See \textsc{Jason H.P. Kravitt}, \textsc{Securitization of Financial Assets} § 9.02 (2012) (describing the duties of the trustee in order to comply with securitization transaction requirements).
\bibitem{4} See \textsc{Dolan} \& \textsc{Davis}, supra note 52, § 4.02[2d-f] (discussing the tax issues of securitization).
\end{thebibliography}
B. Mortgage Securitization with MERS

The process of assigning mortgages was universally cumbersome until the end of the twentieth century. Each assignment from originator to sponsor or from sponsor to mortgage-note pool was recorded in the local land records where the property securing the mortgage loan was located. In the 1990s, industry players including Fannie Mae and Freddie Mac and the Mortgage Bankers Association sought to streamline the process of assigning mortgages from the originator to the mortgage-note pool. They attempted to accomplish this purpose by forming The Mortgage Electronic Recording System (MERS), which was up and running by the late 1990s. The stated purpose of MERS is to reduce the cost and administrative inconvenience of recording mortgage assignments. Members of MERS attempt to accomplish this purpose by naming MERS as nominee of the originator, then trading and recording assignments internally without needing to record each assignment in the local land records. A MERS mortgage contains a statement that says, in substance, “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.” MERS is not named on any note endorsement. This new system was designed to save lenders a small but not insignificant amount of money in the form of recording fees every time a mortgage was transferred. Unfortunately, MERS’s legal status was not clear and it had not been ratified by Congress or by state legislatures, save for a few, and the concept did not receive proper vetting from all affected constituents. Nonetheless, nearly all the major mortgage originators and RMBS sponsors participated in MERS. As of 2012, MERS stated that more than “74 million mortgages have been recorded in the name of MERS Inc., of which 27 million are currently active.”

56. Id., at 1 (detailing how the MERS-sanctioned account was created).
57. Id. (explaining the reasons for creating MERS).
58. See id. (describing how the MERS system does not usurp the function of local recording officials to track changes in ownership of real property).
60. Minnesota enacted a “MERS Statute” that allowed nominees like MERS to record an “assignment, satisfaction, release, or power of attorney to foreclose.” Minn. Stat. § 507.413 (2013).
61. Sargent & Harris, supra note 55, at 10.
A MERS-facilitated securitization originally occurred as follows: first, a person borrowed from a loan originator, executed a note to the originator, and granted the originator a mortgage in the property securing the loan. Second, the originator recorded the mortgage in the local recording office, naming MERS as nominee. Third, the originator assigned its rights in the mortgage note and mortgage and transferred them to an RMBS sponsor, and MERS recorded the assignment. Fourth, the sponsor assigned the mortgage note and mortgage and transferred them to the RMBS trustee, and MERS recorded the assignment. Fifth, MERS updated its database to reflect the transfer of the mortgage to the sponsor and RMBS trustee. Figure 4 illustrates the MERS-facilitated securitization process as originally conceived and executed. The industry used this process from the mid-1990s until the early 2000s.62

![Figure 4: MERS-Facilitated Securitization (mid 1990s to early 2000s)](diagram.png)

During this period, RMBS sponsors became more sophisticated and providers diversified the types of loans they offered, so RMBS sponsors expanded the types of RMBS that they offered. Such specialized mortgage-note pools included adjusted-rate-mortgage (ARM) loans with

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teaser rates, cash-out home equity loans, and various subprime products. One type of RMBS pool that emerged was a second-lien RMBS. A second-lien RMBS trust typically held second-lien mortgage loans. In the case of default foreclosure, second-lien holders receive payment on their loans only after the first-lien is satisfied. These new products appeared to accelerate the demand for RMBS. As that demand increased in the early 2000s, loan originators and RMBS sponsors began cutting corners at every level of the securitization process in order to meet investor demand. Those actions flooded RMBS trusts with mortgage notes that would not allow the trusts to properly account for interest income inflow-outflow mismatch. This jeopardized the REMIC classification of an untold, but significant, percentage of all RMBS trusts.

Litigation decisions and documents detail the lax practices. Somewhat counter-intuitively, downstream litigation (litigation between borrowers and banks) is a primary source of information on lax securitization practices. Upstream litigation (litigation between RMBS investors and banks) is a primary source of information on unsavory lending and loan-origination practices. The discussion of claims in this Article assumes that the plaintiffs can support their claims in many of the cases now being litigated. Given that these claims are consistent with the findings of the Financial Crisis Inquiry Commission, the analysis in this Article relies on the particulars in some of the cases to paint a picture of what a typical REMIC might look like. Perhaps some RMBS trusts were not as bad as the Article describes, but bad actions appear to have been rampant and the portrait painted below likely describes many RMBS trusts. The discussion also relies upon a select few filed complaints, but they are consistent with dozens of other cases. Other studies and reports provide a similar picture of the state of affairs in the RMBS and mortgage lending industry leading up to the financial crisis.
C. Deterioration of the Securitization Process (Downstream Litigation)

Corner-cutting in the lending and securitization process led to the financial crisis. In re Kemp, a frequently cited decision from the U.S. Bankruptcy Court, displays the failed securitization practices that preceded the financial crisis. On May 31, 2006, Countrywide Home Loans, Inc. (Countrywide) lent $167,000 to John Kemp, and Mr. Kemp signed a note naming Countrywide as the lender. No endorsement by Countrywide appeared on the note. An unsigned allonge bearing 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, 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 was recorded in the local county clerk’s office on July 13, 2006 (a month and a half after Mr. Kemp signed it).

On June 28, 2006, Countrywide, as seller, entered into a PSA with CWABS, Inc., as depositor (i.e., sponsor); Countrywide Home Loans Servicing LP as master servicer; and Bank of New York (BNY) as trustee. The PSA provided that Countrywide sold, transferred, or assigned to the depositor “all the right, title and interest of [Countrywide] in and to the Initial Mortgage Loans, including all interest and principal received and receivable by [Countrywide].” The PSA also provided that CWABS would then transfer the Initial Mortgage Loans, which included Mr. Kemp’s loan, to the trustee in exchange for certificates referred to as Asset-backed Certificates, Series 2006-8 (the RMBS). Presumably, the depositor then sold the RMBS to investors.


69. In re Kemp, 440 B.R. 624 (Bankr. D.N.J. 2010) (holding that the bank was not the holder and thus not entitled to enforce the debtor’s promissory note).
70. Id. at 627.
71. Id.
72. Id. An allonge is “[a] slip of paper sometimes attached to a negotiable instrument for the purpose of receiving further indorsements when the original paper is filled with indorsements.” BLACK’S LAW DICTIONARY 83 (8th ed. 2004).
73. Kemp, 440 B.R. at 627.
74. Id.
75. Id. Park Monaco, Inc., and Park Sienna, LLC, also entered into the PSA as sellers.
76. Id.
77. Id.
The PSA also provided that Countrywide, as 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 supposedly subject to the PSA, Countrywide never endorsed it in blank or delivered it to the depositor or trustee as required by the PSA. On the date of the purported transfer, no one recorded a transfer of the note or the mortgage with the county clerk. The PSA 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 (almost two years after the purported assignment of the mortgage).

On March 14, 2007, MERS assigned Mr. Kemp’s mortgage to BNY as trustee for the Certificate Holders CWABS, Inc. Asset-backed Certificates, Series 2006-8. On May 9, 2008, Mr. Kemp filed voluntarily for bankruptcy. On June 11, 2008, Countrywide, as servicer for BNY, 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, seeking to expunge its proof of claim. On September 9, 2009, Countrywide claimed to have possession of the mortgage note.

At trial in late 2009, Countrywide 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 (the master servicer in the PSA) testified that the new allonge was prepared in anticipation of the litigation and was signed weeks before the trial. That same person testified that Mr. Kemp’s original note never
left the possession of Countrywide, but instead went to its foreclosure unit.\textsuperscript{90} She also testified that the new allonge had not been attached to Mr. Kemp’s note and that customarily, Countrywide maintained possession of the notes and related loan documents.\textsuperscript{91}

In a later submission, Countrywide 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.\textsuperscript{92} 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 [had] been able to locate the original Note.”\textsuperscript{93}

The court therefore concluded that at the time of the filing of the proof of claim, Mr. Kemp’s mortgage had been assigned to BNY, but Countrywide had not transferred possession of the associated note to BNY.\textsuperscript{94} Figure 5 summarizes the relevant \textit{Kemp} facts, illustrating the failure to timely transfer and record purported assignments of mortgage notes and mortgages.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{Kemp_Timeline}
\caption{Kemp Timeline}
\end{figure}

the successor of Countrywide Home Loans Servicing LP or Countrywide Home Loans, Inc. See \textit{id.} at 626 n.3, 628 n.6 (providing a short description of the aftermath of Bank of America taking over Countrywide’s entities).

90. \textit{Id.} at 628.
91. \textit{Id.}
93. \textit{Id.} at 628 n.7.
94. \textit{Id.} at 629 (explaining court’s decision to not recognize bank’s enforcement of note because bank did not possess note).
The same types of problems arise in upstream litigation because the failure to transfer mortgage notes and mortgages to the trusts negatively affects the value of RMBS, violates representations in RMBS offering materials, and disregards provisions of PSAs. Studies presented in upstream litigation materials illustrate how rampant cases like Kemp had become. A study of almost a thousand mortgages that were supposed to be held by three RMBS trusts formed in 2005, 2006, and 2007, respectively, found that none of the mortgages had been assigned to the trusts on the date the RMBS sponsor issued the RMBS. Within three months after the issuances of the RMBS, less than 1% of the mortgages had been assigned to the trusts, and more than half of the mortgages were never assigned to the trusts. The study also found that the parties routinely failed to transfer the mortgage notes to the RMBS trusts. A sample of 442 mortgage notes found that only seven, or 1.6% of the total notes, were transferred to the trusts within three months after the issuance of the RMBS.

Investigations also revealed that of the mortgages that the parties did eventually assign to the RMBS trusts, several were assigned to the wrong trust. Other RMBS trustees apparently disregarded and failed to disclose audit information that confirmed that the RMBS trust did not have possession of the notes.

Despite representations in the offering materials and provisions in the PSAs to the contrary, many RMBS trusts did not hold mortgage notes and mortgages they purported to hold on the issuance date. Even though the trusts eventually acquired a small percentage of the mortgage notes and mortgages, those acquisitions occurred several months after the formation of the RMBS trusts. The RMBS sponsors were responsible for transferring the mortgage notes and mortgages, but they knew that the RMBS trusts did not have the mortgage notes or mortgages at the time the RMBS trust was formed. The robo-signing scandal that occurred in the wake of the financial crisis was rooted in part in an effort to remedy the problems that

95. See, e.g., Consolidated Complaint at 13–14, 19–20, HSH Nordbank AG v. Barclays Bank PLC, No. 652678/2011 (Sup. Ct. N.Y. County Apr. 2, 2012) (discussing risks to investors from failure to assign mortgage notes to trusts); Knights of Columbus Amended Complaint, supra note 46, at 11-17(describing the provisions of the PSAs).
96. See Nordbank Consolidated Complaint, supra note 95, at 15–16 (discussing investigation into mortgages that were represented to have been deposited in trusts).
97. See id. at 16.
98. See id. at 18.
99. See id. at 17 (analyzing the assignments of sampled mortgages).
100. See Knights of Columbus Amended Complaint, supra note 46, at 21–22 (describing allegedly misleading practices by RMBS trustees concerning securities filings).
101. See, e.g., Nordbank Consolidated Complaint, supra note 95, at 19 (discussing alleged failure of mortgage issuers to assign mortgages and notes into trusts).
arise when notes are not properly transferred.\textsuperscript{102} This scandal is further evidence that the securitization process in the years preceding the financial crisis failed. Figure 6 depicts the securitization process described in \textit{Kemp}, which was prevalent in the years leading up to the financial crisis.

\begin{figure}
\centering
\includegraphics[width=\textwidth]{MERSFacilitatedSecuritizationDiagram}
\caption{MERS-Facilitated Securitization (leading to the Financial Crisis)}
\end{figure}

The discussion below illustrates how failure of the securitization process jeopardizes the REMIC status of numerous RMBS trusts.\textsuperscript{103}

\textbf{D. Deterioration of Lending Underwriting Practices (Upstream Litigation)}

The discussion of the securitization process reveals that RMBS sponsors did not transfer mortgage notes and mortgages to the RMBS trusts. Even if the sponsors had transferred the mortgage notes and mortgages, the quality of the loans represented by the notes and mortgages was so poor that they would not satisfy REMIC requirements. The following discussion illustrates that RMBS sponsors failed to adequately

\begin{itemize}
\item \textbf{103.} See infra Part II.A (describing the ownership requirement for REMIC).
\end{itemize}
perform due diligence or act on information from the due diligence they did perform, and lenders abandoned responsible mortgage underwriting practices. As a result of the failed due diligence and underwriting functions, loans made to unqualified borrowers for homes with undesirable occupancy rates entered into RMBS trusts. Poor appraisal practices also left loans under-collateralized. As a result of these problems, many loans were delinquent (or soon to be delinquent) when they entered the RMBS trusts.

1. Failure of Mortgage Underwriting and Due Diligence

A critical part of RMBS securitization is mortgage underwriting. Loan originators underwrite loans they make to borrowers. Underwriting in this context is the process of assessing the potential risk and profitability of making a loan to a particular borrower.\textsuperscript{104} Traditional home mortgage underwriting included three elements: (1) collateral, (2) borrower creditworthiness (i.e., willingness to pay), and (3) the borrower’s capacity to pay (e.g., income).\textsuperscript{105} Originators abandoned those traditional underwriting guidelines and, often with the knowledge of RMBS sponsors, transferred low-quality mortgage notes and mortgages to RMBS trusts. Originators found that the riskier loan products were the most profitable, so they pressed sales agents to push those products, which included option ARM, home equity, and subprime loans; originators even structured sales-agent compensation to encourage such efforts.\textsuperscript{106}

As a result of the failed underwriting function, lending practices in the mid-2000s became abysmal. Originators failed to verify borrowers’ employment or income, made loans to borrowers whom they knew could not repay the loans or even make required payments, and reduced the time that had to pass since a borrower’s prior bankruptcy.\textsuperscript{107} Originators also


\textsuperscript{105} See Ling & Archer, supra note 104, at 304 (elaborating on the impact of collateral, creditworthiness, and capacity to pay as it applies to mortgage underwriting decisions).


\textsuperscript{107} See JPMorgan Amended Complaint, supra note 106, at 93, 172–187; Bajaj, supra note 106.
forged proof of loan applicants’ employment and rent-paying history. One originator developed a process called the High Speed Swim Lane (HSSL or Hustle) model for loan origination, complete with the motto, “Loans Forward, Never Backward.” As part of Hustle, the origination eliminated toll gates that slowed the originator process, including processes necessary for originating investment-quality loans and for preventing fraud. Hustle even eliminated the underwriting function from all but the riskiest loans. Originators also steered borrowers to high-risk products and granted loans without establishing credit scores. Using this process, originators made loans to nearly all applicants, even though many clearly did not qualify. RMBS sponsors were aware that originators had abandoned their underwriting guidelines.

RMBS sponsors also let their due diligence practices slip well below the standards they represented in offering materials. For example, sponsors instructed due diligence vendors not to verify occupancy status or credit scores. Sponsors knew that they had to accept bad loans to preserve business relationships with loan originators, so they disregarded


110. See id. (discussing the way in which Hustle allegedly eliminated mechanisms in place for preventing fraud).

111. See id. (alleging that Hustle encouraged risky loans).


113. See, e.g., Fin. Crisis Inquiry Comm’n, supra note 3, at xxii (describing Countrywide lending practices); BoA Complaint-in-Intervention, supra note 109, at 16 (describing Countrywide lending practices).

114. See, e.g., Fin. Crisis Inquiry Comm’n, supra note 3, at xxii (describing lending practices of major financial institutions during the events preceding the financial crisis); JPMorgan Amended Complaint, supra note 106, at 197–232.

115. See Dexia 929 F. Supp. 2d at 240 (alleging that sponsors of mortgage backed securities engaged in fraudulent practices).
due diligence standards and accepted poor-quality loans.\textsuperscript{116} They also abandoned basic due diligence tasks, such as determining the reasonableness of income in a stated-income loan.\textsuperscript{117} Sponsors would uncover problematic loans, but they would still accept them into RMBS trusts. One study shows that up to 65\% of the loans accepted into securitizations violated underwriting guidelines, but RMBS sponsors knowingly included them.\textsuperscript{118} The poor quality of these loans did not satisfy REMIC requirements.\textsuperscript{119}

2. Failed Appraisal Function

Pressure to produce loans also caused the appraisal function to fail. The failure of the appraisal function resulted in misstated loan-to-value (LTV) ratios of securitized loans. The LTV ratio is one of the most important measures of the riskiness of a loan. Loans with high LTV ratios are more likely to default because the property owners have less interest in a property with a high LTV ratio.\textsuperscript{120} For example, if a loan is 90\% of a $150,000 property, the property owner’s interest in the property is only $15,000 ($150,000 \times 10\%), giving the property owner 10\% equity. But if the LTV ratio is 60\%, the property owner’s interest is $60,000 ($150,000 \times 40\%). Thus, the property owner with an LTV ratio of 60\% would lose more than a property owner with an LTV ratio of 90\% if the owner of the mortgage foreclosed. An RMBS trust is also much less likely to recover the amount of a loan in a foreclosure sale if a borrower with a high LTV ratio defaults on a loan.\textsuperscript{121}

An important aspect of the LTV ratio is the appraised value of the property securing the loan. To help ensure that the appraised value was high enough to meet the representations in the RMBS offering materials before the financial crisis, sponsors pressured originators and originators

\textsuperscript{116} See, e.g., FIN. CRISIS INQUIRY COMM’N, supra note 3, at 109-11; J. P. Morgan Securities Complaint, supra note 7, at 18 (arguing that due diligence providers approved bad loans in order to maintain relationships with originators); Stichting Pensioenfonds ABP v. Credit Suisse Group AG, No. 653665/2011, at 35–47 (Sup. Ct. N. Y. County Dec. 29, 2011).

\textsuperscript{117} See, e.g., FIN. CRISIS INQUIRY COMM’N, supra note 3, at 109-11 (discussing mortgage underwriting standards during financial crisis); J. P. Morgan Securities Complaint, supra note 7, at 19 (describing the due diligence practices of Clayton Holdings with regards to residential mortgage backed securities).

\textsuperscript{118} J. P. Morgan Securities Complaint, supra note 7, at 19.

\textsuperscript{119} See infra Part II.B (describing requirements necessary to attain REMIC classification).

\textsuperscript{120} See generally Min Qi & Xiaolong Yang, Loss Given Default of High Loan-to-Value Residential Mortgages, 33 J. BANKING & FIN. 788, 799 (2009).

\textsuperscript{121} See id. (discussing the characteristics of high loan-to-value residential mortgages).
pressed appraisers to ensure that appraised values met the sponsors’
requirements. In fact, a 2007 study reported that 90% of appraisers had
been pressured to raise property valuations. Originators blacklisted
appraisers who refused to inflate collateral values, and sponsors instructed
due diligence vendors not to review appraisals. As a result of these
measures, appraisers increased stated appraisal values of collateral 80% of
the time when originators requested reconsideration.

The failed appraisal function caused the LTV ratio of numerous
loans to be much higher than sponsors represented. Widespread and
systematic overvaluations by mortgage originators created a snowball
effect that inflated appraised housing prices across the country. To
illustrate, an appraiser might overvalue a home by 10% based upon
comparable sales and a few months later overvalue a similar home by an
additional 10% based on the recent appraisal. Through this cumulative
process, appraisals significantly contributed to a run-up in property
values. For example, the LTV ratio of a $100,000 loan would be about
90% of the property’s value, were the value $111,000. If the appraiser
overstated the value by 10%, so the property’s value appeared to be
$122,000, the LTV ratio for the $100,000 loan would appear to be about
82%, instead of 90%. An additional 10% overstatement on a similar home

122. See, e.g., Stichting Complaint, supra note 116, at 77. See also Peter S. Goodman &
Gretchen Morgenson, Saying Yes, WaMu Built Empire on Shaky Loans, N. Y. TIMES, Dec.
27, 2008, at A1 (describing the practice of originators and appraisers in the early 2000s);
Michael Moss & Geraldine Fabrikant, Once Trusted Mortgage Pioneers, Now Scrutinized,
N. Y. TIMES, Dec. 25, 2008, at A1 (discussing the lending practices of prominent financial
institutions).

123. See Stichting Complaint, supra note 116, at 77–78; see also Press Release, A.G.
Schneiderman Secures $7.8 Million Settlement With First American Corporation And
Eappraiseit For Role In Housing Market Meltdown (Sept. 28, 2012),
appraiser-for-role-in-housing-market-meltdown.html.

124. See, e.g., Dexta, 929 F. Supp. 2d 231; FIN. CRISIS INQUIRY COMM’N, supra note 3,
at 18, 91-92 (discussing practices by appraisers during the events preceding the financial
crisis); Vikas Bajaj, In Deal with Cuomo, Mortgage Giants Accept Appraisal Standards,
(describing the pressure faced by appraisers to value homes that match or exceed loan
amounts).

125. See id.

126. See, e.g., Stichting Complaint, supra note 116, at 78 (citing the testimony of
Richard Bitter, a former executive of a subprime mortgage originator); FIN. CRISIS INQUIRY
COMM’N, supra note 3, at 18, 91-92 (reviewing trends in housing prices as a result of
mortgage originator practices).

127. See Stichting Complaint, supra note 116, at 78 (citing the testimony of Richard
Bitter, a former executive of a subprime mortgage originator).

128. See, e.g., id.; FIN. CRISIS INQUIRY COMM’N, supra note 3, at 18, 91-92.
would give it an appraised value of $134,000. A $100,000 loan on such
property would have a 75% LTV ratio. The cumulative process of poor
appraisal practices thus had a significant effect on LTV ratios.

Other practices, such as the use of piggy-back loans (i.e., second or
third loans issued on the acquisition of a property to help ensure that the
LTV ratio of the first mortgage does not exceed 80% of the value of the
collateral) also affected the LTV ratios. A loan with an LTV ratio of less
than 80% has a low LTV ratio and is a desirable loan, but a loan is
underwater if it has an LTV ratio greater than 100% (i.e., the loan exceeds
the value of the property). 129 RMBS sponsors routinely overstated the
percentage of loans that they securitized with low LTV ratios and
understated the percentage of loans that were underwater. 130 In fact,
studies of loans in numerous RMBS trusts found that the RMBS sponsors routinely
represented that the pools had no underwater loans. 131 Samples of the loans
in those pools showed percentages of underwater loans in several pools
exceeding 10% and some exceeding 30%. 132 Not surprisingly, RMBS
sponsors appeared to be aware of the inflated appraisals and the effect they
had on LTV ratios. 133 Nonetheless, they populated RMBS trusts with
undersecured loans. 134 Those actions undermined REMIC classification. 135

3. Failure to Screen and Cure Delinquent Loans

RMBS sponsors knew that the delinquency and default rates of
securitized loans were much higher than they represented or that the loans
would become delinquent shortly after securitization. 136 For example,

129. See, e.g., Stichting Complaint, supra note 116, at 81; FIN. CRISIS INQUIRY COMM’N,
     supra note 3, at 404.
130. See Stichting Complaint, supra note 116, at 81–82 (presenting data that shows one
     RMBS promoter overstated the percentage of loans with low LTV ratios by as much as 42%
     and understated loans that were underwater by as much as 40%); JPMorgan Amended
     Complaint, supra note 106, at 138–142 (presenting data that shows RMBS promoters
     routinely overstated the loans with low LTV ratios and understated the percentage of
     underwater loans).
131. See JPMorgan Amended Complaint, supra note 106, at 138–142; Stichting
     Complaint, supra note 116, at 28-29.
132. See JPMorgan Amended Complaint, supra note 106, at 138–142; Nordbank
     Consolidated Complaint, supra note 96, at 28-29.
133. See, e.g., Stichting Complaint, supra note 116, at 79–82.
     2013)
135. See infra Part III.B (describing the requirements for an RMBS to qualify to be a
     REMIC).
136. See, e.g., Dexia, 929 F. Supp. 2d at 239-240 (describing loans that an originator
     issued despite obvious problems with the borrowers’ qualifications); J. P. Morgan Securities
     Complaint, supra note 7, at 25–26 (describing defendant’s alleged failure to remove loans
RMBS sponsors transferred loans to trusts prior to the expiration of the early payment-default period (the thirty to ninety-day period following the purchase of a loan during which the sponsor could force the originator to repurchase a delinquent or default loan).\textsuperscript{137} Transferring loans to trusts before the expiration of the early payment-default period greatly increases the likelihood that the loans will go into default while in the RMBS trust.\textsuperscript{138} Sponsors also knew that loans from certain originators had high delinquency rates, but they continued to purchase loans from those originators and securitize them.\textsuperscript{139} In fact, sponsors recognized that a significant portion of the loans that they securitized were thirty or more days delinquent, but they continued to transfer them to trusts and sell securities in the trusts.\textsuperscript{140}

Despite high delinquency rates,\textsuperscript{141} RMBS sponsors did not enforce the repurchase provisions of the PSAs.\textsuperscript{142} Instead, sponsors and originators colluded to skirt repurchase provisions for their own gain at the expense of the RMBS investors. RMBS sponsors supposedly adopted quality control measures to determine whether the loans maintained their quality after being transferred to the trust.\textsuperscript{143} If a loan was in default prior to the end of the early payment-default period, it would be defective, and would be covered by the PSA’s repurchase provision.\textsuperscript{144} Instead of enforcing the repurchase provision and removing defective loans from the RMBS trust, however, sponsors entered into confidential settlements with originators at a fraction of the loan’s original price.\textsuperscript{145} Sponsors then pocketed the settlement payments and left the defective loan in the RMBS trust.\textsuperscript{146} This behavior not only deprived RMBS investors of assets that were rightfully theirs; it also demonstrated that RMBS sponsors were well aware that the loans they securitized were below the quality level represented in their

\textsuperscript{138} See id. at 23–24 (describing Bear Stearns’ undisclosed policy to securitize loans before expiration of the early payment-default period).
\textsuperscript{139} See J. P. Morgan Securities Complaint, supra note 7, at 11 (claiming that the sponsor knew that almost 60% of an originator’s loans were thirty or more days delinquent, but continued to purchase loans from that originator).
\textsuperscript{140} See id. (referring to securitization as a “SACK OF SHIT” and “shit breather” because the loans the sponsor was securitizing were believed to be of terrible quality).
\textsuperscript{141} See, e.g., Dexia, 929 F. Supp. 2d at 231 (describing originator’s actual knowledge of high delinquency rates on borrowers’ loans).
\textsuperscript{142} See J. P. Morgan Securities Complaint, supra note 7, at 25–28.
\textsuperscript{143} See KRAVITT, supra note 53, § 16.04.
\textsuperscript{144} See id.
\textsuperscript{146} See id.
offering materials. These practices could have denied RMBS trusts REMIC classification.\textsuperscript{147}

\section*{E. Realistic Hypothetical RMBS Trust}

As the financial crisis approached, the state of the RMBS industry grew bleaker, and an increasing number of RMBS products failed to meet clear legal standards. Until courts decide cases with respect to specific RMBS trusts and facts are published, the general public cannot know the specific bad acts in which RMBS organizers engaged. Nonetheless, information in the news media, academic studies, court filings and government reports provides the basis for constructing a realistic hypothetical RMBS trust. Many, perhaps the vast majority, of RMBS trusts created in the years leading up to the financial crisis appear to have had significant defects.\textsuperscript{148} The realistic hypothetical trust provides an opportunity to apply the REMIC requirements to an RMBS trust created prior to the financial crisis. The analysis reveals the almost certain impossibility that such a trust could be a REMIC. It also provides a blueprint that the IRS (or private parties in \textit{qui tam} or whistleblower cases) can follow to challenge REMIC classification. A similar analysis would apply to other RMBS trusts that may not be as defective as this hypothetical RMBS trust.

\textit{Characteristics of Realistic Hypothetical Second-Lien RMBS Trust}

\begin{itemize}
  \item The sponsor issued RMBS in the hypothetical trust in early 2007.
  \item The sponsor did not transfer any of the mortgage notes or assign any of the mortgages to the RMBS trust within three months after the date it issued the RMBS securities to investors.
  \item The mortgages in the RMBS were recorded in MERS’s name as nominee for the originators, but there is no public record of the assignment of the mortgages to the RMBS trust.
\end{itemize}

\textsuperscript{147} See \textit{infra} Part III.B. (describing the qualified mortgage requirement for REMIC classification).

\textsuperscript{148} Undoubtedly, some trusts would not suffer from all of the ills that afflict our hypothetical trust. Nonetheless, no serious observer would dispute the almost certain possibility that trusts like the realistic hypothetical trust were formed and continue to exist.
An affiliate of the originator serviced the mortgage notes.

- The RMBS trust consists only of second-lien loans.
- The loans that the RMBS trust purportedly owns have the following composition:
  - The originator did not obtain verification of the borrowers’ employment for 75% of the loans;
  - The LTV ratio for of 75% of the loans exceeded 100% on the date of formation;
  - Within the early payment-default period, 66% of the loans were in default, but the sponsor made no effort to remove the loans from the RMBS trust; and
  - The occupancy rate of the collateral was significantly lower than the occupancy rate represented in the offering materials.
- The loans that the RMBS trust purportedly owns were geographically diverse, with loans from all or many of the fifty states.
- The RMBS sponsor would not require the originator to repurchase defective loans and would retain settlement proceeds received from the originator for defective loans.

II. REMIC QUALIFICATION

With a somewhat clear picture of the RMBS industry in the years leading up to the financial crisis, and with a realistic hypothetical trust to examine closely, the analysis turns to the tax aspects of REMICs. Federal tax treatment of REMICs is important in two respects. First, it specially classifies REMICs as something other than tax corporations, tax partnerships, or trusts and generally exempts REMICs from federal income taxation. Second, it treats regular interests in REMICs as debt instruments. These two characteristics provide REMICs and their investors with favorable tax treatment. REMICs must compute taxable income, but because the regular interests are treated as debt instruments, REMICs deduct from their gross income amounts that constitute interest payments to the holders of regular interests. Without these rules, a

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151. See I.R.C. § 163(a) (2006) (allowing “as a deduction all interest paid or accrued within the taxable year on indebtedness”); I.R.C. § 860C(b)(1)(A) (2006) (treating regular interests in REMICs as debt instruments); Van Brunt, supra note 32, at 168:
REMIC would most likely be a tax corporation and the regular interests could be equity interests.\textsuperscript{152} If that were the case, the REMIC would not be able to deduct payments made to the regular interest holders and, as a taxable C corporation, would owe federal income tax on a significant amount of taxable income.\textsuperscript{153} Thus, REMIC classification provides significant tax benefits.

To obtain REMIC classification, an RMBS trust must satisfy several requirements.\textsuperscript{154} Of particular interest in this context is the requirement that within three months after the trust’s startup date, substantially all of the RMBS trust assets must be qualified mortgages or permitted investments (the substantially-all test).\textsuperscript{155} Mortgage notes would not come with the definition of permitted investment, so this article focuses on whether an RMBS trust’s assets would be qualified mortgages.\textsuperscript{156} Thus, REMIC classification has four requirements: (1) the ownership requirement (the RMBS trust must be the tax owner of qualified mortgages); (2) the qualified-mortgage requirement (the assets of the RMBS trust must be qualified mortgages); (3) a timing requirement (the RMBS trust must own a static pool of qualified mortgages within three months after the RMBS startup date); and (4) the substantially-all requirement (the RMBS trust’s assets must be almost exclusively qualified mortgages).

Congress and the Treasury designed the REMIC classification rules for arrangements that existed in 1986, when Congress created REMICs.\textsuperscript{157} The rules do not address the wide-scale problems of the financial crisis, so many of the issues discussed in the following analysis

\[\text{Regular interests in the REMIC shall be treated as indebtedness of the REMIC. This is one of the important advances made by the REMIC legislation—to remove the vexing debt vs. equity issue. In this context, the principal effect of this statutory pronouncement is to ensure that relevant payments to regular interest holders constitute interest and thus are deductible in computing REMIC taxable income or net loss.}\]

\textsuperscript{152} If an arrangement loses REMIC status, it will likely be classified as a taxable mortgage pool or a publicly-traded partnership (assuming its interests are publicly traded). See Kravitt, supra note 53, § 16.04.

\textsuperscript{153} See supra Part I.A.


\textsuperscript{156} The principal assets of a mortgage-backed security are mortgages, not the type of asset that comes within the definition of a permitted investment. Thus, the test is whether the assets are qualified mortgages. If mortgage notes fail to come within the definition of qualified mortgages, they will most likely not come within the definition of a permitted investment.

\textsuperscript{157} See supra Part I.A. (discussing 1986 Tax Reform Act and REMIC flow-through treatment).
will be issues of first impression if a court considers them. A large body of law addresses the question of tax ownership in various contexts, including the ownership of obligations, but none of that law contemplates whether a purported REMIC is the tax owner of mortgage notes. Beyond the guidance in the regulations, no authority appears to address the qualified-mortgage requirement, the timing requirement, or the substantially-all requirement. Thus, existing law provides a framework for part of the analysis, but much of the analysis is original. The law of tax ownership makes the analysis of the ownership requirement larger (but no more important) than the analysis of the other requirements.

A. Ownership Requirement

An arrangement comes within the definition of REMIC only if it owns qualified mortgages within the required time period (assuming none of its assets are permitted investments). The federal tax definition of ownership governs whether a purported REMIC owns qualified mortgages. Federal tax law does not defer to the state-law definition of ownership, but it does look to state law to determine parties’ rights, obligations, and interests in property. 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. Courts focus on whether the benefits and burdens of ownership pass from one party to another when

158. Courts are just beginning to define the relationship between the REMIC rules, foreclosure statutes, and the laws governing the transfer of notes. See, e.g., Glaski v. Bank of America, No. F064556 (Cal. Ct. App. July 31, 2013) (holding that voiding an attempted transfer of note or mortgage was justified when it protected beneficiaries of the trust from potential adverse tax consequences of losing status as REMIC trust).

159. See infra Part II. A. (discussing ownership requirement for REMIC classification).

160. See I.R.C. § 860D(a)(4) (2006) (requiring substantially all of a purported REMIC’s assets to be qualified mortgages or permitted investments within three months of startup date).


162. See Burnet v. Harmel, 287 U.S. 103, 110 (1932) (“The state law creates legal interests, but the federal statute determines when and how they shall be taxed. We examine [state] law only for the purpose of ascertaining whether the leases conform to the standard which the taxing statute prescribes for giving the favored treatment to capital gains.”).

163. See Bailey v. Comm’r, 912 F.2d 44, 47 (2nd Cir. 1990) (discussing cases where the courts have disregarded the transfer of formal title when the transferor continues to retain many of the benefits and burdens of ownership).
considering who is the tax owner of the property.\textsuperscript{164} “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 . . . .”\textsuperscript{165} If, however, the transaction does not coincide with the parties’ bona fide intentions, courts ignore the stated intentions.\textsuperscript{166} Thus, the analysis of ownership cannot merely look to the agreements the parties entered into, because the label that parties give to a transaction does not determine its status.\textsuperscript{167} Instead, the analysis must examine the underlying economics and the attending facts and circumstances to determine who owns the mortgage notes for tax purposes.\textsuperscript{168}

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  \item 164. Grodt & McKay Realty, Inc. v. Comm’r, 77 T.C. 1221, 1237 (1981); Sollberger v. Comm’r, 691 F.3d 1119, 1123–24 (9th Cir. 2012); Calloway v. Comm’r, 691 F.3d 1315, 1327 (11th Cir. 2012); Kinsey v. Comm’r, T.C. Memo 2011-257 (2011). See also I.R.S. Field Serv. Adv. Mem. 2001-30-009, at 13 (Apr. 20, 2001) (stating that “transfer of a substantial portion of the benefits and burdens of ownership of property is not characteristic of a financing,” but rather constitutes sale of an entity’s ownership interest); I.R.S. Tech. Adv. Mem. 98-39-001 (May 29, 1998) (stating that “a transaction is a sale if the benefits and burdens of ownership have passed to the purported purchaser”). In Grodt the Tax Court listed eight factors that it considered relevant in determining whether a sale occurs for tax purposes:

1. Whether legal title passes;
2. how the parties treat the transaction;
3. whether an equity was acquired in the property;
4. whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments;
5. whether the right of possession is vested in the purchaser;
6. which party pays the property taxes;
7. which party bears the risk of loss or damage to the property; and
8. which party receives the profits from the operation and sale of the property.

\textit{Grodt}, 77 T.C. at 1237–38 (internal citations omitted).

165. Haggard v. Comm’r, 24 T.C. 1124, 1129 (1955), aff’d 241 F.2d 288 (9th Cir. 1956) (holding that petitioners whose payment was excessive in relation to the fair rental value of a property, intended to and did acquire an equity in the property).

166. See Union Planters Nat’l Bank of Memphis v. United States, 426 F.2d 115, 117 (6th Cir. 1970) (“We do not agree that subjective intent is decisive here.”); Farley Realty Corp. v. Comm’r, 279 F.2d 701, 705 (2d Cir. 1960) (holding that “the parties’ bona fide intentions may be ignored if the relationship the parties have created does not coincide with their intentions”).

167. See Helvering v. F.& R. Lazarus & Co., 308 U.S. 252, 255 (1939) (standing for the proposition that “formal written documents are not rigidly binding”); Mapco Inc. v. United States, 556 F.2d 1107, 1110 (Cl. Ct. 1977) (recognizing that a transaction “was not an economically real sale and, therefore, cannot be recognized as a sale for tax purposes”); I.R.S. Priv. Ltr. Rul. 80-191-20 (Dec. 20, 1979) (disregarding a lease agreement to rule privately that an arrangement was a sale).

168. See Lazarus, 308 U.S. at 255 (“In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding.”); Gregory v. Helvering, 293 U.S. 465, 470 (1935) (standing for the proposition that courts will not “exalt artifice above reality”); Washington Mut. Inc. v.
The analysis of mortgage-note ownership begins with an examination of a fundamental indicium of owning an obligation—the right to enforce the obligation. In re Kemp addressed the issue of enforceability of a mortgage note under the Uniform Commercial Code (U.C.C.) in the bankruptcy context. The court held that a note was unenforceable against the maker of the note and the maker’s property under the U.C.C. on two grounds. First, the court held that the alleged owner of the note, BNY, could not enforce the note because it did not have possession and because the note lacked proper endorsement. Recognizing that the mortgage note came within the U.C.C. definition of negotiable instrument, the court considered who was entitled to enforce a negotiable instrument under the U.C.C. The three types of persons entitled to enforce a negotiable instrument are:

1. the holder of the instrument,
2. a nonholder in possession of the instrument who has the rights of a holder, or
3. a person not

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United States, 636 F.3d 1207, 1218 (9th Cir. 2011) (“As an overarching principle, absent specific provision, the tax consequences of any particular transaction must reflect the economic reality.”); Lazarus v. Comm’r, 513 F.2d 824, 829 n.9 (9th Cir. 1975) (“Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct’ must not frustrate an examination of the facts in the light of economic realities.” (citing Helvering v. Clifford, 309 U.S. 331, 334 (1940)); Union Planters, 426 F.2d at 118 (“In cases where the legal characterization of economic facts is decisive, the principle is well established that the tax consequences should be determined by the economic substance of the transaction, not the labels put on it for property law (or tax avoidance) purposes.” (citing Comm’r v. P.G. Lake, Inc., 356 U.S. 260, 266–67 (1958), Gregory v. Helvering, 293 U.S. 465 (1935)).

169. See James M. P easlee & David Z. Nirenberg, Federal Income Taxation of Securitization Transactions and Related Topics 80 (4th ed. 2011) (“The power to control encompasses the right to take any of the actions relating to a debt instrument that may be taken by its owner, including enforcing or modifying its terms or disposing of the asset.”).

170. See In re Kemp, 440 B.R. 624, 629 (Bankr. D.N.J. 2010) (stating that 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.”) (citing 11 U.S.C. § 502(b)(1)). New Jersey adopted the U.C.C. in 1962. Clark E. Alpert et al., Guide to New Jersey Contract Law § 1.3.2 (2011). This article cites to the U.C.C. generally, instead of specifically to the New Jersey U.C.C., to illustrate the general applicability of the holding. Other courts have reached conclusions similar to the Bankruptcy Court’s opinion. See, e.g., Cutler v. U.S. Bank Nat’l Ass’n, 109 So. 3d 224, 226 (Fla. Dist. Ct. App. 2012) (holding that if a bank could not establish that it was the holder of the mortgage note or allonge that “took effect prior to the date of the complaint, it did not have standing to bring a foreclosure claim”).

172. Id. at 629–30.
173. See id. at 630 (citing the definition of “negotiable instrument” in [U.C.C. § 3-104]).
174. Id.
in possession of the instrument who is entitled to enforce the instrument pursuant to [U.C.C.] Section § 3-309 or 3-418(d). 175

The court then explained why BNY was not a person entitled to enforce the mortgage note. First, the court described why BNY was not the holder of Mr. Kemp’s note. A holder is “the person in possession of a negotiable instrument that is payable either to bearer or to an identified person that is the person in possession.” 176 A person does not qualify as a holder by merely possessing or owning a note. 177 Instead, a person becomes a holder through “negotiation.” 178 The two elements of negotiation are: (1) transfer of possession to the transferee and (2) endorsement by the holder. 179 The court recognized that because BNY never came into physical possession of the note, it was not the holder. 180 It also recognized that the endorsed allonge was not affixed to the original note until the second trial date (the first trial date is relevant for determining rights), so BNY also failed to satisfy the second element. 181 Thus, to have the rights of enforcement as holder, a person must be in possession of an endorsed note at the time when holder status is important. Based on this analysis, many RMBS trusts, including the hypothetical second-lien RMBS trust, would not be considered holders of many of the mortgage notes they claim to own.

Second, the court described why BNY was not a non-holder in possession. 182 The U.C.C. provides that “[a] person may be a person entitled to enforce the instrument even though the person is not the owner of the instrument or is in wrongful possession of the instrument,” 183 which would include a person in possession who is not a holder. 184 Therefore, a person can be a non-holder in possession if the person acquires an unendorsed note as a successor to a holder of the note. 185 The court

175. U.C.C. § 3-301 (2006).
177. See Adams v. Madison Realty & Dev. Inc., 853 F.2d 163, 166 (3d Cir. 1988) (explaining what is insufficient to qualify as a note holder, noting that ownership alone is not by itself automatically sufficient).
178. See U.C.C. § 3-201(a) (2002).
179. See U.C.C. § 3-201(b) (2002).
180. See Kemp, 440 B.R. at 630 (citing Dolin v. Darnall, 115 N.J.L. 508, 181 A. 201 (E&A 1935)) (“Since the plaintiff was not ‘in possession of’ the notes in question, he was neither the ‘holder’ nor the ‘bearer’ thereof.”). The court also rejected the claim that the Bank of New York was in constructive possession of the note because the U.C.C. requires actual possession. See Kemp, 440 B.R. at 631 n.13 (citing N.J.S.A. § 12A:1-201(20)).
182. See id. at 632 (analyzing the characteristics of a non-holder in possession).
183. See id. at 632 (quoting N.J.S.A. § 12A:3-301).
184. U.C.C. § 3-301 Comment (2002).
185. See Kemp, 440 B.R. at 632 (outlining the third category in which a claimant can enforce a note, whereby a party can qualify as a non-holder in possession if said party buys
recognized that BNY was a successor to a holder and would qualify as a non-holder in possession, if it had possession of the note. Because BNY lacked possession, however, it was not a non-holder in possession. Many RMBS trusts, including the hypothetical second-lien RMBS trust, would similarly fail to be non-holders in possession of many of the mortgage notes they claim to own.

Finally, the court concluded that BNY did not qualify as a non-holder not in possession that could enforce the note. To enforce the note under these rules, however, the person must satisfy three requirements. First, prior to the loss, the person must have been in possession of the note and have been entitled to enforce it when the loss of possession occurred. Second, the loss of possession cannot have been the result of transfer by the person or a lawful seizure. Third, the person must be unable to reasonably obtain possession because the instrument was destroyed, the person cannot determine its whereabouts, or it is in the wrongful possession of an unknown person or a person that cannot be found or is not amenable to service of process. Finding that BNY was never in possession of the note, the court held that it was not a non-holder not in possession. Considering common practices of the times, many RMBS trusts, including the hypothetical second-lien RMBS trust, would also fail to qualify as non-holders not in possession.

the note and becomes the successor to the holder of the note, but where in the facts of the actual case, the successor did not have possession); U.C.C. § 3-301 Comment (2002).

186. See Kemp, 440 B.R. at 632 (explaining how BNY could qualify as a non-holder in possession if it was a successor to the holder).

187. See id. at 632 (explaining why BNY could not enforce the note as a non-holder in possession, because although it was the successor as holder of the note, it never actually had possession of the relevant notes).

188. See id. at 633 (showing how the UCC permits enforcement of lost, destroyed, or stolen instruments).


190. See U.C.C. § 3-309(a) (2002) (outlining the requirements for enforcing an instrument by a person not in possession of the instrument).

191. See U.C.C. § 3-309(a)(1)(A) (2002) (detailing how the right to enforce the instrument when loss of possession occurred can result in instrument enforcement).


194. See Kemp, 440 B.R. at 632–33. Kemp cites Marks v. Braunstein, 439 B.R. 248 (D.Mass. 2010), which held that a person who was never in possession of the note could not enforce it. The purpose of requiring prior possession in a lost-note claim is to protect a borrower from multiple claims, but the Marks court followed a strict interpretation of the statute and disallowed the claim of the person who was never in possession of the note, even though conflicting enforcement claims were not a concern in the case. See 439 B.R. at 251 (citing Premier Capital, LLC v. Gavin, 319 B.R. 27, 33 (1st Cir. 2004)).
Another important aspect of the court’s decision in *In re Kemp* is the discussion regarding the difference between ownership of a note and the right to enforce the note. The court recognized that the recorded assignment of the mortgage evidenced an attempt to assign the note, and the PSA provided for an assignment of the note. The court acknowledged that those documents “created an ownership issue, but did not transfer the right to enforce the note.” “The right to enforce an instrument and ownership of the instrument are two different concepts.”

The U.C.C. acknowledges that a person may transfer all right, title, and interest in a note to a transferee, which gives the transferee a claim to ownership of the note. The transferee is not, however, entitled to enforce the note until the transferee obtains possession of it, so transfer of the instrument occurs only when the transferor delivers it to the transferee. Thus, the court concluded that BNY had a valid claim to ownership, but did not have the right to enforce the note. Based upon sworn testimony, originators retained possession of mortgage notes as a matter of course. Because many RMBS trusts, including the hypothetical second-lien RMBS trust, did not have possession of the mortgage notes on the startup date, or three months thereafter, they could not enforce the notes during that time period. Thus, they lacked an important indicium of ownership at the relevant time.

Courts and the IRS have considered note ownership for tax purposes in other contexts, and a number of cases and rulings provide additional guidance for considering who owns the notes and mortgages. The IRS derived eight factors from the cases that courts consider to

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196. *Id.* Indeed, under Article 9 of the U.C.C., which the *Kemp* court did not consider because it focused on enforceability, BNY might have been the owner of the note. *See generally* Elizabeth Renuart, *Uneasy Intersection: The Right to Foreclose and the UCC*, 48 WAKE FOREST L. REV. (forthcoming), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2316152 (discussing the intersection of Articles 3 and 9 of the U.C.C.).

197. U.C.C. § 3-203 Comment 1 (2002).

198. *See id.*

199. *See id.*

200. *See Kemp*, 440 B.R. at 632–34. (noting that someone may be entitled to enforce an instrument even if they are not the owner, and that BNY, although the owner of the note, did not have rights to enforce said note, while also finding that that even if Countrywide Home Loans, Inc., as servicer for the Bank of New York and holder of the note, was the agent of the Bank of New York, it would have no greater right than the Bank of New York had. Because the Bank of New York had no right to enforce the note, Countrywide Home Loans, Inc., would have no right to enforce the note). This ruling refutes the position that even though the REMIC trust does not have possession of a note, it can enforce it through the PSA using the servicer as an agent.

201. *See Kemp*, 440 B.R. at 628-29 (discussing possession of the instrument at issue).
determine whether the benefits and burdens of an obligation pass from one party to another.\textsuperscript{202} The respective factors do not have any particular weight, and circumstances will determine which factors are the most important.\textsuperscript{203} In fact, “an exclusive list of factors risks over-formalizing the concept of ‘sale,’ hamstrings a court’s effort to discern a transaction’s substance and realities in evaluating tax consequences.”\textsuperscript{204} Thus, courts may apply a flexible, case-by-case analysis to determine whether benefits and burdens have transferred.\textsuperscript{205} The economics of a transaction may, however, dictate that only the risk of loss and potential for gain have real significance, and then only to the extent that they are economically realistic.\textsuperscript{206} Thus, the factors aid with the analysis, but they are not definitive. The following discussion illustrates, however, that many of the benefits and burdens of owning mortgage notes did not transfer to many RMBS trusts, including the hypothetical second-lien RMBS trust.

The first factor for considering who owns a note is whether the parties treat the transactions as a sale.\textsuperscript{207} Courts and the IRS consider many different variables when deciding whether parties treat a transaction as a sale. For example, they look at the agreement between the parties.\textsuperscript{208} In the case of purported REMICs that were part of MERS-facilitated securitizations, PSAs provided that the originator would transfer mortgage notes and the purported REMIC trusts would acquire them.\textsuperscript{209} PSAs also

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203.  See Calloway v. Comm’r, 691 F.3d 1315 (11th Cir. 2012) (balancing factors to determine transaction was a sale, not a loan); Sollberger v. Comm’r, 691 F.3d 1119, 1124–25 (9th Cir. 2012); I.R.S. Field Serv. Adv. Mem. 2001-30-009 (Apr. 20, 2001) (noting factors’ importance are fact-specific and that no one factor is dispositive).

204.  See Sollberger, 691 F.3d at 1124 (citing Frank Lyon Co. v. United States, 435 U.S. 561, 573 (1978) and Lazarus v. Comm’r, 513 F.2d 824, 829 n.9 (9th Cir. 1975)).

205.  See Sollberger, 691 F.3d at 1124 (citing Gray v. Comm’r, 561 F.2d 753, 757 (9th Cir. 1977)).


207.  See I.R.S. Field Serv. Adv. Mem. 2001-30-009 (Apr. 20, 2001) (outlining factors assessed to determine whether obligation passes from one party to another and whether the transaction can be treated as a sale).

208.  See United Surgical Steel Co. v. Comm’r, 54 T.C. 1215, 1220–22, 1230 (1970) (examining how the petitioner treated a transaction, and how the obligations to repay the bank rested in the petitioner, such that it could be categorized as a loan by the bank to the petitioner and its guarantors as opposed to any other party).

209.  See In re Kemp, 440 B.R. 624, 627; Knights of Columbus Amended Complaint, supra note 46, at 11–17 (laying out the PSA provisions for purported REMICs in MERS-
provided that mortgage servicers and REMIC trustees would verify the transfer of the mortgage notes and grant the REMICs legal recourse to obtain untransferred notes.210

Agreements, however, may be inconclusive because they may have conflicting positions.211 Courts and the IRS will also ignore the agreement if its title conflicts with the parties’ intent.212 Instead, they will consider whether the purported transferee parted “with any substantial incident of ownership . . . of the obligation,”213 and whether the purported transferee “retained title to, and possession of, the . . . obligations.”214

Leading up to the financial crisis, originators commonly retained possession of mortgage notes, so in that respect, they did not treat their RMBS trust transactions as transfers.215 Sponsors disregarded the repurchase provisions of PSAs and, instead of purging RMBS trusts of defective loans, agreed to receive settlement proceeds from the originators.216 Thus, while PSAs provided for the transfer of possession of mortgage notes, sponsors routinely disregarded those provisions. Sponsors did this in the hypothetical second-lien RMBS trust as well. The actions of both sponsors and originators before the financial crisis therefore conflicted with relevant agreements.

Courts and the IRS will also look at how parties treat a transaction for tax and accounting purposes to determine tax ownership.217 For federal income tax and accounting purposes, sponsors and originators appear to facilitated securitizations).

210. See Knights of Columbus Amended Complaint, supra note 46, at 21–22 (evidencing such a framework, providing various provisions of a PSA and what rights and obligations exist between the parties).
211. See I.R.S. Field Serv. Adv. Mem. 2001-30-009 (Apr. 20, 2001) (finding language in a servicing agreement that treated the transaction as a sale and language in the private placement memorandum that treated the transaction as a financing arrangement).
212. See Haggard v. Comm’r, 241 F.2d 288, 289 (9th Cir. 1956) (“The intent of the parties was perfectly plain. The bare fact that one of the joined documents was drawn in lease form and terminology by the parties is of no consequence.”).
214. Id.
215. See supra Part II.A.
216. See supra Part I.D.3.
have treated RMBS trusts as both owners and non-owners. With no information to the contrary, this analysis assumes that those parties allocated cash flows from borrowers to the trusts, which the trusts in turn paid to RMBS investors. RMBS trusts also presumably recognized interest income from loans and deducted interest paid to RMBS investors. Presumably, they also allocated phantom income to the holders of residual interests. In these ways, originators and sponsors treated RMBS trusts as tax owners of mortgage notes.

Nonetheless, the originators and sponsors knew that a significant percentage of the loans in RMBS trusts were defective, but they did not replace them. Instead, they agreed between themselves to settle the originators’ repurchase prices and deprive the RMBS investors of their right to the funds. Thus, originators and sponsors knew that the loans in RMBS trusts were worth less than the amount accounted for, but they did not adjust their tax accounting accordingly. In this respect, they treated someone other than the RMBS trust as tax owner of the mortgage notes.

Taxes also include recording fees that parties must pay to record the transfer of a mortgage note or mortgage. Sponsors and originators treated the transaction as something other than a sale for state fee recording purposes. Many mortgages recorded by MERS provide that MERS is nominee or agent of the mortgagee’s successors or assigns, but sponsors and originators often would not record the assignment of a mortgage note to the RMBS trust. Apparently, they did this in order to avoid paying recording fees and taxes at the time of the purported transfers from the originator to the trust. Consequently, for state recording fee purposes, they treated the originator or MERS as the owner of the mortgage note, but not the trust. Local jurisdictions are now seeking recording fees for unrecorded assignments of mortgage notes. Failure to record the transfer of mortgage notes to RMBS trusts is another way in which originators and sponsors treated someone other than the RMBS trusts as tax owner.

218. See supra Part I.D.3.
219. Id.
221. See, e.g., Christian County Clerk, 515 Fed. Appx. at 453 (dismissing case brought by county clerks in Kentucky seeking recording fees from MERS and banks); Montgomery County, 904 F. Supp. 2d 436 (denying MERS’s motion to dismiss counties’ claim for recording fees).
The second factor for considering who owns a note is whether the parties notify the obligor of the transfer of obligations. Failure to notify the obligor of a transfer of an obligation generally indicates that the transaction was not a transfer. Case law does not expound on this factor, but its application appears to be straightforward. In the case of securitized mortgage notes, the obligors are the borrowers. The originators could notify the obligor of a transfer by direct communication or public notice. The originator could provide public notice by recording the transfer in county records. Indeed, the purpose of recording transfers of mortgages is to put the public (including the obligor) on notice of the transfer in order to prevent multiple claims for the same note. In fact, legal conflicts often arise because obligors are unsure of who holds a mortgage note and who has the right to bring foreclosure actions on the corresponding property. By failing to record the assignment of mortgages or providing other notification, originators and sponsors failed to notify borrowers of a transfer of the obligation. This factor suggests the RMBS trusts, including the hypothetical second-lien RMBS trust, were not the tax owners of the mortgage notes.

The third factor for ownership considers which party serviced the obligations. Generally, the originator, or an entity affiliated with the originator, services an RMBS trust’s mortgage notes. The originator’s continuing to service an obligation generally indicates that the originator is the tax owner of the note.

The fourth ownership factor is whether payments made to the purported transferee correspond to collections on the debt instrument. If

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223. See United Surgical Steel Co. v. Comm’r, 54 T.C. 1215, 1230 (1970) (“As far as the customer knew, the [originator] was the person to whom he was indebted.”).
224. See WOLF, supra note 48, § 37.27.
226. See Kemp, 440 B.R. at 627 (providing that the PSA named Countrywide Home Loans, Inc., as originator and Countrywide Home Loans Servicing LP (an affiliate of Countrywide Home Loans, Inc.) as servicer).
227. See United Surgical Steel, 54 T.C. at 1229–30 (“The [originator] continued to handle all collections and otherwise to service its customers. In fact, there was no contact between the customer and the bank.”); Town & Country Food Co., 51 T.C. at 1057 (“[The originator] collected payments as they became due and deposited them in its own bank account.”).
228. See I.R.S. Field Serv. Adv. Mem. 2001-30-009 (Apr. 20, 2001) (stating that a transaction is classified as a sale if benefits and burdens of ownership are passed to alleged purchaser); I.R.S. Tech. Adv. Mem. 98-39-001 (May 29, 1998) (stating that one of the factors examined in determining whether benefits and burdens of ownership have been transferred include whether payments to transferees correspond to collections on notes).
payments to transferees correspond to collections on obligations, the transaction is more likely to be treated as a transfer. But courts have stated that corresponding payments are not dispositive. PSAs generally required the originator (so long as it retained the servicing rights) to collect payments from obligors and deliver them to the RMBS trust or the RMBS investors net of appropriate fees, so if record-keeping was accurate and borrowers made scheduled payments on the notes, payments to the transferee would generally correspond to collections. Such payments would therefore indicate that RMBS trusts were tax owners.

PSAs also provide that originators are obligated to repurchase or replace defective loans. Sponsors, however, would not enforce repurchase obligations and would retain settlement payments paid by originators to compensate for defective mortgage notes. Repurchase payments are one type of payment on the loans, and RMBS trusts would not receive those payments. Because payments to RMBS trusts did not correspond with the collections by the sponsor of repurchase settlement proceeds, such actions would suggest that some RMBS trusts, including the hypothetical second-lien RMBS trust, were not the tax owners of the mortgage notes.

The fifth ownership factor contemplates whether the transferee imposes restrictions on the operations of the transfer that are consistent with a lender-borrower relationship. Cases holding that transactions were loans secured by notes and not transfers of the notes often considered restrictions that lenders placed on the borrowers to help secure repayment

229. See Branhm v. Comm’r, 51 T.C. 175, 180 (1968) (agreeing with IRS’s contention that series of installment payments resulting from note that were identical to amount of principal and interest due to petitioner, which was subsequently transferred to the petitioner’s daughters in exchange for stock in another company, amounted to transfer of ownership benefits).

230. See United Surgical Steel, 54 T.C. at 1228 (“[T]here is no basis in law upon which to conclude that merely because the amount borrowed is substantially equal to the face amount of the collateral, the taxpayer has thereby disposed of the collateral.”).

231. See KRAVITT, supra note 53, § 4.02.

232. See id. at § 16.04.

233. See J. P. Morgan Securities Complaint, supra note 7, at 25–28 (alleging that J. P. Morgan’s quality control department failed to eliminate defective loans that entered securitization, where in some situations it led to J. P. Morgan seeking and obtaining confidential settlements for toxic loans without repurchasing the defective loans as actually required).

234. See I.R.S. Field Serv. Adv. Mem. 2001-30-009 (Apr. 20, 2001) (declaring that one factor in deciding if a sale occurred includes whether restrictions indicative of a lender-borrower relationship are imposed by the transferee); Tech. Adv Memo. 98-39-001 (May 29, 1998) (stating that one factor involved in determining whether a sale occurred is whether the transferee creates limitations on the operations of the transferor that express a lender-borrower type relationship).
of the loan and protect the collateral. Such restrictions include keeping records in a manner that satisfies a lender, allowing the lender to audit the borrower’s books, furnishing periodic financial statements to the lender, paying taxes as they become due, keeping the collateral insured, requiring approval for other purchases, and restricting both the payment of compensation and dividends and the creation of other indebtedness. Distinctive restrictions also include margin account payment requirements and requirements to maintain a certain ratio of collateral to debt. A borrower’s need to satisfy such requirements and its ability to borrow additional funds using the same debt as collateral further show that the arrangement is a loan, not a transfer. A judge applying this factor would consider whether the RMBS trust or sponsor (as potential lender) imposed restrictions like the ones listed above on the originator. PSAs do not appear to explicitly restrict the originator’s operations. Thus, this factor appears to indicate that RMBS trusts were tax owners of the mortgage notes.

The sixth factor considers who has the power to dispose of an obligation. The lack of restrictions on the sale of a note suggests power of disposition. Arrangements that clearly allow one party to dispose of

235. See, e.g., United Surgical Steel, 54 T.C. at 1230 (1970) (concluding that a petitioner’s relationship with a bank was that of a borrower and debtor on the basis of various restrictions placed upon the petitioner by the bank, including recording keeping requirements, rights of audit, and tax liability); Union Planters Nat’l Bank of Memphis v. United States, 426 F.2d 115, 117, 118 (6th Cir. 1970) (concluding that for tax liability purposes, the economic substance of the transaction, including what restrictions banks place to prevent loss of principal, are what determines whether a particular set of transactions qualify as sales or secured loans); Yancey Bros. Co. v. United States, 319 F. Supp. 441, 446 (1970) (evaluating restrictions imposed by the lenders upon a taxpayer who utilized a customer’s installment payments as security for demand loans from the bank to determine whether tax liability results from this form of securitization).


237. See Union Planters, 426 F.2d at 117-118 (noting that the bank involved in the case went to significant lengths to ensure that it did not bear the risk of loss); Yancey Bros., 319 F. Supp. at 446 (noting that the taxpayer loan agreements at issue in the case required a 105% collateral to debt ratio to be maintained as part of the note’s conditions, while using it to evaluate whether the events in the case amount to a taxable transaction or event).

238. See Yancey Bros., 319 F. Supp. at 446 (discussing taxpayer’s ability to borrow additional funds, including the ability to consolidate existing debt into a single borrowing note without the addition of more collateral).

239. See I.R.S. Field Serv. Adv. Mem. 2001-30-009 (Apr. 20, 2001) (concluding that one of the factors to determine if a transfer is a sale includes an evaluation of which party had the power of disposition); Tech. Adv Mem. 98-39-001 (May 29, 1998) (stating that one factor to consider in deciding if a transaction is a sale includes determining whether or not the party had power of disposition).

240. See Rev. Rul. 82-144, 1982-2 C.B. 34 (ruling that taxpayer was free to dispose of obligations at any time despite puts on the obligations).
notes even if they are in the possession of another party also suggest power of disposition.\textsuperscript{241} The rights to dispose of notes, to transfer the registration of the notes, and to keep interest due on the notes point to the person who has the power to dispose of notes.\textsuperscript{242} In cases that rely upon this factor, the originators of notes could dispose of the notes if they replaced the collateral or had sufficient other collateral to secure the lender’s right to repayment.\textsuperscript{243} For example, a manufacturer could sell notes if the value of the remaining notes it held were sufficient to satisfy the lender who held a security interest in the notes.\textsuperscript{244} In other cases, courts consider whether one party has complete dominion of an asset in determining power of disposition.\textsuperscript{245} The pre-financial crisis RMBS arrangements do not squarely align with any of these cases. Neither the RMBS trusts, the originators, nor the sponsors appear to have had complete dominion over the mortgage notes.

Without possession of the mortgage notes, a person cannot transfer possession of the notes. An RMBS trust that did not have possession of notes could sell the rights it had under PSAs to receive payments, but it could not transfer all of the interests and rights in negotiable mortgage notes prior to taking possession of them.\textsuperscript{246} Therefore, an RMBS trust that

\textsuperscript{241} See, e.g., \textit{Union Planters}, 426 F.2d at 117 (holding that the owner was the party that listed the bonds for sale, in spite of a formal distinction and concession by the government that the Bank held formal title to the bonds as a matter of property law); \textit{Am. Nat’l Bank v. United States}, 421 F.2d 442, 452 (5th Cir. 1970) (recognizing that dealers held complete dominion over bonds as they came into possession of the lending bank, and dealers could sell the bonds at any time to the dealers’ customers).

\textsuperscript{242} See \textit{Calloway v. Comm’r}, 691 F.3d 1315, 1327-30 (11th Cir. 2012) (evaluating the rights of respective purported owners of securities to determine whether or not the transaction constituted a sale for tax liability purposes, including evaluating factors such as entitlement to receive benefits from the transaction that resulted, the right to sell or transfer the notes without the permission of the original owner and transferor, among others); \textit{Sollberger v. Comm’r}, 691 F.3d 1119, 1125-27 (9th Cir. 2012) (concluding that petitioner Sollberger’s claims that a transaction he engaged in was not a sale for tax purposes were not valid because the transaction amounted to sale of his floating rate notes to another party, thereby imposing capital gains tax liability and implicitly suggesting he had powers of disposition of the floating rate notes at issue).

\textsuperscript{243} See \textit{Town and Country Food Co., Inc. v. Comm’r}, 51 T.C. 1049 (holding that use of installments paid by customers to secure loans from a third party was not a sale or disposition which obligated reporting of gains under section 453(d) of the tax code).

\textsuperscript{244} See \textit{Town and Country}, 51 T.C. at 1049.

\textsuperscript{245} See \textit{Bailey v. Comm’r}, 912 F.2d 44, 47 (2d Cir. 1990) (holding that the party that had the exclusive right in a film to control distribution, determine the title, date of initial release, advertise, make copies, possess, and distribute to various media was the owner of the film).

\textsuperscript{246} See \textit{PERMANENT EDITORIAL BD. FOR THE UNIF. COMMERCIAL CODE, REPORT ON APPLICATION OF THE UNIF. COMMERCIAL CODE TO SELECTED ISSUES RELATING TO MORTG. NOTES AT 5-6 (November 14, 2011), available at
lacked possession could not transfer the negotiable note to someone who would become a holder in due course.\textsuperscript{247} A rational buyer would not pay fair market value for a negotiable note that did not bestow upon it rights of a holder in due course. Furthermore, the REMIC rules generally prohibit RMBS trusts from transferring any mortgage notes.\textsuperscript{248} PSAs also generally prohibit RMBS trusts from transferring any mortgage note they hold to ensure that they comply with the REMIC rules.\textsuperscript{249} Thus, as a practical matter, RMBS trusts probably cannot dispose of mortgage notes, undermining the position that they are tax owners of the notes.

The originator and RMBS trust would confer very different rights upon potential purchasers of the notes. A person who purchased the note from the originator could become a holder of the note and be entitled to enforce it.\textsuperscript{250} In fact, the originator could sell an untransferred mortgage note to other purchasers who could become a holder of the mortgage note in due course.\textsuperscript{251} A holder in due course who purchased a mortgage note

\textsuperscript{247} See U.C.C. § 1-201 (2005) (defining a “holder” as one in possession).
\textsuperscript{248} See I.R.C. § 860F(a)(2) (noting that a prohibited transaction includes disposition of qualified mortgages transferred to the REMIC with a limited set of exceptions).
\textsuperscript{249} See, e.g., Pooling And Servicing Agreement for Long Beach Mortgage Loan Trust 2006-3 and Asset-Backed Certificates, Series 2006-3, by and among Long Beach Securities Corp., Depositor, Long Beach Mortgage Company, Seller And Master Servicer and Deutsche Bank National Trust Company, Trustee (dated as of April 1, 2006), at 190 available at http://www.sec.gov/Archives/edgar/data/1355515/000127727706000388/palongbeach_20063.pdf (discussing various prohibited transactions and activities barring depositors, master servicers, and trustees from disposing of mortgage notes with limited exceptions, with intentions of avoiding prohibited transactions).
\textsuperscript{250} See U.C.C. § 3-301 (2002) (listing the persons entitled to enforce such a note).
\textsuperscript{251} See U.C.C. § 3-302(a)(2002):

“[H]older in due course” means the holder of an instrument if: (1) the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity; and (2) the holder took the instrument (i) for value, (ii) in good faith, (iii) without notice that the instrument is overdue or has been dishonored or that there is an uncured default with respect to payment of another instrument issued as part of the same series, (iv) without notice that the instrument contains an unauthorized signature or has been altered, (v) without notice of any claim to the instrument described in Section 3-306, and (vi) without notice that any party has a defense or claim in recoupment
from an originator following a purported transfer to an RMBS trust would have greater rights in a mortgage note than the RMBS trust. The RMBS trust’s recourse in such a situation would be against the originator for breach of contract and possibly theft. Thus, the originator who retains possession of a mortgage note has the power to dispose of the note, but the RMBS trust only has power to transfer some of the rights under the note. A good faith transferee of the mortgage note from the originator would have more rights than a good faith transferee of the RMBS trust’s rights in the note. In fact, as RMBS litigation proceeds and additional facts emerge, finding that originators sold single notes to multiple buyers would not be surprising. Neither originators nor RMBS trusts have carte blanche to dispose of the notes, so this factor does not appear to weigh conclusively in either direction. The factor is probably more damning for the RMBS trusts, however, because they are seeking tax ownership.

The seventh factor examines which party bears the risk of loss. This may be the most important factor in determining the tax owner of a mortgage note. In a private ruling, the IRS devoted considerable text to analyzing who bears the risk of loss in a loan securitization arrangement.

described in Section 3-305(a).

252. See U.C.C. § 3-306 (2002):

A person taking an instrument, other than a person having rights of a holder in due course, is subject to a claim of a property or possessory right in the instrument or its proceeds, including a claim to rescind a negotiation and to recover the instrument or its proceeds. A person having rights of a holder in due course takes free of the claim to the instrument.

253. See Kravitt, supra note 53, § 16.04.


255. See John Arnholz & Edward E. Gainor, Offerings of Asset-Backed Securities 14-34 (2013):

Outright fraud is probably unlikely when the parties are well known to each other and a transaction is as highly publicized as a typical MBS offering. But the risk of an inadvertent transfer of mortgage loans should not be lightly dismissed. The authors recall too many occasions on which a client called to report the discovery that assets purportedly transferred had been pledged or sold to another party.


257. See I.R.S. Tech. Adv. Mem. 98-39-001 (May 29, 1998) (“[T]here is no real opportunity for gain due to lower than expected prepayments. Thus, who bears the risk of loss must determine whether the transaction is a sale or secured financing.”).

The IRS identified both credit risk and prepayment risk as types of risk that accompany mortgage securitization. Credit risk is the risk that borrowers will not make payments as provided in the loan agreements. Prepayment risk is the risk that borrowers will refinance when interest rates go down and pay off existing mortgage notes before their maturity dates and that the holder of a note will hold a note with a below-market yield if the interest rates go up. Another risk of securitization is modification risk. Modification risk is the risk that the borrower will modify the loan to reduce the amount of monthly payments.

A mortgage securitization arrangement can transfer any combination of such risks from the originator or provide that the originator will retain any combination of the risks. For example, if an originator retains the most junior tranches of certificates issued with respect to an RMBS trust or it agrees to repurchase defective mortgages, it retains most of the credit risk. Many RMBS trusts had been structured this way, so originators often retained the credit risk by retaining junior RMBS tranches. The parties to a securitization arrangement can transfer the prepayment risk and modification risk to the holders of more senior tranches if they require RMBS trusts to use available funds to pay the holders of senior tranches first. In fact, the economic incentives that accompany different types of risk affect investors’ behavior and preferences. Investors who hold senior RMBS tranches bear most of the

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260. See id. (discussing credit risk and prepayment risk in the context of mortgage loans).
261. See id.
262. See Naveen Investments, Prospectus for Naveen Mortgage Opportunity Term Fund 2 at 78 (Feb. 3, 2010), available at https://www2.morganstanley.com/wealth/Markets/IPOCenter/Prospectus/?DocID=p_JMTC E.
263. See id.
265. See Ingo Fender & Janet Mitchell, Incentives and Tranche Retention in Securitisation: A Screening Model 4 n.4 (BIS Working Papers No 289, May, 2009), available at http://www.bis.org/bcbs/events/cbrworkshop09/fendermitchell.pdf (“[I]n early securitisations, originators would routinely hold on to the equity piece of their transactions. . . . [E]quity tranches, even when originally retained, were increasingly sold or hedged”)

What the FDIC staff understood early on—frankly, before anyone else—was
prepayment risk; investors in junior tranches or the originator bear most of the credit risk.\footnote{268 See Kravitt, supra note 53, \S 16.02.} Margin accounts, repurchase agreements, and other mechanisms can also influence who bears the risk of loss. Thus, determining who bears the risk of loss is fact-specific.

The IRS privately ruled in a non-REMIC mortgage securitization that the trust bore the prepayment risk and the originator bore the credit risk.\footnote{269 See I.R.S. Field Serv. Adv. Mem. 2001-30-009 (Apr. 20, 2001).} Similarly, in REMIC mortgage securitization, originators and REMICs each bear risk. Originators of the loans conveyed to many RMBS trusts agree to repurchase the mortgage notes that do not satisfy underwriting requirements.\footnote{270 See Arnholz & Gainor, supra note 255, at \S 1.04.} Indeed, originators created reserves to cover the estimated costs they would incur as a result of the risks they retained.\footnote{271 See Dolan & Davis, supra note 52, at \S 7.01.} Even though RMBS sponsors retained repurchase settlement payments,\footnote{272 See J. P. Morgan Securities Complaint, supra note 7, at 27-28 (discussing how funds from confidential settlements for toxic debt were retained by the bank instead of being credited to the affected RMBS trusts).} suggesting that the RMBS trust bore the risk of loss, courts will most likely hold the RMBS sponsors liable for paying those proceeds to the RMBS trusts. Courts will also likely enforce the PSAs and hold originators liable for repurchasing or replacing the defective mortgage notes. Thus, in the case of an RMBS trust knowingly formed with defective mortgage notes, the RMBS trust would not bear the risk of loss of the mortgage notes. Many RMBS trusts, including the hypothetical second-lien mortgage RMBS trust, would not bear the risk of loss of mortgage notes.

The eighth factor considers which party had the potential for gain.\footnote{273 I.R.S. Tech. Adv. Mem. 98-39-001 (May 29, 1998); see I.R.S. Field Serv. Adv. Mem. 2001-30-2009 (Apr. 20, 2001) (analyzing the potential for gain on the mortgage loans).} The IRS observed that the potential for gain is the obverse of bearing risk.\footnote{274 See I.R.S. Field Serv. Adv. Mem. 2001-30-009 (Apr. 20, 2001).} Consequently, one might conclude that if the originator or sponsor bore the risk of loss, the RMBS trust might have the potential for gain. The application of this factor to RMBS trusts is unclear, especially if the parties wanted to qualify for REMIC classification. A REMIC does not have the opportunity to profit from the disposition of mortgage notes. If
the notes appreciate in value and a REMIC sells the notes, any gain it recognizes will be taxed at 100%.\textsuperscript{275} Because the tax would consume any gain, the REMICs have no potential for gain from the mortgage notes. The IRS has also concluded that if there is no real opportunity for gain, “who bears the risk of loss must determine whether the transaction is a sale or secured financing.”\textsuperscript{276} RMBS trusts appear to provide no real opportunity for lawfully acquired gain from the mortgage notes, so the focus is on the risk of loss instead of the potential for gain. Nonetheless, REMIC-intended RMBS trusts’ inability to profit from the disposition of mortgage notes suggests they are not the tax owners of the mortgage notes.

Table 1 summarizes the tax-ownership analysis of the hypothetical second-lien mortgage RMBS trust using the eight factors for ownership discussed above. The summary suggests that the IRS could make a strong case that many RMBS trusts, especially the hypothetical second-lien RMBS trust, were not the tax owners of the mortgage notes.

Table 1: Summary of Factors Applied to Hypothetical RMBS Trust

<table>
<thead>
<tr>
<th>Factor</th>
<th>RMBS Trust Owned the Note</th>
<th>RMBS Trust Did Not Own the Note</th>
<th>Direction Balance Leans</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Did parties treat the transaction as a sale?</td>
<td>PSA provided that originator transferred notes; federal tax accounting of interest and principal.</td>
<td>Originators retained possession of notes; transfer not recorded; recording fees not paid; sponsor retained settlement payment.</td>
<td>RMBS trust not tax owner.</td>
</tr>
<tr>
<td>(2) Were obligors notified of transfer of obligation?</td>
<td>Loan documents may provide for possibility of assignment.</td>
<td>No public record of assignment; perhaps no direct notification.</td>
<td>RMBS trust not tax owner.</td>
</tr>
<tr>
<td>(3) Which party serviced the obligation?</td>
<td>Affiliate of originator serviced the obligation.</td>
<td></td>
<td>RMBS trust not tax owner.</td>
</tr>
</tbody>
</table>

Table 1: Summary of Factors Applied to Hypothetical RMBS Trust

<table>
<thead>
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<th>RMBS Trust Did Not Own the Note</th>
<th>Direction Balance Leans</th>
</tr>
</thead>
<tbody>
<tr>
<td>(4) Did payments to the transferee correspond to collections on the</td>
<td>Principal and interest payments to RMBS trust</td>
<td>Settlement payments for defective loans did not</td>
<td>Not apparent.</td>
</tr>
<tr>
<td>debt instrument?</td>
<td>corresponded to collections.</td>
<td>correspond to sponsor’s collection of those</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>payments.</td>
<td></td>
</tr>
<tr>
<td>(5) Did the transferee impose restrictions on the operations of the</td>
<td>No distinctive restrictions imposed.</td>
<td>RMBS trust tax owner.</td>
<td></td>
</tr>
<tr>
<td>transferor?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(6) Which party had power of disposition?</td>
<td>Originator could transfer possession of the notes.</td>
<td>PSA restricted RMBS trust’s right to transfer</td>
<td>Not apparent.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>notes; tax law penalizes transfers; RMBS trust</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>did not have possession of notes.</td>
<td></td>
</tr>
<tr>
<td>(7) Which party bears the risk of loss?</td>
<td>PSA obligated RMBS trust to cure defective loans,</td>
<td>RMBS trust not tax owner.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>and many loans were defective.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(8) Which party has the potential for gain?</td>
<td>Originator could not dispose of mortgage notes</td>
<td>100% tax on gains from dispositions prohibits</td>
<td></td>
</tr>
<tr>
<td></td>
<td>for gain.</td>
<td>RMBS trust from realizing gain.</td>
<td></td>
</tr>
</tbody>
</table>

In addition to applying the multiple-factor test for tax ownership to mortgage notes, the courts and IRS may also estop purported RMBS trusts from arguing that they are owners of notes that they do not possess. Courts
and the IRS apply a substance-over-form doctrine to disregard the form taxpayers choose if the form does not reflect the economic substance of the transaction. They generally do not, however, allow taxpayers to rely upon a substance argument to take a position that differs from the taxpayer’s chosen form. If RMBS trusts and originators chose not to transfer the mortgage notes to the trusts, the principle of estoppel weakens the trusts’ arguments that they were tax owners of notes of which they chose not to take possession.

Commentators anticipate that RMBS trusts may argue that the REMIC rules merely require the REMIC to be the beneficial owner of the obligations. That argument fails because beneficial ownership is analogous to tax ownership, and courts apply the Grodt & McKay benefits and burdens test to determine who is the beneficial owner of property.


278. See, e.g., Branham v. Comm’r, 51 T.C. 175, 175 (1968) (finding that the taxpayer’s assignment of a note was “absolute on its face” and holding that the taxpayer had transferred the note); I.R.S. Tech. Adv. Mem. 98-39-001 (May 29, 1998) (“Taxpayer would be bound by the form of its transactions if it were the first to assert that its transactions were [something other than the chosen form]”).

279. See Borden & Reiss, supra note 161, at 278; Lee A. Sheppard, The Crazy Train of Mortgage Securitization, TAX NOTES 639, 645 (Nov. 8, 2010). Beneficial ownership often appears in the trust context, but even in that context, it closely relates to the concept of tax ownership. See, e.g., BLACK’S LAW DICTIONARY 1137 (8th ed. 2004) (defining beneficial owner as “[o]ne recognized in equity as the owner of something because use and title belong to that person, even though legal title may belong to someone else; esp., one for whom property is held in trust.”). The tax statute provides that qualified mortgage includes “any participation or certificate of beneficial ownership” in an obligation. I.R.C. § 860G(a)(3)(A).

The REMIC regulations refer to beneficial ownership in two places. First, they prohibit a disqualified organization from acquiring beneficial ownership of a residual interest in a REMIC. Treas. Reg. § 1.860D-1(b)(5)(i)(B). That reference does not, of course, address the tax ownership of an obligation. Second, they provide that the definition of “obligations secured by interests in real property” includes “other investment trust interests that represent undivided beneficial ownership in a pool of obligations principally secured by interests in real property and related assets that would be considered to be permitted investments if the investment trust were a REMIC.” Treas. Reg. § 1.860G-2(a)(5). That reference is clearly to an interest in a trust. If the originator holds the mortgage notes, a purported REMIC would have to establish that the originator held the mortgage notes in trust and that the trust was an investment trust to rely upon that rule. The documents used to create the REMICs do not appear to make any provisions for the originator to be trustee, and the originators probably would not come within the definition of investment trust. Furthermore, such a claim would contradict representations in the REMIC offering documents, which did not provide that the originator would hold the mortgage notes in trust.

280. See, e.g., Estate of Kenneth L. Lay v. Comm’r, 102 T.C.M. (CCH) 202 (2011) (“The status of the legal title to the annuity contracts does not control in determining
fact, defendants in upstream litigation acknowledge that tax ownership is the appropriate test to apply in determining whether a purported REMIC is the owner of the obligations. Beneficial ownership would be relevant to an RMBS trust only if the originator held the mortgage note in trust for the RMBS trust.

If an RMBS trust fails to establish that it is the tax owner of mortgage notes, tax law must re-characterize the arrangement. If a purported REMIC received and distributed proceeds, it would own some sort of asset capable of generating cash flow. That asset could be a loan from the originator, the sponsor or another party to the securitization. The security for such a loan could be mortgage notes that would come within the definition of qualified mortgage. But such a loan does not itself come within that definition. Because the asset would be something other than a qualified mortgage, the arrangement would fail to be a REMIC.

This analysis suggests that a court would likely find that many RMBS trusts, including the hypothetical second-lien RMBS trust, were not the tax owners of mortgage notes. The facts of some RMBS trusts may


The federal income tax consequences of property ownership generally depend upon beneficial ownership rather than possession of mere legal title. Speca v. Comm’r, 630 F.2d 554, 556-57 (7th Cir. 1980), aff’d T.C. Memo. 1979-120; Beirne v. Comm’r, 61 T.C. 268, 277 (1973). “[C]onnavigation over property or enjoyment of its economic benefits, which is the mark of true ownership, is a question of fact to be determined from all of the attendant facts and circumstances.” Monahan v. Comm’r, 109 T.C. 235, 240 (1997) (internal quotations omitted) (quoting Hang v. Comm’r, 95 T.C. 74, 80 (1990)). “[A] sale occurs upon the transfer of the benefits and burdens of ownership rather than upon the satisfaction of the technical requirements for the passage of title under State law.” Houchins v. Comm’r, 79 T.C. 570, 590 (1982). The determination of whether the benefits and burdens of ownership have been transferred is one of fact and is based on the intention of the parties, evidenced by their written agreements and the surrounding facts and circumstances. Paccar, Inc. & Subs. v. Comm’r, 85 T.C. 754, 777 (1985), aff’d, 849 F.2d 393 (9th Cir. 1988); Grodt & McKay Realty, Inc. v. Comm’r, 77 T.C. at 1237; Ragghianti, 71 T.C. at 349. Beneficial ownership is marked by command over property or enjoyment of its economic benefits. Yelencsics v. Comm’r, 74 T.C. 1513, 1527 (1980) (holding that the entire interest in a stock was sold even though the title to the stock was not transferred).


282. See Borden & Reiss, supra note 161.

283. See infra Part II.B.
nonetheless indicate that the RMBS trust is the tax owner of the mortgage notes. In such cases the RMBS trusts may still fail to qualify as REMICs because they fail to satisfy other REMIC requirements. As the following analysis indicates, the hypothetical second-lien RMBS trust will almost certainly fail to satisfy other REMIC requirements. The analysis also provides a template for analyzing REMIC classification for other RMBS trusts.

B. Qualified Mortgage Requirement

An RMBS trust must satisfy the qualified mortgage requirement to be a REMIC. 284 A qualified mortgage is an obligation that is principally secured by an interest in real property. 285 This definition has three elements: (1) obligation, (2) principally secured, and (3) secured by an interest in real property. An asset must satisfy all three elements to be a qualified mortgage. Many of the assets in RMBS trusts do not satisfy these elements.

1. Obligation

A qualified mortgage must be an “obligation (including any participation or certificate of beneficial ownership therein).” 286 The REMIC rules do not specifically define obligation. The common legal definition of obligation is “[a] legal or moral duty to do or not do something . . . . A formal, binding agreement or acknowledgment of a liability to pay a certain amount or to do a certain thing for a particular person or set of persons; esp., a duty arising by contract.” 287 A mortgage note would satisfy this definition of obligation because the maker of the note agrees to pay a certain amount. An originator’s promise under a PSA to transfer mortgage notes would also come within the definition of obligation. Participation or certificates of beneficial ownership in an obligation include “non-REMIC pass-through certificates (including senior and subordinated pass-through certificates and IO [Interest Only] and PO [Principal Only] strips) . . . .” 288 A pass-through certificate is an interest in a trust or other arrangement that holds a pool of mortgage notes or other debt instruments. 289 IO and PO strips are types of stripped bonds and

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284. See supra Part II.
286. Id.
287. BLACK’S LAW DICTIONARY 1104 (8th ed. 2004).
288. See PEASLEE & NIRENBERG, supra note 169, at 456.
289. Id. at 23.
coupons governed by section 1286 of the Internal Revenue Code, which grant a holder the rights to identified payments on bonds.\textsuperscript{290} Thus, a strip that grants an RMBS trust the right to receive certain payments due on an obligation principally secured by an interest in real property would appear to satisfy the definition of obligation. These rules are consistent with the general definition of qualified mortgage, which includes any regular interest in another REMIC.\textsuperscript{291}

Because pre-financial crisis RMBS trusts received cash flow, they must have been the tax owners of some type of property. Even if the properties RMBS trusts owned were not qualified mortgages, they could have been obligations. For instance, it could be an obligation from the originator to transfer mortgage notes and to transfer payments on the notes. Such an obligation would not be a pass-through certificate, however, unless the arrangement with the originator was a trust. This does not appear to have been the case, because PSAs do not create a trust on behalf of the RMBS trust.\textsuperscript{292} Thus, the properties owned by RMBS trusts seem to be either mortgage notes—for RMBS trusts that are the tax owners of the notes—or rights to receive something from the originator. The properties owned by an RMBS trust could therefore be binding obligations, even if they are not mortgage notes per se. Obligations in a form other than mortgage notes would not satisfy other elements of the definition of qualified mortgage because they would not be principally secured by an interest in real property.

2. Principally Secured

An obligation is principally secured only if it (1) satisfies the 80% test, (2) satisfies the alternative test, or (3) comes within the reasonable-belief safe harbor.\textsuperscript{293} As the following discussion illustrates, the lending and underwriting practices during the years leading up to the financial crisis will have prohibited many mortgage notes from being principally secured under any of those three alternatives. Any other obligation that an RMBS trust might hold will also fail to satisfy any one of the tests.

\textsuperscript{290} Id. at 438. A stripped bond is a bond that separates the ownership of the bond from any coupons or interest that have not yet come due, and a stripped coupon is the coupon related to the bond. Id. at 701.

\textsuperscript{291} I.R.C. § 860G(a)(3)(C).

\textsuperscript{292} See Borden & Reiss, supra note 14, at 277-279.

\textsuperscript{293} Treas. Reg. § 1.860G-2(a)(1).
a. The 80% Test

An obligation satisfies the 80% test only if the fair market value of the interest in real property securing the obligation is at least 80% of the adjusted issue price of the obligation on one of the following two dates: (1) the obligation’s origination date, or (2) the date the trust acquires the obligation by contribution. In other words, the 80% test compares the value of the collateral to the amount of a loan, so it considers the value-to-loan (VTL) ratio of a mortgage note. The VTL ratio is the inverse of the LTV ratio that RMBS sponsors and investors use. The 80% test requires the VTL ratio of a loan to be at least 80%. Two definitions are key to computing the VTL ratio: the definition of adjusted issue price and the definition of the fair market value of the collateral.

The REMIC rules do not define adjusted issue price of an obligation. Instead, the rules rely on the definitions of “adjusted issue price” in other areas of tax law, particularly in the original issue discount (OID) rules. One such definition provides that the adjusted issue price of a debt instrument is the instrument’s issue price at the beginning of its first accrual period. The issue price for a home mortgage should be the amount of the loan. After the first accrual period, the adjusted issue price is the issue price increased by any original issue discount that any holder of the instrument included in income and decreased by any payments other than qualified stated interest made on the instrument. The adjustments that occur between the origination of a loan, and a transfer of it to an RMBS trust normally should not significantly affect the adjusted issue price of the mortgage note because transfers generally occur shortly after origination. This analysis assumes that the adjusted issue price is the amount of the loan.

The definition of fair market value in the 80% test applies on a property-by-property basis. The test assigns the value of property first to senior liens. The amount assigned to senior liens reduces the fair market

295. See Treas. Reg. § 1.860G-2(a)(1)(i)(B) (qualifying obligations that are at least equal to 80 percent of the adjusted issue price of the obligation at the time the sponsor contributes the obligation to the REMIC as meeting the 80-percent test).
296. See PEASLEE & NIRENBERG, supra note 167, at 455, 58.
298. See I.R.C. § 1273(b)(2) (noting that the issue price of a debt instrument not issued for property and not publicly offered is the price paid by the first buyer of the instrument); See also Treas. Reg. § 1.1273-2(g)(5), Example 1 (deducting points from the borrower’s payment to determine issue price).
300. See supra Part I.
value of the interest in real property assigned to other liens.\textsuperscript{301} Other liens that are on par with the obligation being tested further reduce the fair market value of the interest in real property in proportion to the liens with similar priority.\textsuperscript{302} The computation of fair market value required by these rules could cause many second-lien mortgages (and primary mortgages for that matter) to fail to satisfy the 80% test. Inflated appraisals were common in years leading up to the financial crisis,\textsuperscript{303} and will thus cause many mortgages to fail the 80% test.

An example illustrates how senior liens can cause many second and other subordinate liens to fail the 80% test. Say the originator of an obligation treats an appraised value of $250,000 as the fair market value of a house. Based upon that appraisal, the originator lends a buyer $200,000 secured by a first-lien mortgage on the house and $37,500 secured by a second-lien mortgage on the house (the borrower paid the remaining $12,500 of the purchase price).\textsuperscript{304} The appraised fair market value suggests that both the first and the second mortgages satisfy the 80% test. Applying the test to the first mortgage, the fair market value of the house would be the full $250,000. The VTL ratio of the first mortgage is the $250,000 appraised value divided by the $200,000 mortgage or 125%, which is greater than the required 80%, thus allowing the first-lien mortgage to satisfy the 80% test. The fair market value apportioned to the second-lien mortgage for purposes of the 80% test is $50,000 ($250,000 total fair market value minus the $200,000 first mortgage). The VTL ratio for the second mortgage is 133% ($50,000 fair market value to $37,500 loan). Because 133% is greater than the required 80%, the second mortgage also satisfies the 80% test.

If appraisers overstated the values of homes in this example, and the $250,000 house is only worth $225,000 (just 90% of the appraised value) at the time the buyer borrowed the first or second mortgage,\textsuperscript{305} then the actual value, not the inflated appraised value, is appropriate for the 80% test.\textsuperscript{306} Using the actual value of the collateral, the first-lien mortgage still

\begin{enumerate}
\item \textsuperscript{301} See Treas. Reg. § 1.860G-2(a)(2).
\item \textsuperscript{302} See id.
\item \textsuperscript{303} See supra Part II.B.2.a.
\item \textsuperscript{304} The issuance of a first and second mortgage to home purchasers was typical during the period leading up to the economic meltdown in 2008. See Vikas Bajaj, \textit{Equity Loans as Next Round in Credit Crisis}, N.Y. TIMES (Mar. 27, 2008), http://www.nytimes.com/2008/03/27/business/27loan.html?pagewanted=print (noting the higher risk of loss in second liens).
\item \textsuperscript{305} The $250,000 appraised value represents approximately 11% overstated value ($25,000 ÷ $225,000). Such inflation was not uncommon leading up to the financial crisis. See supra Part II.B.2.a.
\item \textsuperscript{306} See Treas. Reg. § 1.860G-2(a)(1)(i) (referring to fair market value of the collateral).
\end{enumerate}
satisfies the 80% test because it uses the full $225,000 actual fair market value, which exceeds the $200,000 first mortgage. The VTL ratio for the first mortgage is 112.5% ($225,000 value divided by the $200,000 loan). The value for purposes of the second mortgage, however, is $225,000 minus the $200,000 first-lien mortgage, or $25,000. The VTL ratio for the $37,500 second mortgage using that $25,000 value is 67% ($25,000 value divided by the $37,500 loan). Because the 67% VTL ratio of the second-lien mortgage is less than the required 80% VTL ratio, the second-lien mortgage does not satisfy the 80% test.

Studies of mortgages suggest that more than a significant percentage of second-lien mortgage loans would not satisfy the 80% test. Studies of mortgages suggest that more than a significant percentage of second-lien mortgage loans would not satisfy the 80% test. 307

307. It was not uncommon for homebuyers to borrow close to 100% of the appraised value of the home. See Dov Solomon & Odelia Minnes, Non-Recourse, No Down Payment and the Mortgage Meltdown: Lessons from Undercapitalization, 16 FORDHAM J. CORP. & FIN. L. 529, 541-542 (2011). For example, a borrower might take a first mortgage for 80% of the appraised value of the home and a second mortgage for 20% of the appraised value of the home (an 80-20 financing). Assuming the first mortgage was 80% of the value of the home and a second mortgage was 20% of the value of the home with such arrangements, a 4.001% discrepancy between the appraised value and the actual value would cause the second mortgage to fail the 80% test. For instance, if the appraised value of a home was $100,000, the second mortgage would be for $20,000. The VTL ratio of the second home would be less than 80% if the actual value of the home was only $95,999 instead of the appraised $100,000. If the actual value were $95,999, to value assigned to the $20,000 second mortgage for the purpose of the 80% test would be $15,999 ($95,999 total actual value minus the $80,000 first mortgage). The VTL ratio of the second mortgage in such a situation would be 79.995% ($15,999 value to $20,000 loan). These calculations suggest that if the appraised value was just 4.2% greater than the actual value ($4,001 ÷ $95,999), the second mortgage on a 100%-financed home would not satisfy the 80% test. Based upon reports that appraised values were often at least 20% greater than the actual value of the homes, many mortgages would fail to satisfy the 80% test. See, e.g., Griffin & Maturana, supra note 3 (finding that appraisal overstated at least 20% occurred in 14.5% of studied loans).

Instead of being an 80-20 arrangement, the arrangement could have been an 80-10-10 arrangement with a first mortgage equal to 80% of the home’s appraised value and a second and third mortgage each equal to 10% of the home’s appraised value. If the first and second mortgage had priority over the third, the third mortgage would not satisfy the 80% if the actual value was only 2.01% less than the appraised value. To illustrate, a homebuyer would borrow $100,000 to purchase a home with an appraised value of $100,000. The third mortgage in an 80-10-10 arrangement would be $10,000. The third mortgage would not satisfy the 80% test if the value of the property were less than $98,000 because the actual value assigned to the third mortgage would be the $97,999 (for example) actual value minus the $90,000 total amount of the first and second mortgages, which would make the VTL ratio for the third mortgage less than 80% (e.g., $7,999 actual to a $10,000 loan is a only 79.99% VTL ratio).

If the mortgages in an 80-20 or 90-10-10 had equal priority, the actual value of the property would have to be less than 80% of the appraised value for any mortgage to fail the 80% test. For instance, the value assigned to the 80% loan in a $100,000 80-20 arrangement would be 80% of the actual value of the property, and the value assigned to the 20% loan
A study examining combined loan-to-value (CLTV) ratios of pooled mortgages indicates that many loans held by RMBS trusts may not satisfy the 80% test. The CLTV ratio compares the combined principal balance of all liens on the mortgaged property to the value of the mortgaged property. Because LTV is the inverse of the VTL ratio, a VTL ratio of 80% equals an LTV ratio of 125%. Take for example a property with an $80,000 fair market value that secures a $100,000 loan. The VTL ratio for that property and obligation is 80% ($80,000 value divided by the $100,000 loan). The LTV ratio for that property and obligation is 125% ($100,000 loan divided by the $80,000 value). If the VTL ratio of a property and obligation is less than 80%, the obligation will not satisfy the 80% test. Inversely, if the LTV of a property is greater than 125%, the obligation secured by the property will not satisfy the 80% test.

The CLTV ratio includes all mortgages secured by a piece of property, but it does not provide information with respect to individual loans. A study found that the CLTV ratio was greater than 100% for as many as 34% of the loans in one RMBS trust. A CLTV of greater than 100% suggests that any second-lien mortgages in the pool may not satisfy the 80% test. In the example above, if the house secured a $200,000 first-lien mortgage and a $37,500 second-lien mortgage, the combined loans would be $237,500. If the value of the house were $250,000, the CLTV ratio for the property and obligations would be about 95% ($237,500 loan divided by $250,000 value). The VTL ratio of the aggregate loans would be about 91% ($250,000 value divided by the $237,500 loan). If, however, the value of the property were only $225,000, the CLTV ratio would be about 106% ($237,500 loan divided by $225,000 value). The VLT ratio of the aggregate loans would be about 95% ($225,000 value divided by the

would be 20% of the value of the property. See Treas. Reg. § 1.860G-2(a)(2). If the actual value of the property were $90,000 (90% of the appraised value), $72,000 of it would be assigned to the 80% loan, which would have been for $80,000, so the VTL ration would be 90% ($72,000 of value to $80,000 of mortgage). The VTL ratio for the $20,000 second mortgage would also be 90% because $18,000 (20% of $90,000) of the value would be assigned to it.

A diversified mortgage pool that has a ratio of first and subsequent mortgages that equals the ratio of such mortgages to the value of appraised property would most likely have more than a de minimis amount of mortgages that fail the 80% test. Nordbank Consolidated Complaint, supra note 96, at 28 (describing a study on CLTV ratios of pooled mortgages).

See id. at 26 (explaining the meaning and application of the CLTV ration).


The CLTV ratio would also consider third mortgages and any other mortgages secured by the property.

See Nordbank Consolidated Complaint, supra note 96, at 28.
$237,000 loan). Nonetheless, the loan-by-loan analysis shows that some loans may not satisfy the 80% test.

Because each loan is subject to the 80% test, a CLTV ratio of greater than 100% signals that one or more of the loans secured by the property may fail the 80% test. Failure will often result because the fair market value of the property apportioned to the first-lien mortgage leaves a disproportionately small amount of the property value to apportion to the other mortgages. If the first mortgage is for $200,000 (roughly 84% of the total amount of loans) and the actual value of the property is only $225,000, the first-lien mortgage is almost 89% of the actual value of the property. Thus, only 11% of the value of the property is apportioned to the second-lien mortgage under the 80% test. The disproportionately small amount of value assigned to the second-lien mortgage gives it a 150% LTV ratio ($37,500 loan divided by the $25,000 value) and a 67% VTL ratio ($25,000 value divided by the $37,500 loan). The second-lien mortgage thus does not satisfy the 80% test. In fact, loans with lower priority that are part of a CLTV ratio that exceeds 100% will often fail the 80% test.

The study of CLTV ratios demonstrates that as many as 34% of randomly selected loans have CLTV ratios of greater than 100%. The number of loans in an RMBS trust of second-lien mortgages with LTV ratios of greater than 100% would most likely be even higher, and that fact does not bode well for REMIC classification if a trust holds $100,000,000 of loans, and the CLTV ratio for 34% of the loans (based upon actual value) is greater than 100%. With respect to $34,000,000 or 34% of the loans, a question arises about whether some of them fail the 80% test. If $5,100,000, or 15% of the loans (based upon actual value), in that group are second-lien mortgages, and if half of those loans fail the 80% test, $2,550,000 or 2.55% of the loans in the portfolio would fail the 80% test. The percentage of mortgage notes that fail the 80% test would be even greater for RMBS trusts that hold only second-lien mortgage notes.

As stated above, originators pressured appraisers to inflate values 80% of the time. That practice suggests that the value of collateral could have been overstated for at least 80% of the second-lien loans. Because the effect of overstated value of the collateral is magnified with respect to

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313. See supra text accompanying note 307 (applying the 80% test to arrangements with a single property securing multiple loans). As illustrated in that discussion, the structure of the arrangement will often influence the effect of the 80% test. If all loans secured by a piece of property have equal priority, the CLTV ratio would have to be greater than 125% for any of the loans to fail the 80% test. If one or more loans have priority over other loans, a CLTV ratio of greater than 100% signals that one more of the loans probably does not satisfy the 80% test.

314. See Nordbank Consolidated Complaint, supra note 96, at 28.

315. See supra pp. Part II.B.2.a..
second-lien mortgages, as many as 80% of the second-lien mortgages could have VTL ratios lower than 80%. If that is the case, the vast majority of second-lien mortgages granted in the years leading up to the financial crisis will not pass the 80% test. Such loans would be principally secured only if they pass the alternative test or come within the principally-secured safe harbor.

b. The Alternative Test

An obligation that does not satisfy the 80% test will nonetheless be principally secured by an interest in real property if the obligation satisfies the alternative test. An obligation must meet two requirements to satisfy the alternative test.316 First, substantially all of the proceeds of the obligation must be used by the borrower to acquire, improve, or protect an interest in real property.317 Second, at the origination date, the only security for the obligation can be the property that the borrower acquired, improved, and protected with the loan proceeds.318 The test covers real estate construction or acquisition loans for property not appraised at the time of the loan.319

The language in the preamble to the regulations raises the question of whether a loan for appraised property can satisfy the alternative test if it fails the 80% test. That language provides:

[A] home improvement loan made in accordance with Title I of the National Housing Act would be considered to satisfy the principally secured standard even though one cannot readily demonstrate that the loan satisfied the 80-percent test because a property appraisal was not required at the time the loan was originated.320

This language suggests that the alternative test only applies to loans that do not require an appraisal of the collateral, and is not a fall-back test for loans that fail the 80% test based on an inaccurate property value. However, if the collateral is appraised, the 80% test would be the proper test. Thus, any loan that includes an appraisal value of the property and fails the 80% test probably cannot rely upon the alternative test.

317. See id.
318. See id.
319. See Peaslee & Nirenberg, supra note 169, at 459.
Many loans issued before the financial crisis will not satisfy the alternative test. During that period, many borrowers used proceeds from home equity loans for purposes other than acquiring, improving, and protecting interests in real property. Estimates indicate that as many as 40% of loans issued during years before the financial crisis were home equity loans that were not used to acquire, improve, or protect real property.\footnote{See Atif R. Mian & Amir Sufi, House Prices, Home Equity-Based Borrowing, and the U.S. Household Leverage Crisis (Research Paper, May 21, 2010), at 19, available at http://ssrn.com/abstract=1397607: [O]ur findings are suggestive that a large fraction of home equity-based borrowing is used for consumption or home improvement. This conclusion is consistent with survey evidence by Brady, Canner, and Maki (2000) who find that from 1998 to 1999, 40% of households cite home improvement as a reason for home equity extraction, and 39% cite consumer expenditures.} These home equity loans would not satisfy the first part of the alternative test. Borrowers often took a portion of a loan originated at the time of purchase in cash.\footnote{See Hui Chen et al., Houses as ATMs? Mortgage Refinancing and Macroeconomic Uncertainty 2 (Working Paper, 2012), at 4, available at http://ssrn.com/abstract=2024392 (“On average about 70% of refinanced loans involve cash-out, and U.S. households extracted over $1.7 trillion of home equity via refinancing from 1993 to 2010, corresponding to 11.5% of new loan balances.”).} If the amount of cash that the borrower received (or used for purposes other than to acquire, improve, or protect the real property) caused the portion of the loan used to acquire, improve, or protect the property to be less than substantial, the loan would not satisfy the alternative test.

A loan will also fail the alternative test if property other than the real property that the borrower acquired, improved, or protected with the loan proceeds secures the loan. A borrower’s personal liability for the obligation does not violate this rule of the alternative test.\footnote{See Treas. Reg. § 1.860G-2(a)(1)(ii) (stating that to meet requirements of the alternative test, the borrower must use the loan to acquire, improve, or protect specifically real property).} If the borrower offers other property as collateral, however, the loan would not satisfy the second requirement. Determining whether loans are secured by other property requires an examination of each loan. Even without that examination, many second-lien mortgage notes in RMBS trusts will fail the alternative test because borrowers used the proceeds for purposes other than acquiring, improving, or protecting the property.\footnote{See Chen et al., supra note 322 (demonstrating that borrowers are not using loans in accordance with standards of alternative test and giving estimates how frequently this occurs). The borrowers also obtained appraisals (albeit inaccurate appraisals) for the property, suggesting the alternative test probably should not apply. Consequently,}
with respect to many second-lien mortgage notes, the mortgage notes will not satisfy the alternative test.

c. The Reasonable-Belief Safe Harbor

Obligations that fail both the 80% test and the alternative test will nonetheless be principally secured by an interest in real property if they come within the reasonable-belief safe harbor. The reasonable-belief safe harbor treats an obligation as being principally secured by an interest in real property if, at the time the sponsor contributes the obligation to a REMIC, the sponsor reasonably believes the obligation satisfies the 80% test or the alternative test. A sponsor may base reasonable belief on representations and warranties made by the originator. Alternatively, a sponsor may base a reasonable belief on evidence indicating that the originator typically made mortgages in accordance with an established set of parameters, and that any mortgage loan originated in accordance with those parameters would satisfy the 80% test or the alternative test. This safe harbor does not apply if the sponsor actually knew, or had reason to know, that an obligation failed both the 80% test and the alternative test. Thus, in addition to showing reasonable belief, the sponsor must be able to show lack of actual knowledge and lack of reason to know that an obligation does not meet one of the other tests for the obligation to qualify for safe harbor protection.

Sponsors’ only hope to come within the reasonable-belief safe harbor is to demonstrate that they based their reasonable belief on representations and warranties made by the originator. They could not argue that they based their reasonable belief on evidence indicating originators made mortgages in accordance with established parameters that would satisfy the 80% test, because evidence at the time indicated that originators abandoned underwriting guidelines and made loans that could not satisfy the 80% test. Sponsors also knew, or had reason to know, that the loans they were securitizing could not pass the 80% test. In the years leading up to the financial crisis, sponsors acknowledged the low quality of the mortgages that they were securitizing. Nonetheless, they continued to put them into RMBS trusts.

326. See Treas. Reg. § 1.860G-2(a)(3)(ii)(A) (affirming that a sponsor’s reasonable belief can be founded on representations or warranties made by the originator).
329. See supra Part II.B.2.a.
330. See Bajaj, supra note 106 (illustrating that the sponsors were aware of their subpar
Even where sponsors can prove a reasonable belief that mortgage notes satisfied the 80% or alternative test, if a purported REMIC later discovers that an obligation is not principally secured by an interest in real property, the obligation is defective, and loses qualified mortgage status within ninety days of the discovery date. The rules give sponsors those ninety days to cure defective loans.

Sponsors knew that they were transferring defective loans into RMBS trusts at the time they formed the trusts. They also knew that default rates of loans from particular originators were particularly high, but they continued to accept loans from those originators. They were aware that appraisers were overstating the value of homes, so they knew that many loans could not satisfy the 80% test. Members of the industry had to know these things before reporters became aware that the mortgages and notes had serious quality problems. Even though REMICs have the opportunity to cure defective obligations within the ninety-day window, nothing suggests that they took the steps necessary to cure defective obligations. Due to the collapse of the residential real estate market as a result of the practices of RMBS sponsors, insufficient mortgages existed to replace defective obligations that the RMBS trusts held. Sponsors colluded with originators to settle repurchase obligations instead of exercising trusts’ rights to cure defects by replacing defective obligations with compliant loans. No cure alternative would appear to help RMBS trusts principally secure their mortgage notes. Many second-lien mortgage RMBS trusts will also fail to principally secure their mortgage notes.

3. Secured By Real Property

In addition to being principally secured, an obligation held by an RMBS trust must be secured by an interest in real property in order to
come within the definition of qualified mortgage. The regulations do not define “secured by,” but they provide a list of instruments that are secured by interests in real property. Those instruments include mortgages; deeds of trust; installment land contracts; mortgage pass-thru certificates guaranteed by GNMA, FNMA, FHLMC, or CMHC; other investment trust interests; and obligations secured by manufactured housing. Of those instruments, mortgages and deeds of trust would most often be the type of security applicable to an obligation held by an RMBS trust. Practices of the mortgage securitization industry in the years leading up to the financial crisis in general, and the use of MERS in particular, suggest that RMBS trusts often did not hold mortgages or deeds of trust. It also suggests that the mortgage securitization industry lacked the power to enforce them.

In downstream litigation, courts in many states have considered who holds or controls the legal rights and obligations of mortgage notes and mortgages that are designated as RMBS trust property. The issues state courts have considered with respect to mortgage notes and mortgages include standing to foreclose, entitlement to notice of bankruptcy proceeding against a mortgagor, ownership of a mortgage note under a state’s commercial code, the right to initiate a nonjudicial foreclosure, and liability for recording fees. The outcomes of these cases vary from

340. 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, 8 NORTON BANKRUPTCY LAW ADVISOR 1, 1-21 (Aug. 2010).
341. See 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); Eaton v. Fed. Nat’l Mortg. Ass’n, 462 Mass. 569 (Mass. 2012) (holding that the definition of a mortgagee in state statutes governing foreclosure by sale refers to the person or entity holding the mortgage); Jackson v. Mortg. Elec. Registration Sys., 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); Fowler v. Recontrust Co., N.A., 2011 WL 839863 (D. Utah March 10, 2011) (holding that MERS is the beneficial owner under Utah law); Bain v. Metro. Mortg. Grp., 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).
342. See Landmark Nat’l Bank v. Kesler, 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).
343. See In re Kemp, 440 B.R. 624, 624 (D.N.J. 2010) (holding that bank was not considered a holder that could enforce debtor’s promissory note under New Jersey’s Uniform Commercial Code).
jurisdiction to jurisdiction. Many cases pit a borrower against one or more banks or MERS. Courts often rule in favor of the borrower, eliminating the rights of the bank to collect on a note or foreclose on property; in other cases, courts have found that banks have standing.\footnote{See, Ebube Okoli, Bankruptcy Court Rules MERS Has Standing and the Customary Rights of a Mortgagee and May Act Under the Mortgage, \textit{REFinBLOG.COM} (Aug. 8, 2013), http://www.refinblog.com (indicating that of the cases analyzed through Mar. 11, 2014, courts held that MERS or the Bank had standing in 223 and lacked standing in 63, meaning that in more than 20\% of cases, bank could not foreclose or collect on the note).}

The outcomes of such cases often turn on whether the bank initiating a claim (or on whose behalf another party initiates a claim) holds both the mortgage note and the mortgage at the initiation of the claim.\footnote{See Bradley T. Borden, David J. Reiss & William KeAupuni Akina, \textit{Show Me the Note!}, 19 \textit{Bank & Lender Liability} 3 (June 3, 2013) (reviewing cases where party initiating foreclosure did not hold mortgage note at commencement of foreclosure).} In some jurisdictions, courts allow banks to foreclose so long as they are the mortgagees; other jurisdictions require banks to have the note to initiate foreclosure.\footnote{See \textit{generally} Whitman & Milner, \textit{supra} note 246 (commenting on the various requirements to initiate a foreclosure in different jurisdictions).} Banks in every jurisdiction can obtain rights to foreclose through possession of the necessary documents. Because timing of their rights is important for REMIC classification, obtaining those rights before initiating legal proceedings may not be sufficient for tax purposes.

The inability to foreclose on an obligation calls into question whether the obligation was secured by real property. REMICs, sponsors, originators, underwriters, and their advisors were put on notice as early as 2001 that their security positions probably lacked legal support. In 2001, the Attorney General of New York concluded that recording a MERS instrument violates New York real property law.\footnote{See MERSCORP, Inc. v. Romaine, 861 N.E.2d 81, 83 (N.Y. 2006) (responding to claim that a MERS instrument cannot be recorded under New York law).} Even though the New York Court of Appeals (the highest court in New York State) later ruled that the clerk had to record the MERS documents,\footnote{See \textit{id.} at 96.} that ruling put RMBS trustees and other industry participants on notice that purported REMICs may not be able to foreclose on mortgage notes that were part of a MERS securitization.

Some commentators claim that an obligation is secured by an interest in real property if, after all of the agreements and rights have been enforced, the RMBS trust ends up with the collateral real property or the proceeds from the sale of that property (the ultimate-outcome argument).\footnote{See \textit{Peaslee} \& \textit{Nirenberg}, \textit{supra} note 169, at 464–65.} They argue that an originator can transfer possession of a mortgage note and assign the mortgage to the purported REMIC before it attempts to...
enforce the mortgage note through payment collection efforts or foreclosure.350 Courts typically find in favor of a bank that holds the mortgage note and the mortgage prior to commencing a foreclosure action, but the outcome is much less predictable if the bank does not hold both instruments when the action commences.351 Thus, the possession of the note and ownership of the mortgage often affect the rights of an RMBS trust.

The ultimate-outcome argument does not hold up under scrutiny. The REMIC rules provide that an obligation is not principally secured by an interest in real property if the obligation’s security is an interest in another obligation.352 The fact that a collateral obligation is secured by an interest in real property does not affect this analysis.353 If an RMBS trust holds an obligation from the originator and that obligation is secured by mortgage notes that the originator holds, the RMBS trust’s obligation is not principally secured by an interest in real property. This result holds true even if interests in real property secure the originator’s mortgage notes. Consequently, if an RMBS trust does not own mortgage notes for tax purposes, but they own an obligation from the originator secured by the mortgage notes, the obligation that the RMBS trust holds will not be principally secured by an interest in real property. This result obtains even though the RMBS trust may be able to foreclose on the originator’s mortgage notes, gain ownership and possession of them and the mortgage, and then foreclose on the underlying real estate. The ultimate outcome of this series of events is the RMBS trust gaining the proceeds from the sale of real property. However, the REMIC rules do not treat the RMBS trust as holding an obligation secured by an interest in real property.

If the ultimate-outcome argument is not effective with respect to obligations secured by interests in real property, it should not be effective with respect to other obligations that require similar foreclosure actions. On this rationale, the ultimate-outcome argument should not apply to obligations that an RMBS trust cannot foreclose upon immediately. If an RMBS trust must take action to compel an originator to transfer a mortgage note and mortgage in order to foreclose on property, the RMBS trust does not own an obligation principally secured by an interest in real property. The state of affairs leading up to the financial crisis indicated that most RMBS trusts could not foreclose on the homes securing their mortgage notes without taking additional steps. Such steps would be similar to those

350. See id.
351. See generally Whitman & Milner, supra note 246 (noting the variation of outcomes when the entity initiating the foreclosure does not hold the promissory note).
353. See id.
a person would take if he or she held an obligation secured by another obligation that was secured by interests in real property. Consequently, many RMBS trusts, including the hypothetical second-lien RMBS trust, probably did not hold obligations secured by real property.

The ability to timely foreclose is critical to the underlying purpose of the REMIC rules. As stated above, the assets of a REMIC must remain static to enable an accurate accounting of the REMIC’s interest income and deductions. The inability to foreclose on the collateral of a loan impedes the static-asset objective. If a REMIC can foreclose in a timely manner, it can restore the cash flow from the defaulted loan with a new loan or other eligible asset. If, however, the REMIC must go through numerous additional steps to foreclose, it loses a source of cash flow for the period of time it takes to complete those additional steps. That loss will affect the computation of income and deduction related to the mortgage notes and interests in the REMIC. Thus, the ability to foreclose immediately is at the heart of the REMIC rules, and the ultimate-outcome argument undermines a fundamental purpose of the rules. Consequently, courts and the IRS should reject the ultimate-outcome argument.

The ultimate-outcome argument links to the timing requirement. The relationship suggests that an obligation may be secured by an interest in real property on the date of acquisition, even if the holder of the obligation is unable to enforce the obligation or initiate foreclosure proceedings at that time. In addition to ignoring the purposes of the REMIC rules, this point of view disregards the timing requirement, which generally requires the RMBS trust to hold the secured obligation on the REMIC startup date, but no later than three months thereafter. The inability to foreclose on a significant portion of the mortgage notes on the startup date (or within three months after it) indicates that many mortgage notes in RMBS trusts were not secured by interests in real property. Because the securitization process using MERS was inadequate, this problem probably applied equally to all types of RMBS trusts created in the years leading up to the financial crisis.

354. See supra Part I.B.
C. Timing Requirement

To satisfy the timing requirement, an RMBS trust must hold qualified mortgages on a specific date keyed to the RMBS trust’s formation. Generally, an obligation is a qualified mortgage only if: (1) the RMBS trust is the tax owner of the obligation on the startup date; or (2) within three months after the startup date, the RMBS trust purchases it.\(^{357}\) Furthermore, an RMBS trust comes within the definition of REMIC only if it holds principally-secured obligations within three months after the startup date.\(^{358}\) The description above of lending and securitization practices reveals that RMBS trusts rarely had possession of mortgage notes or were mortgagees of record within three months after the startup date, much less on the startup date.\(^{359}\) The parties also probably failed to transfer tax ownership to the RMBS trusts within that time period.\(^{360}\) Finally, until an RMBS trust is mortgagee of record and has possession of the mortgage note, it will be unable, in some jurisdictions, to foreclose on the real property securing the mortgage notes,\(^{361}\) so its loans would not appear to be principally secured by an interest in real property within the required time period. Thus, even if an RMBS trust takes some steps to cure defects in the securitization process after the three-month period expires, such efforts probably would not result in the RMBS trust owning an obligation that was principally secured by an interest in real property within the required time period. The failure to own an obligation principally secured by real property within the required time period will cause many RMBS trusts to fail the timing requirement. The failure would be equally applicable to a trust with second-lien mortgages.

D. Substantially-All Requirement

A trust satisfies the substantially-all requirement only if no more than a de minimis amount of the trust’s assets are prohibited assets (i.e., assets that are not qualified mortgages or permitted investments).\(^{362}\) A regulatory safe harbor provides that an RMBS trust satisfies the substantially-all test if the aggregate basis of the prohibited assets is no

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359. See supra Part I.B-C.
360. See supra Part II.A.
361. See REFinBLOG, supra note 4.
362. Treas. Reg. § 1.860D-1(b)(3)(i) (as amended in 1992). This article uses “prohibited asset” to refer to any asset that is not a qualified mortgage or permitted investment.
greater than 1% of the aggregate basis of all of the trust’s assets. 363 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. 364 The regulations neither provide guidance regarding what a trust must do to demonstrate it owns less than a *de minimis* amount of prohibited assets nor do they provide a percentage beyond which the amount of prohibited assets would cease to be *de minimis*. Nonetheless, with the 1% safe harbor and the overall tax accounting reasons for granting special tax treatment to REMICs, 365 a *de minimis* amount of prohibited assets surely cannot exceed a small percentage of an RMBS trust’s total assets. This article illustrates that a significant percentage of the assets of perhaps most RMBS trusts would not come within the definition of qualified mortgage, so perhaps most RMBS trusts formed in the years leading up to the financial crisis would have a difficult time meeting the substantially-all requirement. The hypothetical second-lien RMBS trust would almost certainly fail the substantially-all requirement test.

One might argue that if an RMBS trust is not the tax owner of a mortgage note, the basis of the note reduces both the numerator and the denominator for purposes of applying the substantially-all requirement. This theory is unfounded because it does not account for the trust owning some sort of asset. Even if an RMBS trust’s assets are not qualified mortgages, an RMBS trust still holds some type of asset. If an RMBS trust does not own qualified mortgages, the nature of the asset it does in fact own will likely depend upon the reason the asset fails to be a qualified mortgage. The discussion above illustrates that even if an RMBS trust does not hold qualified mortgages, it could hold a loan from an originator or sponsor. Consequently, for purposes of determining the portion of the trust’s assets that are prohibited assets, these reclassified assets would be a part of both the numerator and denominator. If they are much greater than 1% of the trust’s total assets, the trust will likely not come within the definition of a REMIC. In many situations, reclassified assets appear to be a significant portion of the trust’s total holdings.

For example: if an RMBS trust owns $50,000,000 in assets, but because of a failed securitization it is the tax owner of only $35,000,000 of mortgage notes. The $15,000,000 balance of its assets could be an obligation from an originator. The numerator, for purposes of applying the substantially-all requirement, would be the $15,000,000 obligation from the originator, and the denominator would include all $50,000,000 of the

364. Id.
365. See supra Part II.B (setting forth accounting requirements for REMICs).
trust’s assets. The percentage of prohibited assets would thus be 30% ($15,000,000 divided by $50,000,000). This computation does not exclude the $15,000,000 that results from the trust’s failure to be the tax owner of the mortgage notes.

The discussion to this point has reviewed the state of affairs in the RMBS industry in the years leading up to the financial crisis. It also demonstrates that many RMBS trusts most likely failed to satisfy the REMIC requirements and provided the legal basis for challenging REMIC classification. Some RMBS trusts would have an almost impossible chance of convincing a court that they satisfied the requirements of the REMIC rules. Thus, this Article has presented the legal reasons for challenging the REMIC classification of numerous RMBS trusts. The next part of this Article presents the policy reasons for challenging the REMIC classification of many RMBS trusts.

III. POLICY REASONS TO ENFORCE REMIC RULES

At present, the IRS is probably not auditing REMICs or enforcing the REMIC rules. Perhaps its reason for not challenging REMIC status at this time is that it is studying the issues, observing the outcome of the numerous actions against RMBS trusts, sponsors, and originators, and gathering better information to choose the appropriate trusts to challenge. If the IRS fails to act, private parties will eventually instigate qui tam or whistleblower actions that serve the same policy reasons that should compel IRS action. Because REMICs did not file the correct returns and may have committed fraud, the statute of limitations for earlier years should remain open indefinitely, giving the IRS and other parties adequate time to pursue REMIC litigation after obtaining the necessary information. Ultimately, the IRS should take action against these parties. Failure to do so deprives the government of significant tax revenue, tacitly sanctions illegal behavior, cedes control of tax enforcement decision-making to private industry, disregards Congressional mandate, and relieves the tax bar of its obligation to help protect the tax system and prudently counsel RMBS sponsors and trustees.

The private-label RMBS industry is huge. At its peak in 2007, it held $2.2 trillion in outstanding securities. Large amounts of interest

366. See I.R.C. § 6501(c)(2) (2012) (providing that the statute of limitations remains open indefinitely if a return is fraudulent); I.R.C. § 6501(c)(3) (2012) (providing that the statute of limitations remains open indefinitely if no return is filed). But see I.R.C. § 6501(g)(1) (2012) (providing that the statute of limitations does not remain open indefinitely if a tax corporation, in good faith, files a trust return).

payments are likely to change hands on $2.2 trillion of RMBS. At just 4%, the annual interest alone would be $88 billion. REMIC rules ensure that RMBS investors and RMBS trustees properly account for that interest and pay tax on it. RMBS sponsors’ failure to properly create REMICs caused them to be unable to account for interest inflow and interest outflow. As a consequence, they most likely failed to report income due to the federal government, depriving it of billions of dollars of tax revenue.

By overstating the value of mortgage notes, the parties to RMBS trusts understated the interest rates on those notes. Because of the lack of sufficient collateral securing a mortgage note and borrowers’ lack of qualification, mortgage notes were worth much less than their stated value. Consequently, the stated interest of the note would be much less than the actual interest. For example, if the face value of a mortgage note was $100,000 and the stated interest was 5%, the borrower would pay $5,000 of interest on the note. If, however, the actual value of the mortgage note was $80,000, the $5,000 payment would represent a 6.25% interest rate. A RMBS trust that reported interest income using the 5% rate would underreport income. Therefore, if the interest deductions were otherwise appropriate, the RMBS trust would understate its taxable income. Additionally, the inability to maintain a static asset pool with the types of assets entering RMBS trusts and their poor quality would result in a miscalculation of phantom income, further depriving the government of tax revenues.\textsuperscript{368}

The IRS’s lack of enforcement in this area prior to the financial crisis contributed to the magnitude of the crash.\textsuperscript{369} If the IRS had audited RMBS trusts, it would have recognized the inadequacies of the securitization process, the poor quality of mortgage notes being securitized, and the lack of effort to cure defective mortgage notes. Enforcement would have presented RMBS sponsors not only with the prospect of losing favorable tax classification for multiple-tranche RMBS products, but also would have threatened to expose their misdeeds to unsuspecting investors. Exposure would have ended the demand for shoddy RMBS products, which potentially would have placed sufficient market pressure on RMBS organizers and loan originators to clean up their acts. Thus, the IRS could have helped deter the financial crisis. Its continued failure to enforce

\textsuperscript{368} See \textit{supra} text accompanying note 44 (explaining the difficulties in correctly calculating income for RMBS trusts).

\textsuperscript{369} See Bradley T. Borden, \textit{Did the IRS Cause the Financial Crisis?}, HUFFINGTON POST (Oct. 18, 2012), http://www.huffingtonpost.com/bradley-t-borden/did-the-irs-cause-the-fin_b_1972207.html (arguing that the IRS could have prevented the financial crisis by more actively policing REMICs).
REMIC rules empowers RMBS organizers and loan originators to repeat their actions using REMIC classification as a front for illegal action.

The IRS has been slow to enforce the REMIC rules and clean up the RMBS industry. Instead, the actions it has taken have benefitted many of the parties who caused the financial crisis. On December 6, 2007, the IRS released Revenue Procedure 2007-72, which stated “it would not view loan modifications specifically made under these guidelines [framework to fend off foreclosure of subprime mortgages] as grounds to challenge the tax benefits held by REMICS . . .”370 In October 2009, the IRS provided some flexibility for CRE loans held in a REMIC. This was later followed by federal bank regulators encouraging lenders not to foreclose on delinquent CRE borrowers because of the economic downturn.371 On August 17, 2010, the IRS announced that it would not challenge the ability of REMICs “to claim certain loans as ‘qualified mortgages’ even if they no longer meet the specific requirements of such loans under tax code Section 860.”372 These IRS actions were not directed at the heart of the problem, but rather appear to accommodate the parties who caused the financial crisis.

At least one commentator worries that taxing REMICs will unduly harm investors.373 The sponsors’ failure to adequately structure REMICs, with no enforcement of the laws, has harmed investors. And sponsors’ failure to structure the arrangements to obtain favorable tax treatment also harms the investors because the tax exposure reduces the value of the REMIC interests. Investors should be able to recover that lost value from the sponsors, so the tax burden, which represents revenue properly belonging to U.S. taxpayers, should fall upon the wrongdoers who organized these shams and misrepresented their quality to investors. Furthermore, the IRS may be able to impose transferee liability on the sponsors who transferred mortgage notes worth far less than the consideration received and collect any taxes and penalties not covered by the value of RMBS trusts’ assets.

370. Alison Bennett, IRS Reassures REMICs It Will Not Challenge Tax Status if Subprime Loans Are Modified, 89 BBR 948 (Dec. 10, 2007).
371. Richard Cowden, Securitizers Gearing up from ‘CMBS 2.0’ In a Market Where Demand Outstrips Supply, 3 REAL EST. & INDUS. REP. 474 (Jul. 13, 2010).
The IRS’s unwillingness to enforce the REMIC rules cedes control to private industry, which is aware of and abuses its position of power. As one commentator noted,

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. 374

Industry experts who made rules as they went along now invoke the Wall Street Rule. An author of the leading REMIC treatise is credited with saying that “even if the IRS finds wrongdoing, it may be loath to act because of the wide financial damage the penalties would cause,”375 Such patent recognition of IRS impotence is frightening and threatens to undermine not only the tax system but also the already tenuous ideal of treating taxpayers equally. The IRS should not cede control to private parties. If the IRS had audited in the years leading up to the financial crisis, it could have prevented the problem in the first place and would not have to take action now that could potentially cause financial damage.

If the concern is that enforcement at this time will cause wide financial damage, this article should help alleviate that concern. The IRS could focus on low-hanging fruit, such as second-lien mortgage RMBS trusts that claimed to be REMICs. Second-lien mortgage RMBS trusts formed in the years leading up to the financial crisis almost certainly will not satisfy the REMIC requirements. Proving a case against them will be very possible for the IRS. Also, second-lien mortgage RMBS issuances were comparatively small, with about $60 billion in 2005. 376 Financial damage to the world economy will not result from challenging the tax classification of second-lien mortgage RMBS trusts. The trusts will owe taxes and penalties, and the parties will have to determine the ultimate liability for those taxes and penalties. Under a transference liability theory,


that liability could rest with the RMBS sponsors or loan originators—the parties most responsible for the financial crisis.

After pursuing second-lien mortgage RMBS trusts, the IRS could evaluate the results and decide whether they should make a case with respect to other types of RMBS trusts and pursue further action against them. IRS enforcement, even with respect to a portion of the RMBS market, will help the IRS develop further expertise in this area and enable it to use the expertise to develop better audit and enforcement practices. The IRS could use those improved skills to help prevent a catastrophe similar to the one that caused the financial crisis. Enforcement would also reestablish the IRS as the police power in this area and take back that function from Wall Street. Finally, enforcement in this area would bring other viewpoints and voices to lawmaking in this area.

The IRS’s inaction also damages the tax system in a more general way. The tax bar traditionally has accepted some responsibility for upholding the integrity of the tax system. Members of the bar do this by ensuring that advice they give reflects the highest standards and that they do not participate in transactions that violate the law. This article illustrates that a significant percentage of RMBS trusts probably do not satisfy the REMIC requirements, but RMBS organizers treated them as REMICs. Some RMBS trusts appear to have almost no chance of satisfying the requirements. Nonetheless, “will” tax opinion letters accompanied RMBS offering materials. A will opinion is the authors’ assurance that the RMBS trust has a 95% chance of prevailing on the merits should the IRS challenge the classification. The authors of will opinions qualify them by providing that they are reliable only if the securitization occurs as described in the offering materials. Despite that qualifier, opinion authors should be accountable for inaccurate opinions to the extent that they were aware of the RMBS problems. As industry participants who were close to the action, they probably knew about many of the problems that existed. Because of the Wall Street Rule and IRS inaction, they continued to issue unsupported opinions. If the IRS does not enforce the REMIC rules, members of the bar arguably will feel no greater obligation to abide by the rules. Consequently, the IRS’s inaction causes exponential damage to the tax system as a whole.

377. See Robert P. Rothman, Tax Opinion Practice, 64 TAX LAW. 301, 312 (Winter 2011) (stating that “will” opinion has no material chance of being wrong).

378. See id. at 367.

379. See Complaint, supra note 7, available at https://iapps.courts.state.ny.us/fbem/DocumentDisplayServlet?documentId=4EP2AF38l3ql/RHTZ6TMYQ==&system=prod (revealing that attorneys and accounting firms were aware of the securitization deficiencies).
Finally, IRS inaction is an affront to the law that grants favorable tax treatment to only certain types of RMBS trusts. This offends many commentators who believe that the IRS should not exercise such discretion but should enforce the laws as created by Congress.\textsuperscript{380} Furthermore, the detailed rules in the REMIC regime address specific purposes,\textsuperscript{381} and a failure to enforce the rules undermines those purposes. Consequently, significant policy supports the IRS challenging REMIC classification of at least some RMBS trusts. If the IRS fails to take action, it must accept responsibility for the resulting financial harm.

\textbf{CONCLUSION}

The issue of REMIC failure is important in at least four contexts: (1) in any potential effort by the IRS to clean up the industry and collect tax and penalties from organizations that did not satisfy the REMIC requirements; (2) in civil lawsuits brought by REMIC investors against sponsors, underwriters, and other parties who pooled mortgages and sold mortgage-backed securities; (3) to state and federal prosecutors who may consider bringing criminal or civil fraud claims against sponsors, underwriters, and other parties who pooled mortgages and sold RMBS; and (4) to private parties who know of specific abuse and may bring \textit{qui tam} or whistleblower action against purported REMICs. This article provides a roadmap for pursuing tax enforcement action against RMBS trusts. It illustrates that many RMBS trusts, perhaps the majority of them, formed in the years leading up to the financial crisis could not satisfy the REMIC requirements. Instead of advocating action against all such trusts, however, the IRS should consider bringing action against RMBS trusts that fail to satisfy the REMIC requirements. A logical starting point would therefore be an examination of RMBS trusts comprised of second-lien mortgage notes. Findings and results of such actions would inform the IRS about whether it should expand the scope of its efforts. Both law and policy support this action, so continued inaction is unacceptable.

\textsuperscript{380} See, e.g., Yves Smith, \textit{IRS Likely to Expand Mortgage Industry Coverup by Whitewashing REMIC Violations}, \textit{Naked Capitalism} (Apr. 28, 2011), http://www.nakedcapitalism.com/2011/04/irs-likely-to-expand-mortgage-industry-coverup-by-whitewashing-remic-violations.html#sdR8UXJzAHLllBG.99 (arguing that the IRS employs a “nothing to see here” strategy regarding widespread violations of REMICs rules to avoid “blow[ing] up the mortgage industrial complex” and reigniting the financial crisis).

\textsuperscript{381} See supra Part I.