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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 numerous aspects of the 2008 Financial Crisis and the role that residential mortgage-backed securities (RMBS) played in that crisis. Big banks create RMBS by pooling mortgage notes into trusts and selling interests in those trusts as RMBS. 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 is the first to examine 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 jeopardize 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, which facilitates future economic catastrophes. Even without the IRS taking action, private parties can rely upon the blueprint set forth in the Article to 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.

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I. 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 and it also fuels economic growth. Unfortunately, in the years leading up to the 2008 Financial Crisis, REMIC sponsors disregarded Congressional mandates, labeling arrangements as “REMICs” even though they did not qualify for that label. 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 of the notes. Having
established these purported REMICs, the organizers then misrepresented their quality to investors.

The practices of REMIC organizers were an integral part of 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 his knees as its 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.1 The 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 help prevent or, at least, reduced the magnitude of the Financial Crisis. Now the IRS must take action to help clean up the mess and collect 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 (commonly 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. Loan originators 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 be a REMIC and receive favorable tax treatment.2

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 to audit REMICs and enforce the REMIC rules thus allowed practices to deteriorate and was one of the causes of the Financial Crisis. Having missed that opportunity, the IRS should now take action by challenging the classification of at least certain types of REMICs. Such actions will add to government revenues, put mortgage securitizers on notice that they must comply with Congress’ mandates, re-establish 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.

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2 See infra text accompanying notes 151-153.
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.\(^3\) 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.\(^4\) 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.\(^5\) In other jurisdictions, courts allow purported mortgage holders to proceed with foreclosures or participate in bankruptcy proceedings.\(^6\) States have also filed lawsuits against lenders and other financial institutions in the mortgage industry claiming unfair and otherwise inappropriate lending and foreclosure practices.\(^7\) The results of some of these actions appear in headlines reporting settlements between states and financial institutions that total many billions of dollars.\(^8\)

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.\(^9\) Much

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\(^4\) REFinblog.com presents and summarizes both downstream and upstream litigation matters.

\(^5\) See id.

\(^6\) See id.


\(^9\) See infra text accompanying notes 93-144.
of the upstream litigation is in its early stages but involves astronomical sums of money. Figure 1 summarizes the litigation landscape in this area.

![Figure 1: Upstream and Downstream Litigation](image)

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 flagrantly violate the REMIC rules.

Part II 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 simply ceased to satisfy the applicable requirements. The result was disastrous.

Part III provides the legal basis for challenging the REMIC classification of many RMBS arrangements. A comparison of 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 therefore 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 IV 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 allows parties to siphon significant tax revenue from government coffers. The failure to audit purported REMICs 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’s economy to its knees. Part V concludes.

II. OVERVIEW OF RMBS INDUSTRY AND ROLE OF REMICS

For generations, Americans who wanted to buy a home would typically contact a local thrift institution such as a savings and loan, or bank, and speak to a loan officer who would evaluate their applications. Reserve requirements and balance sheet restrictions limited the amount of money institutions could lend under these conditions.11 That system stifled growth by limiting the amount of cash available to lend to potential homeowners.12 Limited amounts of cash drive up interest rates, making homeownership available only to people with prime

12 See id.
profiles. Thus, the traditional practice for financing home ownership needed innovation to make homeownership possible for a larger segment of society. The answer appeared to lie with Wall Street.

A. Origins of the RMBS Market

Wall Street investors had 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 are carefully structured to achieve precise tax, accounting, and regulatory treatment to make them attractive to such investors. To help reduce risks associated with local economies the pool of mortgages were drawn from diverse locations. Interests in these pools of mortgages are 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. While Fannie had created a secondary market for certain loans prior to 1970, 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, meaning they had to meet strict standards related to the borrower’s credit worthiness and the value of the collateral.

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14 A part of the discussion of the history of RMBS derives from Reiss, *supra* note 13.
16 See Reiss, *supra* note 13, at 1004.
18 See id. at 1032.
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 not related to the federal government such as commercial banks and mortgage companies began to issue RMBS. These “private label” securities do 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 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 the mortgage-note pools as investment trusts, which required the mortgage-note pool to remain constant and the investors to have proportionate interests in the mortgages that equaled their proportionate 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

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21 Id.
23 See id.
becoming a taxable entity. Thus, RMBS sponsors had to choose between a single tranche flow-through pool or a multiple-tranche taxable pool of mortgages.

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 can pay 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. The lower-rated tranches thus have higher risk and pay a higher rate of interest. The ability to provide tranches with different risk profiles make RMBS attractive to a broader swathe of investors and add more capital to the residential mortgage market. Most importantly, the least risky tranches were rated investment-grade by the rating agencies, making them eligible for purchase by a range of institutional investors.

As noted, the problem with the multiple-tranche RMBS structure was that it would not qualify for flow-through taxation. Consequently, a multiple-tranche RMBS trust would be a tax corporation and have to pay tax on interest it earned on loans; interests in such a trust might have been equity and not debt, so payments to holders might not have been deductible; and RMBS holders would have to pay tax on payments that they received. Thus, the tax aspects of multi-tranche RMBS structures made them unattractive to investors.

Congress was concerned about granting favorable tax treatment to multiple-tranche RMBS structures because cash inflows and outflows and interest income and deductions of such structures do not match. Because the risk profile and date to maturity of the different tranches vary, the interest rate for the various tranches varies, and the RMBS trust and the RMBS investors recognize interest income at different times under the rules governing original issue discount. Even if over time the income of RMBS holders and of the RMBS trust equalized, the

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27 See 1986 Bluebook, supra note 25, at 407; Treas. Reg. § 301.7701-4(c) (amended Dec. 17, 1996) (“An ‘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 cases of ownership interests ordinarily will be classified as a [corporation].”).
29 See I.R.C. § 163(a) (allowing a deduction for interest payment, but no similar deduction exists for dividend payments).
30 See I.R.C. § 61(a)(7).
timing difference of that recognition 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.\textsuperscript{33} Thus, Congress would only grant flow-through treatment to multiple-tranche RMBS trusts if it could solve that problem.

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

\textsuperscript{33} See id. at 154–156, 184–185 (describing the timing difference).
\textsuperscript{34} See 1986 Bluebook, supra note 25, at 412 (“Holders 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) (“Holders 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 the regular interests . . . .”).
\textsuperscript{35} See I.R.C § 860B(b) (requiring the use of the accrual method); § 1272(a)(6) (applying special accrual rules to regular interest investors).
\textsuperscript{36} See I.R.C. §§ 860C(a), 860E(a) (requiring that the residual interest holder’s income be no less than the excess inclusion (“phantom income”) for the year).
\textsuperscript{37} See supra text accompanying note 37.
\textsuperscript{38} See Van Brunt, supra note 31, at 203.
\textsuperscript{39} See I.R.C. § 1272(a)(6)(A) (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)(ii), (iii) (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 1986 Bluebook, supra note 25, 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 Treasure regulations
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 the RMBS trust. It also supports a fairly accurate assessment of the value of the mortgage notes in the pool and the likelihood that the borrowers will make timely payments on the loans. Factors such as the creditworthiness of the borrower, the value of the 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 and the likelihood and timeliness of payments. Consequently, Congress imposed strict requirements related to the trust assets that multi-tranche RMBS trusts must satisfy to qualify for REMIC flow-through treatment. RMBS trusts that fail to

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40 See I.R.C. § 860A.
41 See, e.g., Griffin & Maturana, supra note 3 (identifying negative impact on payments of unreported second liens, inflated appraisals, misrepresentation of owner occupancy and flipping); State-Level Guarantee Fee Pricing: Notice, 77 Fed. Reg. 58991, 58991 (Sept. 25, 2012) (noting “the exceptionally high costs” incurred “in cases of mortgage default in” certain states).
42 See I.R.C. §§ 860D, 860G; infra Part III.
satisfy these requirements cannot accurately compute the income of the RMBS holders and can siphon revenues from government coffers, if they use REMIC flow-through taxation. 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 elect 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 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 of 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 the first 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 indorsed the note and transferred possession of it. As part of the second step, the REMIC sponsor recorded the

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43 For example, miscalculations may result in understated phantom income of the holders of residual interests. 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 result in the trust reporting 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.

44 See I.R.C. § 7701(i) (treating taxable mortgage pools as tax corporations); 1986 Bluebook, supra note 25, at 411 (“The 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 the availability of other vehicles should be limited to the extent possible.”).


47 See generally 4 MICHAEL ALLAN WOLF, POWELL ON REAL PROPERTY § 37.28 (2013).

48 See Reiss, supra note 13, at 1003 (describing securitization process).

49 See WOLF, supra note 47, § 37.27.
transfer of the mortgage note and mortgage. 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. The REMIC trust had no managers, so its trustee recorded the transfer of the mortgage note and mortgages with the county clerk. Fourth, the sponsor sold the beneficial interests in the REMIC trust to investors. Figure 3 illustrates the traditional RMBS securitization process from its inception in the 1970s until the 1990s.

B. Mortgage Securitization with MERS

The process of assigning mortgages had been universally cumbersome until the end of the 20th Century. Each assignment from originator to sponsor or from sponsor to mortgage-note pool would be 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

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50 See id.
51 See FESTA, supra note 11, § 4.02.
52 See JASON H.P. KRAVITT, SECURITIZATION OF FINANCIAL ASSETS § 9.02 (2012).
53 See FESTA, supra note 11, § 4.02.
originator to the mortgage-note pool. They thought they had accomplished 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 the need of recording each assignment in the local land records. A MERS mortgage contains a statement that says, in substance, that “MERS is a separate corporation that is acting solely as nominee for the Lender and Lender’s successors and assigns. MERS is the mortgagee under this Security Instrument.” 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 the legal status of this private MERS tracking system was not clear and had not been ratified by Congress or 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, and MERS registered millions of mortgages within a couple of years of its inception. 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.”

A MERS-facilitated securitization originally occurred as follows: First, a person would borrow from a loan originator, execute a note to the originator, and grant the originator a mortgage in the property securing the loan. Second, the originator would record the mortgage in the local recording office, naming MERS as nominee. Third, the originator would assign its rights in the mortgage note and mortgage and transfer them to an RMBS sponsor, and MERS would record the assignment. Fourth, the sponsor would assign the mortgage note and mortgage and transfer them to the RMBS trustee, and MERS would record the assignment. Fifth, MERS would update its database to reflect the transfer of the mortgage to

55 Id.
56 Id.
57 See id.
59 For example, 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).
60 Sargent & Harris, supra note 54.
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 to the early 2000s.61

During this period of time, RMBS sponsors became more sophisticated and the types of loans that lenders made proliferated, so RMBS sponsors expanded the types of RMBS that they offered. Such specialized mortgage-note pools included adjusted-rate-mortgage (ARM) loans with teaser rates, cash-out home equity loans, and various subprime products.62 One type of RMBS pool that emerged, and that is of particular interest here, 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.63 These new products appeared to accelerate the demand for RMBS. As that demand increased in the early 2000s, loan originators and

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62 See FINANCIAL CRISIS INQUIRY COMMISSION, supra note 3, at 102.
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. Therefore, 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 related to lax securitization practices. Upstream litigation (litigation between RMBS investors and banks) is a primary source of information relating to 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 very consistent with the findings of the Financial Crisis Inquiry Commission, the analysis 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 very likely describes many RMBS trusts. The discussion also relies upon just a handful of 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

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64 See generally FINANCIAL CRISIS INQUIRY COMMISSION, supra note 3.
68 See id. at 627.
the lender; no endorsement by Countrywide appeared on the note. An unsigned allonge of the same date accompanied the note and directed Mr. Kemp to “Pay to the Order of Countrywide Home Loans, Inc., d/b/a America’s Wholesale Lender.” On the same day, Mr. Kemp signed a mortgage in the amount of $167,000, which listed the lender as America’s Wholesale Lender, 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 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.

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

69 See id.
70 See 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).
71 See Kemp, 440 B.R. at 627.
72 See id.
73 See id. Park Monaco, Inc., and Park Sienna, LLC, also entered into the PSA as sellers. See id.
74 See id.
75 See id.
76 See id.
77 See id.
78 See id. at 627–28.
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 voluntary 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, it went to its foreclosure unit. She also testified that the new allonge had not been attached to Mr. Kemp’s note and that customarily, Countrywide maintained possession of the notes and related loan documents.

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. It also produced a Lost Note Certificate dated February 1, 2007, providing that Mr. Kemp’s original note had been “misplaced, lost or destroyed, and after a thorough and diligent search, no one has been able to locate the original Note.” The court therefore concluded that at the time of the

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79 See id. at 627.
80 See id.
81 See id.
82 See id. at 626.
83 See id.
84 See id.
85 See id. at 628.
86 See id. The allonge misidentified the asset-backed certificates as 6006-8 instead of 2006-8. See id. at n.5.
87 See id. at 628. The record leaves some doubt about whether the supervisor worked for the successor of Countrywide Home Loans Servicing LP or Countrywide Home Loans, Inc. See id. at 626 n.3, 628 n.6.
88 See id. at 628.
89 See id.
90 See id. at 628–9.
91 See id. at 628 n.7.
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. Figure 5 summarizes the relevant Kemp facts, illustrating the failure to timely transfer and record purported assignments of mortgage notes and mortgages.

![Figure 5: Kemp Timeline](image)

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

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92 See id. at 629.
94 See Nordbank Consolidated Complaint, supra note 93, at 15–16.
the trusts.\textsuperscript{95} 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 7, or 1.6\% of the total notes were transferred to the trusts within three months after the issuance of the RMBS.\textsuperscript{96} Investigations also revealed that of the mortgages that the parties did eventually assign to the RMBS trusts, several were assigned to the wrong trust.\textsuperscript{97} Other RMBS trustees apparently disregarded and failed to disclose audit information that confirmed that the RMBS trust did not have possession of the notes.\textsuperscript{98} 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 they 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 to transfer the mortgage notes and mortgages,\textsuperscript{99} 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 arise when notes are not properly transferred.\textsuperscript{100} This scandal is further evidence that the securitization process in the years preceding the Financial Crisis failed terribly. Figure 6 depicts the securitization process described in Kemp that was prevalent in the years leading up to the Financial Crisis.

\begin{itemize}
\item \textsuperscript{95} See id. at 16.
\item \textsuperscript{96} See id. at 18.
\item \textsuperscript{97} See id. at 17.
\item \textsuperscript{98} See Knights of Columbus Amended Complaint, supra note 93, at 21–22.
\item \textsuperscript{99} See, e.g., Nordbank Consolidated Complaint, supra note 93, at 19.
\end{itemize}
The discussion below illustrates that failure of the securitization process jeopardizes the REMIC status of numerous RMBS trusts.101

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 they had transferred the mortgage notes and mortgages, the quality of the loans represented by the notes and mortgages was so poor, they would not satisfy REMIC requirements. The following discussion illustrates that RMBS sponsors failed to adequately perform due diligence and 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 undercollateralized. As a result of these problems, many loans were delinquent (or delinquency was imminent) when they entered the RMBS trusts.

101 See infra Part III. A.
1. Failure of Mortgage Underwriting and Due Diligence

A critical part of the RMBS securitization process is the mortgage underwriting function. Loan originators underwrite loans they make. Underwriting in this context is the process of assessing the potential risk and profitability of making a loan to a particular borrower.\(^{102}\) Traditional home mortgage underwriting included three elements: (1) collateral, (2) borrower creditworthiness (i.e., willingness to pay), and (3) the borrowers capacity to pay (e.g., income).\(^{103}\) Originators abandoned those traditional underwriting guidelines, and, often with the knowledge of RMBS sponsors, transferred low-quality mortgages notes and mortgages to RMBS trusts. Originators found that the more risky loan products were the most profitable, so they pressed sales agents to push the risky products, such as option ARM, home equity, and subprime loans, and they structured sales-agent compensation to encourage such efforts.\(^{104}\)

As a result of the failed underwriting function, the lending practices in the mid-2000s became abysmal. Originators failed to verify borrowers’ employment or income, made loans to borrowers who 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.\(^{105}\) Originators would also fake proof of loan applicants’ employment and rent-paying history.\(^{106}\) 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.”\(^{107}\) As part of Hustle, the origination eliminated toll gates that slowed the originator process, including processes necessary for originating investment-quality loans.


\(^{103}\) See Ling & Archer, supra note 102, at 304.


\(^{105}\) See Bajaj, supra note 104; JPMorgan Amended Complaint, supra note 104, at 93, 172–187.

\(^{106}\) See, e.g., Internal Revenue Service, Examples of Mortgage and Real Estate Fraud Investigations - Fiscal Year 2013, http://www.irs.gov/uac/Examples-of-Mortgage-and-Real-Estate-Fraud-Investigations-Fiscal-Year-2013 (listing successful prosecutions involving misrepresentations in loan applications of employment, rent payment and other material terms); Financial Crisis Inquiry Commission, supra note 3, at 12 (noting that Minnesota Attorney General’s office found “file after file where the [Ameriquest] borrowers were described as ‘antiques dealers’”).

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. With this process, they would make loans to just about anybody who applied for one, even though the borrowers clearly did not qualify. RMBS sponsors were aware that originators had abandoned their underwriting guidelines.

RMBS sponsors also relaxed their due diligence practices 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 due diligence standards and accepted poor-quality loans. They also abandoned basic due diligence tasks, such as determining the reasonableness of income in a stated-income loan. 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. The poor quality of loans does not satisfy REMIC requirements.

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

108 See id.
109 See id.
111 See, e.g., FINANCIAL CRISIS INQUIRY COMMISSION, supra note 3, at xxii; BoA Complaint-in-Intervention, supra note 107, at 16.
112 See, e.g., FINANCIAL CRISIS INQUIRY COMMISSION, supra note 3, at xxii; JPMorgan Amended Complaint, supra note 104, at 197–232.
113 See Dexia 12 Civ. 4761, at 12.
115 See, e.g., FINANCIAL CRISIS INQUIRY COMMISSION, supra note 3, at 109-11; J. P. Morgan Securities Complaint, supra note 7, at 19.
116 J. P. Morgan Securities Complaint, supra note 7, at 19.
117 See infra part III. B.
the owners have less interest in a property with a high LTV ratio.\textsuperscript{118} For example, if the loan is 90% of a $150,000 property, the owner’s interest in the property is only $15,000 ($150,000 x 10%), giving the owner ten percent equity. On the other hand, if the LTV ratio is 60%, the owner’s interest is $60,000 ($150,000 x 40%). Thus, the owner with an LTV ratio of 60% would lose more than an 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{119}

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, sponsors pressured originators and originators pressured appraisers to help ensure that the appraised values met the sponsors’ requirements.\textsuperscript{120} In fact, a 2007 study reported that 90% of appraisers had been pressured to raise property valuations.\textsuperscript{121} Originators blacklisted appraisers who refused to inflate collateral values, and sponsors instructed due diligence vendors not to review appraisals.\textsuperscript{122} As a result of these measures, appraisers increased the stated appraisal value of collateral 80% of the time that originators requested reconsideration.\textsuperscript{123}

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.\textsuperscript{124} To illustrate, an appraiser might overvalue a home by 10% based upon comparable sales and a few months later

\textsuperscript{118} See generally Min Qi & Xiaolong Yang, \textit{Loss Given Default of High Loan-to-Value Residential Mortgages}, 33 J. BANKING & FIN.788 (2009).
\textsuperscript{119} See \textit{id.}
\textsuperscript{121} See id.
\textsuperscript{122} See \textit{id.}
overvalue a similar home by an additional 10% based on the recent appraisal.\(^{125}\) Through this cumulative process, appraisals significantly contributed to a run-up in property values.\(^{126}\) 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 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).\(^{127}\) RMBS sponsors routinely overstated the percentage of loans that they securitized with low LTV ratios and understated the percentage of loans that were underwater.\(^{128}\) In fact, studies of loans in numerous RMBS trusts found that the RMBS sponsors routinely represented that the pools had no underwater loans.\(^{129}\) Samples of the loans in those pools showed, however, that a material portion of loans from the studied pool was underwater, with percentages of underwater loans in several pools exceeding 10% and some exceeding 30%.\(^{130}\) Not surprisingly, RMBS sponsors, who made it their business to know this industry, appeared to be aware of the inflated appraisals and the effect they had on LTV ratios.\(^{131}\)

\(^{125}\) See Stichting Complaint, supra note 114, at 78 (citing the testimony of Richard Bitner, a former executive of a subprime mortgage originator).

\(^{126}\) See, e.g., id.; Financial Crisis Inquiry Commission, supra note 3, at 18, 91-92.

\(^{127}\) See, e.g., Stichting Complaint, supra note 114, at 81; Financial Crisis Inquiry Commission, supra note 3, at 404.

\(^{128}\) See Stichting Complaint, supra note 114, 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 104, at 138–142 (presenting data that shows RMBS promoters routinely overstated the loans with low LTV ratios and understated the percentage of underwater loans).

\(^{129}\) See JPMorgan Amended Complaint, supra note 104, at 138–142; Stichting Complaint, supra note 114, at 28-29.

\(^{130}\) See JPMorgan Amended Complaint, supra note 104, at 138–142; Nordbank Consolidated Complaint, supra note 93, at 28-29.

\(^{131}\) See, e.g., Stichting Complaint, supra note 114, at 79–82.
they populated RMBS trusts with undersecured loans. Those actions undermine REMIC classification.

3. Failure to Screen and Cure Delinquent Loans

In addition to the other defects described above, 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. For example, RMBS sponsors would transfer loans to trusts prior to the expiration of the early payment-default period (the 30- to 90-day period following the purchase of a loan during which the sponsor could force the originator to repurchase a delinquent or default loan). 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. Sponsors also knew that loans from certain originators had high delinquency rates, but they continued to purchase loans from those originators and securitize them. In fact, sponsors recognized that a significant portion of the loans that they were securitizing were 30 or more days delinquent, but they continued to transfer them to trusts and sell securities in the trusts.

Despite high delinquency rates, RMBS sponsors did not enforce repurchase provisions of the PSAs. Instead, sponsors and originators would collude to skirt repurchase provisions of the PSA 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. If a loan was in default prior to the end of the early payment-default period, it would be defective and covered by the PSA’s repurchase provision. Instead of enforcing the repurchase provision and

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132 Dexia, 12 Civ. 4761, at 15.
133 See infra Part III. B.
136 See id. at 23–24.
137 See J. P. Morgan Securities Complaint, supra note 7, at 11 (claiming that the sponsor knew that the almost 60% of an originator’s loans were 30 or more days delinquent, but they continued to purchase loans from that originator).
138 See id. (referring to securitization as a “SACK OF SHIT” and “shit breather” because the loans the sponsor was securitizing were so terrible).
139 See, e.g., Dexia, supra note 110, at 7.
141 See KRAVITT, supra note 52, § 16.04.
142 See id.
removing defective loans from the RMBS trust, however, a sponsor would enter into confidential settlements with originators at a fraction of the loan’s original price. The sponsor could then pocket the settlement payment and leave the defective loan in the RMBS trust. Not only did such behavior deprive RMBS investors of assets that were rightfully theirs, the behavior also demonstrates that RMBS sponsors were well aware that the loans they were securitizing were well below the quality they represented in the offering materials. These practices could deny RMBS trusts REMIC classification.

E. Realistic Hypothetical RMBS Trust

The information from numerous sources paints a bleak picture of the state of the RMBS industry and reveals that a significant percentage of the products that RMBS sponsors sold during the years leading up to the Financial Crisis were rubbish. Until plaintiffs exhaust their investigations through discovery, try cases with respect to specific RMBS trusts, and courts decide such cases and publish the facts, the general public cannot know with specificity all of the bad acts that RMBS organizers engaged in with respect to any single RMBS trust. Nonetheless, information in the news media, academic studies, court filings, and government reports provide 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. This information provides the opportunity to create a realistic hypothetical. Undoubtedly, some trusts would not suffer from all of the ills that afflict the 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. The following realistic hypothetical trust provides the 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 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.

Characteristics of Realistic Hypothetical Second-Lien RMBS Trust

- The sponsor issued RMBS in the hypothetical trust in early 2007.

144 See id.
145 See infra Part III. B.
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.

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.

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.
- 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 from defective loans.

III. 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 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

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146 See I.R.C. § 860A(a).
147 See I.R.C. §§ 860B(a), 860C(b)(1)(A).
payments to the holders of regular interests. Without these rules, a REMIC would most likely be a tax corporation and the regular interests could be equity interests. If that were the case, the REMIC would not be able to deduct payments made to the regular interest holders and, as a taxable C corporation, would owe federal income tax on a very significant amount of taxable income. Thus, REMIC classification provides significant tax benefits.

To obtain REMIC classification, an RMBS trust must satisfy several requirements. 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). 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. REMIC classification thus 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 Treasury designed the REMIC classification rules for arrangements that existed in 1986 when Congress created REMICs. The rules do not address the wide scale problems of the Financial Crisis, so many of the issues discussed in the following analysis will be issues of first impression when a

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148 See I.R.C. §§ 163(a), 860C(b)(1)(A); Van Brunt, supra note 31, at 168 (“[R]egular 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.”).

149 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 52, § 16.04.

150 See supra text accompanying notes 28-30.

151 See, e.g., I.R.C. §§ 860D(a) (defining REMIC); 860D(b) (requiring the RMBS trust to make an election).


153 The principal assets of a mortgage-backed security are mortgages, not the type of asset that comes within the definition of 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 permitted investment.

154 See supra text accompanying notes 40-44.
court considers them. A large body of law considers the question of tax ownership in various contexts, including the ownership of obligations, but none of that law considers 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 extensive body of law governing 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 looks 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 considering who is the tax owner of property. To properly discern the

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155 Courts are just beginning to identify the interplay between the REMIC rules, foreclosure statutes and the laws governing the transfer of notes. See, e.g., Glaski v. Bank of America, No. F064556 (July 31, 2013 Cal. 5th App. Dist.).
156 See infra Part III. A.
157 See I.R.C. § 860 D(a)(4) (requiring substantially all of a purported REMIC’s assets to be qualified mortgages or permitted investments within three months after the startup date).
159 See, e.g., 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 with the taxing statute prescribes for giving the favored treatment to capital gains.”); United States v. Mitchell, 403 U.S. 190, 197 (1971).
160 See Bailey v. Comm’r, 912 F2d 44, 47 (2d Cir. 1990).
161 A frequently cited case for this principle is Grodt & McKay Realty, Inc. v. Comm’r, 77 T.C. 1221, 1237 (1981). Other authorities include 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, See also I.R.S. Field Serv. Adv. Mem. 2001-30-009 (Apr. 20, 2001); Tech. Adv Memo. 98-39-001 (May 29, 1998). In Grodt & McKay Realty, Inc., 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
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.” If, however, the transaction does not coincide with the parties’ bona fide intentions, courts will ignore the stated intentions. Thus, the analysis of ownership cannot merely look to the agreements the parties entered into because the label parties give to a transaction does not determine its status. Instead, the analysis must examine the underlying economics and the attending facts and circumstances to determine who owns the mortgage notes for tax purposes.

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 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.” Grodt & McKay Realty, Inc. v. Comm’r, 77 T.C. 1221, 1237–38 (1981) (internal citations omitted).

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162 See Haggard v. Comm’r, 24 T.C. 1124, 1129 (1955), aff’d 241 F.2d 288 (9th Cir. 1956).
164 See Helvering v. Lazarus & Co. 308 U.S. 252, 255 (1939); Mapco Inc. v. United States, 556 F.2d 1107, 1110 (Cl. Ct. 1977); Priv. Ltr. Rul. 80-191-20 (Dec. 20, 1979) (disregarding a lease agreement to rule privately that an arrangement was a sale).
165 See Helvering v. F.&R. Lazarus & Co., 308 U.S. 252, 255 (1939) (“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); Wash. Mut. Inc. v. 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)).
166 See JAMES M. PEASLEE & 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.”).
167 See In re Kemp, 440 B.R. 624 (Bkrtcy.D.N.J. 2010). A claim in bankruptcy is disallowed after an objection “to the extent that . . . such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is
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. 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 indorsement. Recognizing
that the mortgage note came within the U.C.C. definition of negotiable
instrument, the court considered who is 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 right of a holder, or [3] a person not in
possession of the instrument who is entitled to enforce the instrument pursuant to
[U.C.C. § 3-309 or 3-301(d)].” 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 if the instrument is payable to bearer
or, in the case of an instrument payable to an identified person, if the identified
person is in possession.” A person does not qualify as a holder by merely
possessing or owning a note. Instead, a person becomes a holder through
“negotiation.” The two elements of negotiation are (1) transfer of possession to
the transferee and (2) indorsement by the holder. The court recognized that
because BNY never came into physical possession of the note, it was not the
holder. It also recognized that the indorsed 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. Thus, to have the rights of enforcement as holder, a person must be in possession of an indorsed note at the time when holder status is important. Based on the information presented above, many RMBS trusts, including the hypothetical second-lien RMBS trust, would not be holders of many of the mortgage notes they claim to own.

Second, the court described why BNY was not a non-holder in possession. 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,” which would include a person in possession who is not a holder. Therefore, a person can be a nonholder in possession if the person acquires an unendorsed note as a successor to a holder of the note. The court 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 was not a non-holder not in possession that could enforce the note. A non-holder not in possession of a note can enforce a note that is lost, destroyed, or stolen. 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

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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)).
178 See Kemp, 440 B.R. at 631.
179 See id. at 632.
180 See U.C.C. § 3-301.
181 See id. at 633.
182 See Kemp, 440 B.R. at 633; U.C.C. § 3-301 Comment.
183 See Kemp, 440 B.R. at 632.
184 See id. at 632.
185 See id. at 632.
186 See id. at 633.
187 See U.C.C. § 3-309.
188 See U.C.C. § 3-309(a).
189 See id.
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, will also fail to be non-holders not in possession.

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 note.

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190 See id.
191 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)).
192 See *Kemp*, 440 B.R. at 624.
193 See id.
194 See U.C.C. § 3-203 Comment 1.
195 See id.
196 See id.
197 See *Kemp*, 440 B.R. at 633–34. The court also found 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. See *In re Kemp* at 634. 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.
198 See *Kemp*, 440 B.R. at 628.
notes during that relevant 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 determine whether the benefits and burdens of an obligation pass from one party to another.\textsuperscript{199} The respective factors do not have any particular weight, and the circumstances will determine which factors are the most important.\textsuperscript{200} 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{201} Thus, courts may apply a flexible, case-by-case analysis to determine whether benefits and burdens have transferred.\textsuperscript{202} 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{203} Thus, the factors aid with the analysis, but they are not definitive. The following analysis 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.

(1) Did parties treat the transaction as a sale?

The first factor is whether the parties treat the transactions as a sale.\textsuperscript{204} 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 to help determine whether the parties treat the transaction as a sale.\textsuperscript{205} In the case of purported REMICs that were part of MERS-facilitated securitizations, the PSA provided that the originator would transfer the mortgage notes and the purported REMIC trust would acquire them.\textsuperscript{206} PSAs also provide

\begin{itemize}
  \item \textsuperscript{200} See Calloway 691 F.3d 1315 (11th Cir. 2012); 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).
  \item \textsuperscript{201} 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)).
  \item \textsuperscript{202} See Sollberger, 691 F.3d at 1124 (citing Gray v. Comm’r, 561 F.2d 753, 757 (9th Cir. 1977)).
  \item \textsuperscript{205} See United Surgical Steel Co. v. Comm’r, 54 T.C. 1215, 1220–22, 30 (1970).
  \item \textsuperscript{206} See Kemp, 440 B.R. at 627; Knights of Columbus Amended Complaint, \textit{supra} note 45, at 11–17.
\end{itemize}
that mortgage servicers and REMIC trustees will verify the transfer of the mortgage notes and grant the REMICs legal recourse to obtain untransferred notes.\footnote{See Knights of Columbus Amended Complaint, \textit{supra} note 45, at 21–22.} The agreements may, however, be inconclusive because they may have conflicting positions.\footnote{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).} Courts and the IRS will also ignore the agreement if other actions by the parties and the economics of the arrangement belie the nominal description in the documents.\footnote{See \textit{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.").} Instead, they consider whether the purported transferee parted "with any substantial incident of ownership . . . of the obligation," \footnote{See \textit{id.}} and they will consider whether the purported transferee "retained title to, and possession of, the . . . obligations."\footnote{See \textit{id.}}

Originators commonly retained possession of the mortgage notes, so in that respect, the parties did not treat the transaction as a transfer.\footnote{See \textit{supra} text accompanying note 198.} Sponsors also disregarded the repurchase provisions of the PSAs and instead of purging RMBS trusts of defective loans, they agreed to receive settlement proceeds from the originators.\footnote{See \textit{supra} text accompanying notes 140-144.} Thus, the PSAs provide for the transfer of possession of the mortgage notes but the parties routinely disregarded the provisions of the PSA, and uniformly did in the hypothetical second-lien RMBS trust. The actions of the parties therefore conflict with the agreement, and actions should trump the agreement.

Courts and the IRS will also look at how the parties treat the transaction for tax and accounting purposes to determine tax ownership.\footnote{See \textit{Sollberger}, 691 F.3d at 1122, 1125 (recognizing that the parties stopped reporting interest earned on the purported collateral and the purported borrower stopped making interest payments); \textit{United Surgical Steel Co.}, 54 T.C. at 1221–22; \textit{Yancey Bros. Co. v. United States}, 319 F. Supp. 441, 446 (N.D. GA 1970) (recognizing that the taxpayer continued to pay intangibles tax due from the owner of a note held that no transfer occurred); I.R.S. Field Serv. Adv. Mem. 2001-30-009 (Apr. 20, 2001).} For federal income tax and accounting purposes, the parties appear to have treated the RMBS trust as both owner and non-owner. With no information to the contrary, this analysis assumes that the parties allocated the cash flows from borrowers to the trusts, and the trusts paid those amounts to the RMBS investors. The RMBS trusts also presumably recognized interest income from the loans and deducted interest paid to the RMBS investors. Presumably, they also allocated phantom income to
the holders of the residual interests. In those ways, the parties treated the RMBS trusts as tax owners of the mortgage notes.

Nonetheless, the originators and sponsors knew that a significant percentage of the loans were defective, but they did not replace them. Instead, they agreed between themselves to settle the originator’s repurchase price and deprive the RMBS investors of their right to the funds. Thus, they knew that the loans were worth less than the amount accounted for, but they did not adjust their tax accounting accordingly. In this respect, the parties 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. The parties 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 the parties often would not record the assignment of the mortgage note to the RMBS trust. Apparently the parties generally would not record mortgage assignments 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, the parties treated the originator or MERS as the owner of the mortgage note, but not the trust. Local jurisdictions now seek recording fees for unrecorded assignments of mortgage notes. Failure to record the transfer of a mortgage note to RMBS trusts is another way in which the parties treated someone other than the RMBS trusts as tax owner.

(2) Were obligors notified of transfer of obligations?

The second factor is whether the parties notify the obligor of the transfer of obligations. Failure to notify the obligor of a transfer of an obligation

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215 See supra text accompanying notes 140-144.
216 See id.
217 See supra text accompanying notes 54-57.
218 See Kemp, 440 B.R. at 628 (recording assignment of mortgage twenty-one months after the parties executed the PSA and the originator purportedly transferred the note and the trust acquired it); Christian County Clerk v. Mortgage Electronic Registration Systems, Inc., 2013 WL 565198, slip op. No. 12-5237 (6th Cir. 2013) (dismissing case brought by county clergers in Kentucky seeking recording fees from MERS and banks); Montgomery County, Pennsylvania v. MERSCORP, Inc., 904 F.Supp.2d 436 (E.D. Penn. 2012) (denying MERS’s motion to dismiss counties’ claim for recording fees).
219 See, e.g., Christian County Clerk, 2013 WL 565198 (dismissing case brought by county clergers 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).
generally indicates that the transaction was not a transfer. Case law and rulings do 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 arguably 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 to prevent multiple claims for the same note. In fact, many of the legal conflicts arise because obligors are unsure of who holds the mortgage note and who has the right to bring foreclosure actions on the property. By failing to record the assignment of mortgages or providing other notification, the parties failed to notify the obligor 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.

(3) Which party serviced the obligations?

The third factor 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 would indicate that the originator is the tax owner of the note.

(4) Did payments to the transferee correspond to collections on the debt instruments?

The fourth factor is whether payments made to the purported transferee correspond to collections on the debt instrument. If payments to the transferee correspond to collections on the obligations, the transaction is more likely to be

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221 See United Surgical Steel Co., 54 T.C. at 1230 (“As far as the customer knew, the [originator] was the person to whom he was indebted.”).
222 See WOLF, supra note 47, § 37.27.
224 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).
225 See United Surgical Steel Co., 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.”).
treated as a transfer, but courts have stated that corresponding payments are not dispositive. PSAs generally required the originator (so long as it retains 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, the 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 would, however, 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 the 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.

(5) Did the transferee impose restrictions on the operations of the transferor that are consistent with a lender-borrower relationship?

The fifth factor considers whether the transferee imposes restrictions on the operations of the transfer that are consistent with a lender-borrower relationship. Case law holding that transactions were loans secured by notes and not transfers of the notes often considered the restrictions the lenders placed on the borrowers to help secure repayment 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 books of the borrower; furnishing financial statements to the lender periodically; paying taxes as they become due; keeping the collateral insured; requiring approval for other purchases; and restricting the payment of compensation, creation of other indebtedness, and the payment of

227 See Branham v. Comm’r, 51 T.C. 175, 180 (1968).
228 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.”).
229 See KRAVITT, supra note 52, § 4.02.
230 See id. § 4.02.
Dividends. 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 ability to borrow additional funds using the same debt as collateral further evinces the arrangement is a loan, not a transfer. To apply this factor the analysis would consider whether the RMBS trust or sponsor (as potential lender) imposed such restrictions 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.

(6) Which party had power of disposition?

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 allowed one party to dispose of notes, even if in the possession of another party, also suggest power of disposition. 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. 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. 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. In other cases, courts consider whether one party has complete dominion of an asset in determining power of

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235 See Union Planters, 426 F.2d at 117, 118; Yancey Bros., 319 F. Supp. at 446. Margin account payment requirements serve to protect the lender where a borrower’s “security is decreasing in value.” Union Planters, 426 F.2d at 117.
236 See Yancey Bros., 319 F. Supp. at 446.
238 See Rev. Rul. 82-144, 1982-2 C.B. 34.
239 See, e.g., Union Planters, 426 F.2d at 117 (holding that the owner was the party that listed the bonds for sale); American National Bank of Austin v. United States, 421 F.2d 442, 452 (5th Cir. 1969) (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).
240 See Calloway v. Comm’r, 691 F.3d 1315, 1319–34 (11th Cir. 2012); Sollberger v. Comm’r, 691 F.3d 1119, 1125–27 (9th Cir. 2012).
242 See id.
The 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 obviously cannot transfer possession of the notes. An RMBS trust that did not have possession of notes could sell the rights it had under the 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. Therefore, an RMBS trust that lacks possession cannot transfer the negotiable note to someone who would become a holder in due course. 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. PSAs also generally prohibit RMBS trusts from transferring any mortgage note they hold to ensure that they comply with the REMIC rules. Thus, as a practical matter, RMBS trusts probably are not able to dispose of mortgage notes, which goes against 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. In fact, the originator could sell an untransferred mortgage note to other purchasers...

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243 See 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).

244 See PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, REPORT ON APPLICATION OF THE UNIFORM COMMERCIAL CODE TO SELECTED ISSUES RELATING TO MORTGAGE NOTES (November 14, 2011), available at http://www.uniformlaws.org/Shared/Committees_Materials/PEBUCC/PEB_Report_111411.pdf (noting that pursuant to U.C.C. section 3-301, one must possess or have formerly possessed a note to be a person entitled to enforce it). The situation with non-negotiable notes is very different. See Dale A. Whitman & Drew Milner, Foreclosing on Nothing: The Curious Problem of the Deed of Trust Foreclosure Without Entitlement To Enforce the Note, 66 ARK. L. REV. 21, 27 (2013) (“It is clear that, unlike a negotiable instrument, enforcement rights in a nonnegotiable note can be transferred by a separate document of assignment.”).

245 See U.C.C. § 1-201 (defining a “holder” as one in possession).

246 See I.R.C. § 860F(a)(2).


248 See U.C.C. § 3-301.
who could become a holder in due course of the mortgage note.\footnote{See U.C.C. § 3-302(a) ("'holder 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 described in Section 3-305(a).").} A holder in due course who purchased a mortgage note from an originator following a purported transfer to an RMBS trust would have greater rights in a mortgage note than the RMBS trust.\footnote{See U.C.C. § 3-306 ("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.").} The RMBS trust’s recourse in such a situation would be against the originator for breach of contract and possibly theft.\footnote{See KRAVITT, supra note 52, § 16.04.} 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.\footnote{But see I.R.S. Tech. Adv. Mem. 85-52-002 (Sep. 16, 1985) (ruling privately that the facts and circumstances determined that the party in possession of assets was not the tax owner). The IRS also considers contractual repurchase agreements and tacit understanding of parties in determining who is the tax owner of an asset. See I.R.S. Tech. Adv. Mem. 85-52-002 (Sep. 16, 1985).} 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 litigation proceeds and additional facts emerge, finding that originators sold single notes to multiple buyers would not be surprising.\footnote{See id. ("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 retransfer 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. ").} 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.

(7) Which party bears the risk of loss?
The seventh factor examines which party bears the risk of loss.\(^\text{254}\) This may be the most important factor in determining who is the tax owner of a mortgage note.\(^\text{255}\) In a private ruling, the IRS devoted considerable text to analyzing who bears the risk of loss in a loan securitization arrangement.\(^\text{256}\) The IRS identified both credit risk and prepayment risk as types of risk that accompany mortgage securitization.\(^\text{257}\) Credit risk is the risk that borrowers will not make payments as provided in the loan agreements.\(^\text{258}\) 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.\(^\text{259}\) Another risk of securitization is modification risk.\(^\text{260}\) Modification risk is the risk that the borrower will modify the loan to reduce the amount of monthly payments.\(^\text{261}\)

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 the 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.\(^\text{262}\) Many RMBS trusts had been structured this way,\(^\text{263}\) so originators often retain 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.\(^\text{264}\) In fact, the economic incentives that accompany the


\(^{258}\) See id.

\(^{259}\) See id.

\(^{260}\) See Nuveen Investments, Prospectus for Nuveen Mortgage Opportunity Term Fund 2 82 (Feb. 3, 2010), available at https://www2.morganstanley.com/wealth/Markets/IPOCenter/Prospectus/?DocID=p_JMTCE.

\(^{261}\) See id.


\(^{263}\) See Ingo Fender and 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”).

\(^{264}\) See I.R.S. Field Serv. Adv. Mem., 2001-30-009 (Apr. 20, 2001) (ruling privately that a sufficient amount of the economic benefits and burdens transferred to warrant treating the arrangement as a transfer for tax purposes).
different types of risk affect investors’ behavior and preferences. Investors who hold senior RMBS tranches bear most of the prepayment risk; investors in junior tranches or the originator bear most of the credit risk. 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 that in a non-REMIC mortgage securitization, the trust bore the prepayment risk and the originator bore the credit risk. Similarly, 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. Indeed, originators created reserves to cover the estimated costs they would incur as a result of the risks they retained. Even though RMBS sponsors retained repurchase settlement payments, 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.

(8) Which party had the potential for gain?

The eighth factor considers which party had the potential for gain. The IRS observed that the potential for gain is the obverse of bearing risk. Consequently, one might conclude that if the originator or sponsor bore the risk of

265 See SHEILA BAIR, BULL BY THE HORNS, 60-62 (2012) (“What the FDIC staff understood early on—frankly, before anyone else—was that the usual forces of economic self-interest would not result in the kind of wide-scale restructuring that was needed to avoid a massive wave of foreclosures. That was because through the securitization process, those who owned the mortgages were different from those who would be responsible for restructuring them and the legal contracts governing the modification process created economic incentives skewed in favor of foreclosure.”).

266 See KRAVITT, supra note 52, § 16.02.

267 See, e.g., supra text accompanying notes 140-144.


269 See JOHN ARNHOLZ & EDWARD E. GAINOR, OFFERINGS OF ASSET-BACKED SECURITIES § 1.04 (2013).

270 See FESTA, supra note 11, § 7.01.

271 See J. P. Morgan Securities Complaint, supra note 7.


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 were to sell the notes, any gain it recognizes would be taxed at 100%. Because the tax would consume any such 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.” 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. The summary suggests that the IRS could make a very strong case that many RMBS trusts, and especially the second-lien RMBS trust, were not the tax owners of the mortgage notes.

<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>
</tbody>
</table>

Table 1: Summary of Factors Applied to Hypothetical RMBS Trust

<table>
<thead>
<tr>
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<tbody>
<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; probably 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>RMBS trust not tax owner.</td>
<td></td>
</tr>
<tr>
<td>(4) Did payments to the transferee correspond to collections on the debt instrument?</td>
<td>Principal and interest payments to RMBS trust corresponded to collections.</td>
<td>Settlement payments for defective loans did not correspond to sponsor’s collection of those payments.</td>
<td></td>
</tr>
<tr>
<td>(5) Did the transferee impose restrictions on the operations of the transferor?</td>
<td>No distinctive restrictions imposed.</td>
<td>RMBS trust tax owner.</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 notes; tax law penalizes transfers; RMBS trust did not have possession of notes.</td>
<td></td>
</tr>
<tr>
<td>(7) Which party bears the risk of loss?</td>
<td>PSA obligated trust to cure defective loans, and many loans were defective.</td>
<td>RMBS trust not tax owner.</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 RMBS trusts, the principle of estoppel weakens RMBS 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. 278

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277 See, e.g., Branham v. Comm’r, 51. T.C. 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]”).
278 See, e.g., Borden & Reiss, supra note 158 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. See 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. See Treas. Reg. § 1.860D-1(b)(3)(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.

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<table>
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</tr>
</thead>
<tbody>
<tr>
<td>(8) Which party has the potential for gain?</td>
<td>Originator could not dispose of mortgage notes for gain.</td>
<td>100% tax on gains from dispositions prohibits RMBS trust from realizing gain.</td>
<td>RMBS trust not tax owner.</td>
</tr>
</tbody>
</table>
That argument is meaningless 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.\footnote{279} In 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.\footnote{280} Beneficial ownership would be relevant to an RMBS trust only if the originator held the mortgage note in trust for the RMBS trust.\footnote{281} If an RMBS trust fails to establish that it is the tax owner of mortgage notes, tax law must recharacterize the arrangement. If a purported REMIC 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.” See 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.

\footnote{279} See, e.g., Estate of Kenneth L. Lay v. Comm’r, T.C. Memo 2011-208, 102 T.C.M. 202 (2011) (CCH) (“The status of the legal title to the annuity contracts does not control in determining whether a sale occurred. Beneficial ownership, and not legal title, determines ownership for Federal income tax purposes. Ragghianti v. Commissioner, 71 T.C. 346 (1978), aff’d, without published opinion, 652 F.2d 65 (9th Cir. 1981); Pac. Coast Music Jobbers, Inc. v. Commissioner, 55 T.C. 866, 874 (1971), aff’d., 457 F.2d 1165 (5th Cir. 1972). The Federal income tax consequences of property ownership generally depend upon beneficial ownership, rather than possession of mere legal title. Speca v. Commissioner, 630 F.2d 554, 556-557 (7th Cir. 1980), aff’d T.C. Memo. 1979-120; Beirne v. Commissioner, 61 T.C. 268, 277 (1973). “‘[C]ommand 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. Commissioner, 109 T.C. 235, 240 (1997) (quoting Hang v. Commissioner, 95 T.C. 74, 80 (1990)). This Court has stated that “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. Commissioner, 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. Commissioner, 85 T.C. 754, 777 (1985), aff’d., 849 F.2d 393 (9th Cir. 1988); Grodt & McKay Realty, Inc. v. Commissioner, 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. Commissioner, 74 T.C. 1513, 1527 (1980) (stock was sold in accordance with an agreement for the sale, even though the title to the stock was not transferred, in accordance with the agreement of the parties.”).\footnote{280} See Memorandum of Law in Support of Defendants’ Motion to Dismiss the Complaint, HSH Nordbank v. Barclays Bank PLC, No. 652678/2011, at 24 n. 38 (Sup. Ct. N.Y. County May 11, 2012), available at \url{https://iapps.courts.state.ny.us/fbem/DocumentDisplayServlet?documentId=xKBnC5REEodDnG7SCCByTg==&system=prod}.\footnote{281} See supra note 278.
received and distributed proceeds, it would clearly own some sort of asset capable of generating cash flow. That asset could be a loan from the originator, the sponsor, or other 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 the definition of qualified mortgage. 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 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 the other REMIC requirements. As the following analysis indicates, the hypothetical second-lien RMBS trust will almost certainly fail to satisfy the other REMIC requirements. The analysis also provides a template analyzing the REMIC classification of other RMBS trusts.

B. Qualified Mortgage Requirement

An RMBS trust must satisfy the qualified mortgage requirement to be a REMIC.283 A qualified mortgage is an obligation that is principally secured by an interest in real property.284 That 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 come within the definition of qualified mortgage. Many of the assets in RMBS trusts will not come within that definition.

1. Obligation

A qualified mortgage must be an “obligation (including any participation or certificate of beneficial ownership therein).”285 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.”286 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

282 See infra text accompanying notes 284-285.
283 See supra text accompanying notes 151-153.
285 See id.
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). . . ”287 A pass-through certificate is an interest in a trust or other arrangement that holds a pool of mortgage notes or other debt instruments.288 IO and PO strips are types of stripped bonds and coupons governed by section 1286 of the Internal Revenue Code, which grant a holder the rights to identified payments on bonds.289 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.290

Because RMBS trusts received cash flow, they must have been the tax owners of some type of property. Even if the property RMBS trusts owned was not qualified mortgages, it could have been an obligation. 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, which would not appear to be the case because PSAs do not appear to create a trust on behalf of the RMBS trust.291 Thus, the property owned by RMBS trusts would appear to be either mortgage notes, for RMBS trusts that are the tax owners of the notes, or the right to receive something from the originator. The property owned by an RMBS trust could, therefore, be some kind of binding obligation, even if it is not mortgage notes per se. Obligations in a form other than mortgage notes would not, however, satisfy other elements of the definition of qualified mortgage. In particular, such other obligation 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.292 As the following discussion illustrates, the lending and underwriting

287 See Peaslee & Nirenberg, supra note 166, at 456.
288 See id. at 23.
289 See 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. See id. at 701.
291 See Borden & Reiss, supra note 13, at 277-279.
practices during the years leading up to the Financial Crisis will prohibit many mortgage notes from being principally secured under any of those three alternatives. Any other obligation that an RMBS trust might hold would also fail to satisfy any one of the tests.

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,293 or (2) the date the trust acquires the obligation by contribution.294 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. Notice that 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 appear to define adjusted issue price of an obligation. Instead, the rules appear to rely upon the definition “adjusted issue price” in other areas of tax law, in particular in the original issue discount (OID) rules.295 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.296 The issue price for a home mortgage should be the amount of the loan.297 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.298 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 the transfers generally

293 See Treas. Reg. § 1.860G-2(a)(1)(i)(A). If an obligation is significantly modified before the REMIC acquires it, its origination date is the date of the modification. See Treas. Reg. § 1.860G-2(b)(1).
295 See Peaslee & Nirenberg, supra note 166, at 455, 58.
297 See I.R.C. § 1273(b)(2); Treas. Reg. § 1.1273-2(g)(5), Example 1 (deducting points from the borrower’s payment to determine issue price).
298 See Treas. Reg. § 1.1275-1(b)(1)(i), (ii).
occur shortly after origination. Therefore, 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 value of the interest in real property assigned to other liens. 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. 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, 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. Assume 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). The appraised fair market value suggests that both the first and the second mortgages satisfy the 80% test. For purposes of 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 would therefore be the $250,000 appraised value divided by the $200,000 mortgage or 125%, which is obviously greater than the required 80%. Because the VTL ratio is greater than 80%, the first-lien mortgage satisfies the 80% test. The fair market value apportioned to the second-lien mortgage for purposes of the 80% test would be $50,000 ($250,000 total fair market value minus the $200,000 first mortgage). The VTL ratio for the second mortgage would therefore be 133% ($50,000 fair market value to $37,500 loan). Because 133% is obviously greater than the required 80%, the second mortgage would also appear to satisfy the 80% test.

Assume that because appraisers overstated the values of homes, the $250,000 appraised value is significantly higher than the property’s actual value. The actual value of the house is $225,000 (just 90% of the appraised value) at

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299 See supra text accompanying note 152. Of course, failed underwriting could affect the value and original discount of a loan. See supra text accompanying notes 120-126.
300 See Treas. Reg. § 1.1275-1(b)(2).
301 See id.
302 See supra text accompanying notes 120-126.
303 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, Equity Loans as Next Round in Credit Crisis, N.Y. TIMES (no page) (Mar. 27, 2008), available at http://www.nytimes.com/2008/03/27/business/27loan.html?pagewanted=print.
time the buyer borrowed the first or second mortgage. The actual value, not the inflated appraised value, is appropriate for the 80% test. Using the actual value of the collateral, the first-lien mortgage would still satisfy the 80% test because it would use the full $225,000 actual fair market value, which exceeds the $200,000 first mortgage. The VTL ratio for the first mortgage would be 112.5% ($225,000 value divided by the $200,000 loan). The value for purposes of the second mortgage, however, would be the $225,000 actual value minus the $200,000 first-lien mortgage, or $25,000. The VTL ratio for the $37,500 second mortgage using that $25,000 value would be 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 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. For example, a

304 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 text accompanying notes 120-126 (claiming that appraisals often overstated values by as much as 10% on a cumulative basis).


306 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 overstatements of 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
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.\textsuperscript{307} The CLTV ratio compares the combined principal balance of all liens on the mortgaged property to the value of the mortgaged property.\textsuperscript{308} Because LTV is the inverse of the VTL ratio, a VTL ratio of 80% equals an LTV ratio of 125%.\textsuperscript{309} To illustrate, assume a property with an $80,000 fair market value secures a $100,000 loan. The VTL ratio for that property and obligation would be 80% ($80,000 value divided by the $100,000 loan). The LTV ratio for that property and obligation would, however, be 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. For instance, if the property’s value was $78,000, the VTL ratio would be 78% ($78,000 value divided by the $100,000 loan), and the LTV ratio would be about 128% ($100,000 loan divided by $78,000 value). This illustrates the inverse relationship of the VTL and the LTV ratios. To pass the 80% test, a loan’s VTL ratio must be greater than or equal to 80%, and, inversely, the LTV ratio of a loan must be less than or equal to 125%.

The CLTV ratio includes all mortgages secured by a piece of property, but it does not provide information with respect to individual loans.\textsuperscript{310} A study found that the CLTV ratio was greater than 100% for as many as 34% of the loans in one RMBS trust.\textsuperscript{311} A CLTV of greater than 100% suggests that any secondary-lien mortgages in the pool may not satisfy the 80% test. The CLTV ratio considers all loans that a single property secures. For instance, in the example

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 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 ratio 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.

\textsuperscript{307} Nordbank Consolidated Complaint, supra note 93, at 28.
\textsuperscript{308} See Nordbank Consolidated Complaint, supra note 93, at 26.
\textsuperscript{310} The CLTV ratio would also consider third mortgages and any other mortgages secured by the property.
\textsuperscript{311} See Nordbank Consolidated Complaint, supra note 93, at 28.
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
slightly above 100% at 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 $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 for purposes of applying the 80% test to the second
mortgage. 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 therefore would not satisfy the 80% test. In fact, loans with
lower priority that are part of a CLTV ratio that exceeds 100% would often fail
the 80% test.\footnote{See supra note 306 (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.}

The study of CLTV ratios demonstrates that as many as 34% of randomly
selected loans have CLTV ratios of greater than 100%.\footnote{See Nordbank Consolidated
Complaint, supra note 93, at 28.} The percent 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. For example, assume 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. Assume that $5,100,000 or 15% of the loans
(based upon actual value) in that group are second-lien mortgages. 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. Based on the assumptions in this analysis, 2.55% of the loans in the portfolio would not be principally secured by an interest in real property under the 80% test. The percentage of mortgage notes that fail the 80% test would be even greater for RMBS trusts that held 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 second-lien mortgages, as many as 80% of the second-lien mortgages could have VTL ratios that are less than 80%. If that is the case, the vast majority of second-lien mortgages granted in the years leading up to the Financial Crisis would 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 it satisfies the alternative test. To satisfy the alternative test an obligation must meet two requirements. 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. 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. The purpose of this test is to cover real estate construction or acquisition loans for property for which an appraisal was not obtained at the time of the loan.

The language in the preamble to the regulations raised 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.” That language suggests that the alternative test was meant only for loans that did not require an appraisal

314 See supra text accompanying notes 123.
316 See id.
317 See id.
318 See Peaslee & Nirenberg, supra note 166, at 459.
of the collateral. It does not appear to be a fall back test for loans that fail the 80% test based on an inaccurate property value. If the collateral were appraised, the 80% test would appear to be the proper test. Thus, any loan that included an appraisal value of the property and fails the 80% test probably cannot rely upon the alternative test.

Many loans issued prior to 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 prior to the Financial Crisis were home equity loans that were not used to acquire, improve, or protect real property. Many such home equity loans would not satisfy the first part of the alternative test. Another common practice was for borrowers to take a portion of a loan originated at the time of purchase in cash. 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 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 to satisfy the alternative test if property other than the real property that 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. If the borrower offers other property as collateral, however, the loan would not satisfy this 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, and they obtained appraisals (albeit inaccurate appraisals) for the property, suggesting the test probably should not apply. Consequently, especially with respect to many second-lien mortgage notes, the mortgage notes will not satisfy the alternative test.

320 See Atif R. Mian & Amir Sufi, House Prices, Home Equity-Based Borrowing, and the U.S. Household Leverage Crisis (Research Paper, May 21, 2010), 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.”).


323 See supra note 321.
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. The regulations provide two methods for establishing that reasonable belief. First, a sponsor may base reasonable belief on representations and warranties made by the originator. Second, 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. The rules also provide that the safe harbor does not apply if the sponsor actually knew or had reason to know an obligation fails 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. Evidence at the time indicated that originators had abandoned underwriting guidelines and made loans that could not satisfy the 80% test. Sponsors also knew or had reason to know that 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.

If, despite the sponsors’ reasonable belief that the notes satisfied the 80% or alternative test, a purported REMIC later discovers an obligation is not

328 See supra text accompanying notes 306.
329 See supra text accompanying notes 104.
330 See id.
principally secured by an interest in real property, the obligation is defective and loses qualified mortgage status within 90 days after the date the purported REMIC discovers the defect.\textsuperscript{331} Thus, the rules give sponsors 90 days to cure defective loans.\textsuperscript{332} The sponsors appeared to have known that they were transferring defective loans into RMBS trusts at the time they formed the trusts. They knew that default rates of loans from particular originators were particularly high, but they continued to accept loans from those originators.\textsuperscript{333} They were similarly aware that appraisers were overstating the value of homes,\textsuperscript{334} so they knew that many loans could not satisfy the 80% test. Surely members of the industry had to know 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 90-day window,\textsuperscript{335} nothing suggests that they took the steps necessary to cure defective obligations. In fact, 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. Also, sponsors colluded with originators to settle repurchase obligations instead of exercising the trusts’ rights to cure defects by replacing defective obligations with compliant loans.\textsuperscript{336} Consequently, the cure alternative would not appear to help RMBS trusts establish that their notes were principally secured. Thus, many of the mortgage notes that RMBS trusts claimed to own will not be principally secured. The percentage of mortgage notes that fail to be principally secured will probably be significant for second-lien mortgage RMBS trusts.

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 to come within the definition of qualified mortgage.\textsuperscript{337} The regulations do not specifically 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.\textsuperscript{338} Of the items in the list, mortgages and deeds of trust would most often

\begin{itemize}
\item \textsuperscript{331} See Treas. Reg. § 1.860G-2(a)(3)(iii).
\item \textsuperscript{332} See Treas. Reg. § 1.860G-2(f)(2).
\item \textsuperscript{333} See supra text accompanying notes 134-138.
\item \textsuperscript{334} See supra text accompanying notes 121-123.
\item \textsuperscript{335} See Treas. Reg. § 1.860G-2(f)(2).
\item \textsuperscript{336} See supra text accompanying notes 140-144.
\item \textsuperscript{337} See I.R.C. § 860G(a)(3)(A).
\item \textsuperscript{338} See Treas. Reg. § 1.860G-2(a)(5).
\end{itemize}
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, and they 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 jurisdiction to jurisdiction depending upon the issue under consideration and the facts of a particular case. Many cases pit a borrower against one or more banks or MERS. In many cases, the courts 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.

The outcome of such cases often turns 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. In some jurisdictions,

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339 Litigation in this area is moving quickly, so even work done a few years ago is not up to date. Nonetheless, an early article with a nice overview of cases that consider state-law issues associated with MERS recording is John R. Hooge & Laurie Williams, Mortgage Electronic Registration Systems, Inc.: A Survey of Cases Discussing MERS’ Authority to Act, NORTON BANKRUPTCY LAW ADVISOR 1 (Aug. 2010).

340 See Bain v. Metropolitan Mortgage Group, Inc. 175 Wash.2d 83, 285 P.3d 34 (Wash. 2012) (holding that MERS was not a beneficiary under Washington Deed of Trust Act because it did not hold the mortgage note); Eaton v. Federal National Mortgage Association, 462 Mass. 569 (Mass. 2012); Ralph v. Met Life Home Loans, No. CV 2010-0200 (5th D. Idaho August 10, 2011) (holding that MERS was not the beneficial owner of a deed of trust, so its assignment was a nullity and the assignee could not bring a nonjudicial foreclosure against the borrower); Fowler v. Recontrust Company, N.A., 2011 WL 839863 (D. Utah March 10, 2011) (holding that MERS is the beneficial owner under Utah law); Jackson v. Mortgage Electronic Registration Systems, Inc., 770 N.W.2d 487 (Minn. 2009) (holding that MERS, as nominee, could institute a foreclosure by advertisement, i.e., a nonjudicial foreclosure, based upon Minnesota “MERS statute” that allows nominee to foreclose).

341 See Landmark National Bank v. Kesler, 289 Kan. 528, 216 P.3d 158 (Kan. 2009) (holding that MERS had no interest in the property and was not entitled to notice of bankruptcy or to intervene to challenge it).

342 See Kemp, 440 B.R. 624.

343 See, REFinBlog.com (indicating that of the cases analyzed through July 20, 2013, courts held that MERS or the Bank had standing in 48 and lacked standing in 53) (last visited Aug. 9, 2013).

344 See Bradley T. Borden, David J. Reiss & William KeAupuni Akina, Show Me the Note!, 19 BANK & LENDER LIABILITY 3 (June 3, 2013).
courts allow banks to foreclose if they are just the mortgagee, but other jurisdictions require banks to have the note to initiate foreclosure. Banks in every jurisdiction can obtain rights to foreclosure through possession of the necessary documents. Because timing of their rights is important for REMIC classification, acquisitions of the relevant rights prior to initiating legal proceedings may not be sufficient for tax purposes.

The inability to foreclose on an obligation calls into question whether it was secured by real property. REMICs, sponsors, originators, underwriters, and their advisors were put on notice as early as 2001 that their positions regarding security probably lacked legal support. In 2001, the Attorney General of New York concluded that recording a MERS instrument violates New York real property 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, 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 will end up with the collateral real property or proceeds from the sale of such property (the ultimate-outcome argument). They may argue that the originator can transfer possession of the mortgage note and assign the mortgage to the purported REMIC before the attempt to enforce the mortgage note through payment collection efforts or foreclosure. As a general rule, courts typically find for a bank that holds the mortgage note and the mortgage prior to commencing a foreclosure action, but the outcome is much less predictable where the foreclosing party does not hold both instruments when the action commences. 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. The fact that the collateral obligation is secured by an interest in real property does not affect this analysis. Thus, if an RMBS trust holds an obligation from the originator, and that obligation is secured by mortgage notes that the originator

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345 See generally Whitman & Milner, supra note 244.
347 See id. at 96.
349 See id.
350 See generally Whitman & Milner, supra note 244.
352 See id.
holds, the RMBS trust’s obligation is not principally secured by an interest in real property. This result holds true even if the originator’s mortgage notes are secured by interests in real property. Consequently, if an RMBS trust does not own mortgage notes for tax purposes, but they do 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, but 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 obligations secured by interests in real property, it should not be effective with respect to other obligations that require similar foreclosure actions. Thus, the ultimate-outcome argument should not apply to obligations that an RMBS trust cannot foreclose upon immediately. If an RMBS trust must take actions to compel the originator to transfer the mortgage note and mortgage to foreclose on property, the RMBS trust would not appear to own an obligation principally secured by an interest in real property. The atrocious state of affairs leading up to the Financial Crisis indicates that most RMBS trusts could not foreclose on the homes securing the mortgage notes without taking additional steps. Such would be similar to those a person would take if the person held an obligation secured by another obligation secured by interests in real property. Consequently, many RMBS trusts, including the hypothetical second-lien RMBS trust, appear not to have held 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,

353 See supra text accompanying note 39.
courts and the IRS should, and upon careful reflection most likely would, reject the ultimate-outcome argument.

The ultimate-outcome argument links to the timing requirement. The argument 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 appears to disregard 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 so inadequate, this problem would appear to apply equally to all types of RMBS trusts created in the years leading up to the Financial Crisis.

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 the RMBS trust is the tax owner of the obligation on the startup date, or if the trust receives it by contribution or within three months after the startup date if the RMBS trust purchases it. Furthermore, an RMBS trust comes within the definition of REMIC only if it holds principally-secured obligation within three months after the startup date. The description above of lending and securitization practices reveals that RMBS trusts rarely had possession of mortgage notes or were mortgagee of record within three months after the startup date, much less on the startup date. The parties also appear to fail to transfer tax ownership to the RMBS trusts within that time period. 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, so the 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

358 See supra Parts II. B. and C.
359 See supra Part III. A.
360 See supra text accompanying notes 4-6.
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 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). A regulatory safe harbor provides that an RMBS trust satisfies the substantially-all test if the aggregate basis of the prohibited assets is no greater than 1% of the aggregate basis of all of the trust’s assets. 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. The regulations provide no 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, 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.

A person 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 holds some type of asset. If an RMBS trust does not own qualified mortgages, the nature of the asset it owns will likely depend upon the reason the asset fails to be a qualified mortgage. The discussion above illustrates that if an RMBS trust does

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361 See Treas. Reg. § 1.860D-1(b)(3)(i). This article uses “prohibited asset” to refer to any asset that is not a qualified mortgage or permitted investment.

362 See id.

363 See supra text accompanying notes 95.
not hold qualified mortgages, it could hold a loan from the 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 should not come within the definition of a REMIC. In many situations, they would appear to be a significant portion of the trust’s total assets.

An example illustrates the application of the substantially-all requirement. Suppose an RMBS trust owns $50,000,000 of 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 the originator. The numerator, for purposes of applying the substantially-all requirement would be the $15,000,000 of obligation from the originator, and the denominator would include all $50,000,000 of the trust’s assets. The percent of prohibited assets would thus be 30% ($15,000,000 divided by $50,000,000). The 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, the 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.

IV. POLICY REASONS TO ENFORCE REMIC RULES

At the present, the IRS does not appear to be engaged in auditing REMICs or enforcing the REMIC rules. Perhaps their reason for not challenging REMIC status at this time is that they are 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, undoubtedly 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

365 See I.R.C. § 6501(c)(2) (providing that the statute of limitations remains open indefinitely if a return is fraudulent); I.R.C. § 6501(c)(3) (providing that the statute of limitations remains open indefinitely if no return is filed). But see I.R.C. § 6501(g)(1) (providing that the statute of
litigation after it obtains the information it needs. Ultimately, the IRS should, however, take action against the parties that made a mockery of the tax system. The IRS’s 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 there was $2.2 trillion dollars in outstanding securities. The amount of interest payments that changes hands on $2.2 trillion of RMBS is astronomical. At just 4%, the annual interest on the RMBS alone would be $88 billion. The 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.

To illustrate, by overstating the value of mortgage notes, the parties to RMBS trusts understated the interest rates on the 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. The stated interest of the note would therefore 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. An RMBS trust that reported interest income using the 5% rate would underreport income. If the interest deductions were otherwise appropriate, the RMBS trust would therefore 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.

The IRS’s lack of enforcement activity in this area prior to the Financial Crisis contributed to the magnitude of the crash. If the IRS had been active auditing RMBS trusts, it would have recognized the inadequacies of the


\[367\] See supra note 43.

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 the multiple-tranche RMBS products, but also would have threatened to expose their misdeeds to otherwise unsuspecting investors. Exposure of those matters would have spelled the end of the demand for shoddy RMBS products, and that potential 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 REMIC rules empowers RMBS organizers and loan originators to repeat their actions using REMIC classification as a front for their illegal actions.

The IRS has been slow to take action to help enforce the REMIC rules and clean up the RMBS industry. Instead, 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 said “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 . . .”369 In October 2009, the IRS provided a degree of 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.370 The IRS announced on August 17, 2010 that it will 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.”371 These IRS actions are not directed at the heart of the problem and appear to accommodate the parties who caused the Financial Crisis.

At least one commentator worries that taxing REMICs will unduly harm investors.372 The sponsors’ failure to adequately structure REMICs, not enforcement of the laws, has harmed investors. Their 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

369 Alison Bennett, IRS Reassures REMICs It Will Not Challenge Tax Status if Subprime Loans Are Modified, 89 BBR 948 (Dec. 10, 2007).
370 Richard Cowden, Securitizers Gearing up from ‘CMBS 2.0’ In a Market Where Demand Outstrips Supply, 3 REAL EST. L. & INDUS. REP. 474 (Jul. 13, 2010).
wrongdoers who organized these shams and misrepresented their quality to investors. Furthermore, the IRS may be able to impose transferee liability on 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.

The IRS’s unwillingness to enforce the REMIC rules cedes control to private industry, and private industry knows that and abuses its position of power. As one commentator astutely 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.” 373 Industry experts who appeared to make rules as they went along now invoke the Wall Street Rule. For example, an author of the leading REMIC treatise “said that even if the IRS finds wrongdoing, it may be loath to act because the wide financial damage the penalties would cause.” 374 Such patent recognition of IRS impotence is frightening and threatens to not only undermine 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 performed its audit function in the years leading up to the Financial Crisis, it could have helped prevent the problem in the first place and would not have to take action now that some perceive could potentially cause financial damage.

If the concern is that enforcement action at this time will cause wide financial damage, this Article should help alleviate that concern. The IRS could focus on low-hanging fruit: namely, 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. Thus, proving the 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. 375 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—those parties most responsible for the Financial Crisis. Courts can work that out.

After pursuing second-lien mortgage RMBS trusts, the IRS could evaluate the results and decide whether they should make the 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 that function back from Wall Street. Enforcement in this area would also 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 has traditionally 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 the 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.\footnote{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).} The authors of the opinions qualify them by providing that they are reliable only if the securitization occurs as described in the offering materials.\footnote{See id. at 367.} Despite that qualifier, the opinion authors should be accountable for their inaccurate opinions to the extent that they were aware of the RMBS problems. As industry participants who were close to the action, they had to know about many of the problems that existed.\footnote{See J. P. Morgan Securities Complaint, supra note 7 (revealing that attorneys and accounting firms were aware of the securitization deficiencies), available at https://iapps.courts.state.ny.us/lbem/DocumentDisplayServlet?documentId=4EP2AF3813ql/RHTZ6TMYQ==&system=prod.} Because of the Wall Street Rule and IRS inaction, they continued to issue unsupported opinions. If the IRS does not enforce the REMIC rules, however, members of the bar arguably will feel no greater obligation to abide by the rules. IRS failure to enforce the rules gives implicit license to the tax bar to ignore the rules.
Consequently, the IRS’s inaction causes exponential damage to the tax system as a whole.

Finally, IRS inaction is an affront to the Congressional action that grants favorable tax treatment to only certain types of RMBS trusts that satisfy very specific rules. This offends many commentators, who believe that the IRS should not exercise such discretion, but should enforce the laws as created by Congress.\footnote{See, e.g., Yves Smith, IRS Likely to Expand Mortgage Industry Coverup by Whitewashing REMIC Violations, NAKED CAPITALISM (Apr. 28, 2011), available at \url{http://www.nakedcapitalism.com/2011/04/irs-likely-to-expand-mortgage-industry-coverup-by-whitewashing-remic-violations.html#sdR8UXJzAHLIIIVG.99}.} Furthermore, the detailed rules in the REMIC regime address very specific purposes,\footnote{See supra text accompanying notes 40-44.} and a failure to enforce them undermines those purposes. Consequently, very 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 financial harm that results from such inaction.

V. CONCLUSION

The issue of REMIC failure is important in at least four contexts: (1) in any potential effort by the IRS to clean up this 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 qui tam or whistleblower action against purported REMICs. This Article provides a roadmap for pursuing tax enforcement action against RMBS trusts. The Article illustrates that many RMBS trusts, perhaps the majority of them, leading up to the Financial Crisis could not satisfy the REMIC requirements. Instead of advocating action against all such trusts, however, the Article recommends that the IRS should consider bringing action against RMBS trusts that clearly 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 help inform the IRS about whether it should expand the scope of its efforts. Both the law and policy support such action, so continued inaction is unacceptable.