NO. 89367-5

SUPREME COURT OF THE STATE OF WASHINGTON

CASHMERE VALLEY BANK,

Petitioner,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

DEPARTMENT OF REVENUE'S ANSWER TO AMICUS CURIAE MEMORANDUM

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I. INTRODUCTION

The question in this case is one of statutory interpretation, whether Cashmere Valley Bank was entitled to deduct from its business & occupation ("B&O") tax income it earned during 2004-2007 on investments in real estate mortgage investment conduits ("REMICs") and collateralized mortgage obligations ("CMOs").[1] During this period, financial businesses could deduct "amounts derived from interest received on investments or loans primarily secured by first mortgages or trust deeds on nontransient residential properties." RCW 82.04.4292 (2004). The trial court and the Court of Appeals both held as a matter of law that Cashmere's income from these investments did not qualify for the statutory deduction. *Cashmere Valley Bank v. Dep't of Revenue*, 175 Wn. App. 403, 406, 419, 305 P.3d 1123 (2013) (affirming summary judgment).

Amicus curiae Washington Bankers Association's suggestions for why this Court should accept review lack merit. The Association argues that the Court of Appeals decision is contrary to principles of "lending security," and it claims the decision is damaging to the public interest, citing trust law and federal banking regulations. Not once in its memorandum, however, does the Association even mention RCW 82.04.4292, the law being applied in this case. Nor does it acknowledge or grapple with facts in the record regarding the specific investments at

[1] Henceforth, the Department will use the word "REMIC" to mean both REMICs and CMOs unless indicated otherwise.

issue. Accordingly, the Association has not demonstrated a basis for this Court to accept review under RAP 13.4.

II. ARGUMENT

A. The Court Of Appeals Decision Is Not In Conflict With The Decision In *Security Pacific*.

The Association argues that review should be accepted because the Court of Appeals decision conflicts with *Department of Revenue v. Security Pacific Bank of Washington N.A.*, 109 Wn. App. 795, 38 P.3d 354 (2002). Amicus Mem. at 3-5; *see* RAP 13.4(b). The Association claims the Court of Appeals in this case incorrectly equated "security" with "remedy," when the court in *Security Pacific* did not require recourse to mortgage loan payments to conclude that Security Pacific's loans to mortgage companies were secured by the mortgages. Amicus Mem. at 4-5 (criticizing *Cashmere*, 175 Wn. App. at 418-19 ¶ 34).

There is no conflict. The Department has already explained why the decision below is consistent with the decision in *Security Pacific*. Answer to Petition at 13-17; *see also* Respondent's Br. at 30-31. Unlike in this case, Security Pacific demanded assignments from mortgage companies in return for loaning funds to those companies to make residential loans, and as a result of those assignments, Security Pacific became the owner of those mortgage loans. *Security Pacific*, 109 Wn. App. at 807-08. Indeed, Security Pacific would not advance any money to a mortgage company for a mortgage loan until it received full assignment

of the promissory note and deed of trust. *Id.* at 799. This effectively relegated the mortgage company to a mortgage lender in name only.

Here, none of the REMIC trustees assigned loans to Cashmere or pledged real property to back their promises to pay interest or principal on the debt (bond) instruments associated with Cashmere's investment in specific REMIC tranches or certificate classes. And unlike in *Security Pacific* or *HomeStreet* (the other published case addressing RCW 82.04.4292), Cashmere had no connection with the original mortgage loans. *See HomeStreet, Inc. v. Dep't of Revenue*, 166 Wn.2d 444, 210 P.3d 297 (2009) (allowing deduction to original lender on servicing fees after loan partially sold to secondary market). Both *Security Pacific* and *HomeStreet* are distinguishable on their facts, and nothing in the Court of Appeals decision in this case conflicts with those decisions.

B. The Court Of Appeals Decision Does Not Create An Issue Of Substantial Public Importance Requiring Review By This Court.

The Association argues that this Court should accept review "to avoid incoherence" between the B&O tax and other state and federal law. Amicus Mem. at 5. Specifically, the Association asserts that the Court of Appeals decision "divorces Washington law of security interests from the banking and trust law that give these secured transactions (and securities) their context." *Id.* In making this argument, the Association reads way too much into the decision. Banking and trust law are unaffected by the

Court of Appeals decision. There is no issue of substantial public importance requiring review under RAP 13.4(b)(4).

1. RCW 82.04.4292's application to Cashmere's interest income from investments in REMICs is unrelated to federal regulations governing bank investing.

The Association disagrees with the Court of Appeals' conclusion that Cashmere's investments in REMICs were not secured by residential first mortgages and deeds of trust, relying on federal regulations governing the types of investments in which banks may invest. Amicus Mem. at 5-7. Significantly, the Association does not argue that the Court of Appeals decision in this case actually conflicts with those regulations or that federal law preempts the holding in this case. Instead, the Association seems to suggest that the Court of Appeals decision is incorrect because federal regulations use the word "secured" in describing allowable "Type IV" and "Type V" investments, and those types of securities include REMICs. Amicus Mem. at 6-7.

Type V securities are "secured by interests in a pool of loans" and Type IV securities include residential mortgage-related securities representing ownership of notes or certificates of participation in promissory notes that are "directly secured by a first lien" on real estate. Amicus Mem. at 6-7; 15 U.S.C. § 78c(a)(41)(A) & (B); 12 C.F.R. §§ 1.2(m)(3) & (n); *see also* 12 C.F.R. § 1.3 (describing limitations on dealing in securities for Types I to V). Using these definitions, the

Association asserts all of Cashmere's REMIC investments were "secured" investments. Amicus Mem. at 7.

This case concerns the application of a state B&O tax deduction statute, RCW 82.04.4292, not whether Cashmere has complied with federal investment limitations applicable to banks. The Association admits that Cashmere's compliance with these federal limitations "is not in question." Amicus Mem. at 7 n.2. Thus, the federal definitions describing allowable bank investments are not relevant.[2]

Even if they were relevant, however, the definitions of Type IV and Type V investments would not apply to most of the investments at issue in this case. A significant majority of Cashmere's REMIC investments were what are considered Type I securities, which include obligations of the Federal National Mortgage Association ("Fannie Mae") or the Federal Home Loan Mortgage Corporation ("Freddie Mac").[3] *See* 12 U.S.C. § 24 (Seventh) (allowing banks to deal in or purchase, without limitation, such obligations); 12 C.F.R. § 1.2(j)(5) (defining Type I to include obligations authorized in 12 U.S.C. § 24, with no mention of whether the investment is "secured"). The Association admits that Type I

[2] Although the definitions of Type IV and Type V securities are mutually exclusive, the Association does not identify which definition it believes applies to the investments at issue in this case. *See* 12 C.F.R. § 1.2(n) (defining Type V in part as not a Type IV security).

[3] In 2004, for instance, all but two of the 53 REMICs in Cashmere's portfolio were Type I investments issued by Fannie Mae, Freddie Mac, and Ginnie Mae. *See* CP 500, column C (investment description), CP 510, column DC (bank accounting code "4.b.1"); CP 340 (Federal Financial Institutions Examination Council Instructions requiring banks to report using code 4.b.1 for CMOs and REMICs issued by Fannie Mae, Freddie Mac, Ginnie Mae, and the U.S. Dept. of Veteran's Affairs).

REMICs are expressly excluded from the Type IV definition. Amicus Mem. at 7.

2. The nature of the investment dictates whether it qualifies for the deduction in RCW 82.04.4292, not whether a trust has issued the investment.

According to the Association, the reason federal banking regulations treat REMICs as "secured" investments is that the investment vehicle is a trust, which creates "the flow-through nature of the investors' beneficial *interests* in trusts and beneficial *ownership* of trust assets." Amicus Mem. at 7 (emphasis in original). The Association argues that the Court of Appeals failed to recognize the significance of this trust relationship. *Id.* at 2, 8. These arguments are ineffective because REMIC payments to investors do not simply "flow through" from trust assets to the investors, unlike investments in some other mortgage-backed securities. Rather, REMIC payments are dictated by the particular bond class in which an investor holds a certificate. In addition, the Association gives controlling weight to the investment being a trust vehicle, rather than to the specific features of the investment. In doing so, it loses sight of the requirement in RCW 82.04.4292 that a qualifying investment be "secured *by* first mortgages or trust deeds on nontransient residential properties." (Emphasis added). A taxpayer may not take the deduction merely because it has a "'secured' status" as a trust beneficiary with a beneficial interest in trust assets. *See* Amicus Mem. at 9.

Historically, pools of mortgages used to create mortgage-backed securities were placed into a trust for federal income tax reasons, with the

goal that income the trust received and distributed to investors was subject to federal income tax only at the investor level. Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 Notre Dame L. Rev. 497, 502-03 (1989). There is a type of mortgage-backed security in which income to investors *does* "flow through" the trust from the trust assets to the trust beneficiaries (investors), and those are known as "mortgage pass-through securities." The Court of Appeals took pains to distinguish mortgage pass-through securities, in which the investor has an undivided interest in a pool of mortgages, from REMICs, in which investors have the contractual rights stated for a particular certificate class to specific cash flows from mortgage loans, mortgage pass-through securities, or certificates from other REMICs. *Cashmere*, 175 Wn. App. at 410-13; *see also* CP 339; CP 761-62. As the Court correctly stated, REMICs "remove investor rights in the underlying mortgages." 175 Wn. App. at 412.

Like Cashmere has done in its own briefing, the Association attempts to blur the distinction between mortgage pass-through securities and REMICs.[4] But the only investments at issue here are REMICs. A sample investment in the court record demonstrates how Cashmere's investment income was controlled by contract terms for the tranche or

[4] For instance, the Association relies on a federal district court case from New York as providing an appropriate description of REMICs, CMOs, and other mortgage-backed securities, but the case concerns mortgage pass-through certificates. Amicus Mem. at 2-3; *see In re Lehman Bros. Securities and ERISA Litigation*, 681 F. Supp. 2d 495, 496-97 (S.D.N.Y. 2010), *aff'd sub nom. In re Lehman Bros. Mortgage-Backed Securities Litigation*, 650 F.3d 167 (2d Cir. 2011).

certificate class, rather than by any generalized beneficial ownership interest Cashmere had as a trust investor.

The sample REMIC is Fannie Mae REMIC Trust 2000-38, and it offered sixteen tranches, designated by letters. CP 355. About half of the classes were bonds paying fixed interest, but several had floating interest rates. One class paid principal only, and two classes paid interest only. *Id.* Cashmere purchased a Z class bond in this REMIC. CP 512; CP 630. For this Z class bond, Cashmere received a fixed interest rate of seven percent during the time it owned this investment. CP 632. However, because the Z class represented an "accrual" bond, interest was not paid in the typical way. Rather than regular interest payments made to Cashmere, the interest was actually paid to two other bond classes, with equivalent amounts added to the principal amount of the Z class bond. The effect was to postpone Cashmere's receipt of principal and interest payments on its investments until the other bond classes were paid fully. CP 632-25; CP 367, 369 (prospectus supplement describing how interest and principal was distributed to Z class bondholders).[5]

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[5] In a case the Association cites, the Seventh Circuit recognized that creating multiple tranches of investment bonds having different rights and carrying different interest rates creates latent conflicts of interest.

> Faced with a choice between modifying one of the mortgages and foreclosing, the servicer might make a different decision as a representative of the senior tranche holder [who was entitled to the first 80 percent of any income generated by the mortgages] from the decision he'd make as a representative of the junior one [who would bear more risk and be compensated with a higher interest rate].

CWCapital Asset Management, LLC v. Chicago Properties, LLC, 610 F.3d 497, 500 (7th Cir. 2010); *see* Amicus Mem. at 9. The servicer may prefer modifying a mortgage to

In contrast to the foregoing example, mortgage pass-through securities (unlike CMOs and REMICs) represent a beneficial ownership of a fractional undivided interest in a fixed pool of mortgage loans. CP 619; Pittman, 64 Notre Dame L. Rev. at 499. Each fractionalized interest is entitled to a pro rata share of the interest and principal payments generated by the underlying mortgage loans. 7 J. William Hicks, *Exempted Transactions Under the Securities Act of 1933* § 1:92 (2012); CP 619. Although a trust is the vehicle for issuing investments in mortgage pass-through securities, REMICs, and CMOs, only in the simpler mortgage pass-through security does the nature of the investment create a direct path from the trust assets to the trust investors.

As a final point, the Association also argues that Cashmere's lack of direct recourse or contractual rights against the mortgage collateral are merely a function of civil procedure and trust law. Amicus Mem. at 9-10. However, given the conflicts created by multi-tranche securities (*see CWCapital*, 610 F.3d at 500, quoted in footnote 5, above), this absence of rights is more accurately understood as a necessity dictated by the nature of the investment vehicle. Likewise, as *CWCapital* also demonstrates, the specific details concerning actions to address a delinquent mortgage loan are commonly found in a pooling and servicing agreement between the

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foreclosing, which would suit the preferences of the senior tranche holder if the diminished income still covered its 80 percent interest in the revenue. On the other hand, the junior tranche holder might prefer the servicer gamble on obtaining more money by foreclosing or holding out for a less generous modification. The Seventh Circuit concluded that the servicer "must balance impartially the interests of the different tranches as determined by their contractual entitlements." *CWCapital*, 610 F.3d at 500.

trustee of a REMIC or other mortgage-backed security and the loan servicer. *CWCapital*, 610 F.3d at 501. In other words, regardless of the trust structure of the investment, the primary sources of trustee, servicer, and investor rights and responsibilities are the contracts between the respective parties, not general principles of trust law.

No evidence in the record in this case suggests that Cashmere had any rights, under contract or otherwise, to seek recourse against any mortgage borrowers or the real property securing their mortgage loans for either a borrower default or a REMIC trustee's default in making a required bond payment to Cashmere. The Court of Appeals decision creates no "incoherence" with trust law, and review is not warranted.

III. CONCLUSION

For the foregoing reasons and those addressed in the Department's answer to the petition for review, this Court should deny Cashmere's petition for review.

DATED this 11th day of December, 2013.

ROBERT W. FERGUSON
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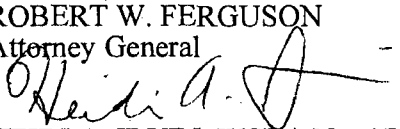

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I certify under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DATED this 11th day of December, 2013, at Tumwater, WA.

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