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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 BRIEF OF AMICUS CURIAE WASHINGTON BANKERS ASSOCIATION

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I. INTRODUCTION

Although the Legislature allows most other taxpayers to deduct investment income from the measure of business and occupation ("B&O") tax, the Legislature expressly excluded banks from that broad deduction. RCW 82.04.4281(1)(a) & (2)(b). The deduction it enacted for banks is much narrower, applying only to interest income from investments or loans "primarily secured by first mortgages or trust deeds on nontransient residential properties." RCW 82.04.4292 (2004). Interpreting this requirement in the context of Cashmere Valley Bank's investments in REMICs and CMOs, the Court of Appeals applied the common and ordinary meaning of what it means for an investment or loan to be "secured by" specified collateral. *Cashmere Valley Bank v. Dep't of Revenue*, 175 Wn. App. 403, 417, 305 P.3d 1123 (2013) (noting that a familiar legal term should be given its familiar meaning). Focusing on Cashmere's lack of any legal recourse to the mortgages and trust deeds underlying its investments, the Court of Appeals correctly held as a matter of law that Cashmere's investments in REMICs and CMOs did not qualify for the deduction in RCW 82.04.4292. *Id.* at 406, 417-19.

Amicus curiae Washington Bankers Association criticizes the Court of Appeals for taking a "blinkered" approach to the case. Amicus Br. at 1. However, it is the Association, not the Court of Appeals, that turns a blind eye to inconvenient facts and legal authorities. The Court of Appeals decision is consistent with federal banking law, state and federal case law, and the evidence in the record.

The Association makes plain its belief that public policy supports expanding the deduction to include investments such as REMICs that are not secured by mortgages and deeds of trust, where the interest income can be traced back to loans secured by mortgages and trust deeds. The Association should make that case to the Legislature. In the meantime, this Court should interpret RCW 82.04.4292 as the Court of Appeals did, discerning the Legislature's intent by applying the common and ordinary meaning of statutory terms.

II. ARGUMENT

A. The *Security Pacific* Decision Turned On Ownership Of The Mortgage Loans And Is Consistent With The Court Of Appeals Decision In This Case.

The Association argues 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 Br. at 7-9. The Association claims the Court of Appeals in this case incorrectly equated "security" with "remedy" because 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 Br. at 7 (criticizing *Cashmere*, 175 Wn. App. at 418-19).

As the Department has already explained, there is no conflict. Answer to Amicus Curiae Mem. at 2-3; Answer to Petition at 13-17. Unlike in this case, Security Pacific demanded assignments from mortgage companies in return for loaning funds to those companies to make residential loans. 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 instruments (bonds) Cashmere purchased. 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.

The Association does not dispute that REMIC investors such as Cashmere have no legal recourse against mortgage borrowers in the event of either the REMIC trustee's default or borrower default. In the Association's view, however, a REMIC investor's remedies do not determine whether the investment is secured by mortgages. According to the Association, the court in *Security Pacific* "held" that:

> The *value* of collateral rights directly *or indirectly* associated with a mortgage-related investment determines the investment's "primary security," not the procedural remedies directly available to the investor.

Amicus Br. at 7 (emphasis in original). The Association provides no citation to *Security Pacific* for its assertion, and no such statement can be found in the case.

What *Security Pacific does* hold is that the mortgage company's assignments transferred ownership of the mortgage loans to Security Pacific. *Security Pacific*, 109 Wn. App. at 807-08 (upholding Board of Tax Appeals). If the mortgage company defaulted on its debt to Security Pacific, Security Pacific was able to foreclose against real property subject to an assigned deed of trust related to any defaulting home buyer. *Id.* at 801 n.3. Because the assignments put Security Pacific "in the shoes of" the mortgage companies as to the home buyers, it qualified to take the deduction in RCW 82.04.4292 for interest earned on the mortgage loans before selling them to the secondary market. *Id.* at 810-11.

Rather than supporting Cashmere in this case, *Security Pacific* highlights the reasons why Cashmere is not entitled to the deduction for its investments in REMICs and CMOs. Cashmere has not been assigned, nor assumed ownership of, any mortgage loans or rights under mortgages or deeds of trust. In this case, Cashmere purchased investments in REMIC certificates (essentially bond instruments) in return for the issuer's promise to pay Cashmere interest and principal at specific times from cash flows generated by the assets of the trusts. CP 595; CP 684; CP 761-62. The assets of the trust were mortgage pass-through securities comprised of pools of loans secured by first mortgages or deeds of trust on residential properties. CP 358, 362; CP 697. The REMIC issuers promised to pay

Cashmere in accordance with the terms of the bond class Cashmere purchased. *See, e.g.,* CP 355, 367; CP 704. Unlike in *Security Pacific*, however, the REMIC issuers provided no assignment of a real property interest as collateral for their promises to pay. As the court correctly noted, a mere promise to pay "is not security." *Security Pacific*, 109 Wn. App. at 808. In contrast, a mortgage or deed of trust provides security that "can be foreclosed after default on the note." *Id.* Thus, *Security Pacific* supports the Court of Appeals decision below.

B. The Association's Federal Law Authorities Do Not Reveal Any Error In The Court Of Appeals Decision, Which Interprets A State Tax Statute.

The Association argues that the Court of Appeals decision is "at variance" with federal banking and securities law. Amicus Br. at 1, 9-18. Contrary to the Association's arguments, neither federal statutes nor federal cases establish any error in the Court of Appeals decision in this case.[1]

1. Federal law regarding permissible bank investments does not demonstrate why investments in REMICs do not qualify for the deduction in RCW 82.04.4292.

This case does not address whether Cashmere's investments in REMICs and CMOs were allowed by federal law, and the Association agrees that Cashmere's compliance with federal law is not in question. Amicus Br. at 10 n.3. Nonetheless, based on what federal regulators have

[1] Significantly, the Association does not argue that federal law preempts an interpretation of RCW 82.04.4292 that precludes banks from taking the tax deduction for income from investments in REMICs and CMOs.

classified as Type IV and Type V securities, the Association argues that Cashmere's investments were "secured." *Id.* at 10.

The federal definitions of Type IV and Type V securities do not apply to most of the investments at issue in this case. A significant majority of Cashmere's REMIC investments were Type I securities, which include obligations of the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac").[2] *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 REMICs are expressly excluded from the Type IV definition. Amicus Br. at 11 n.4.

To the limited extent the regulatory definitions of Type IV and Type V securities apply to any of Cashmere's privately-issued REMICs, they do not suggest any error in the Court of Appeals interpretation of RCW 82.04.4292. The definition of a Type IV security in part incorporates the statutory definition of "mortgage related security" in Section 3(a)(41) of the Securities Exchange Act of 1934, codified at 15

[2] 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. Department of Veteran's Affairs).

U.S.C. § 78c(a)(41). 12 C.F.R. § 1.2(m)(3).[3] The "mortgage related securities" that fall within the definition in 15 U.S.C. § 78c(a)(41) include simpler forms of residential mortgage-backed securities such as mortgage pass-through certificates, so long as they meet certain standards of credit-worthiness and are directly secured by first liens on real estate (or a manufactured home) and originated by a qualified financial institution.[4] 15 U.S.C. § 78c(a)(41)(A). Congress also included certain multi-tranche investments such as CMOs and REMICs in the "mortgage related security" definition. 15 U.S.C. § 78c(a)(41)(B); Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 Notre Dame L. Rev. 497, 516 (1989).[5]

As commentators have noted, the federal definition of "mortgage related security" was "crafted broadly to include both pass-through certificates as well as mortgage pay-through bonds, such as CMOs."

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[3] The regulatory definition of a Type IV security also includes certain small-business-related securities and commercial mortgage-related securities. 12 C.F.R. § 1.2(m)(1)-(2).

[4] For a description of mortgage pass-through securities, see Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 Notre Dame L. Rev. 497, 499 (1989) and 7 J. William Hicks, *Exempted Transactions Under the Securities Act of 1933*, § 1:92 (2012). As the Department has discussed in prior briefing and the Court of Appeals noted, the Department allows financial institutions to deduct interest from investments in mortgage pass-through certificates under RCW 82.04.4292. Dep't Supp. Br. at 16-17; Determination No. 90-288, 10 Wash. Tax Dec. 314 (1990) (CP 874-78); *Cashmere*, 175 Wn. App. at 411-12, 418.

[5] Contrary to the Association's assertions, the only investments at issue in this case are REMICs and CMOs. *See* Amicus Br. at 5. Cashmere stated the investments were REMICs and CMOs in its complaint and designated them as such in its financial records, according to bank regulatory standards. *See* CP 15 (¶ 19); CP 339 (FFIEC instructions); CP 510, 521 ("DC" column). Cashmere also acknowledged that the Department allowed the deduction for interest on mortgage pass-through certificates during the tax period. Cashmere's Suppl. Br. at 17 n.12.

Pittman, 64 Notre Dame L. Rev. at 515. However, the same cannot be said of RCW 82.04.4292, which was drafted narrowly, not broadly. The only investments that qualify for the tax deduction are those that are "primarily secured by first mortgages or trust deeds on nontransient residential properties." RCW 82.04.4292 does not include language that would extend the deduction to multi-tranche investments that provide interest and principal payments to the investor from specific cash flows, merely because the cash flow can be traced to first-lien mortgage payments. Instead, the deduction in RCW 82.04.4292 is limited to those investments that are actually and primarily secured by the first lien on residential real estate. *See Cashmere*, 175 Wn. App. at 416 (to take the deduction, Cashmere must show that its investments are themselves secured by mortgages or trust deeds).

The regulatory definition of a Type V security in 12 C.F.R. § 1.2(n) includes certain other asset-based securities (e.g., securities backed by auto loans, credit card loans, etc.) that are not Type IV securities. The definition of a Type V security does not require the pool of loans to be secured by "first mortgages or trust deeds on nontransient residential properties." RCW 82.04.4292. Therefore, 12 C.F.R. § 1.2(n) is of no assistance in determining whether any particular investment qualifies for the deduction in RCW 82.04.4292.

The definitions of Type IV and Type V securities in which banks are allowed to invest largely do not apply to Cashmere's investments and are otherwise of little assistance in discerning legislative intent regarding

RCW 82.04.4292. The language the Legislature used in 1970 does not mirror, and is not controlled by, the federal regulatory definitions of Type IV and Type V securities promulgated many years later. The Association's arguments are neither relevant nor persuasive.

2. The language of RCW 82.04.4292, rather than policies regarding the secondary mortgage market, controls the outcome of this case.

The Association argues that the Legislature's purpose in RCW 82.04.4292 to stimulate the residential housing market "will be undone" if the Court of Appeals decision is upheld. Amicus Br. at 11-12 (quoting *HomeStreet, Inc. v. Dep't of Revenue*, 166 Wn.2d 444, 454, 210 P.3d 297 (2009)). If that were so, there should have been an outcry from the banks in 1990, when the Department issued a published determination denying the deduction for investments in CMOs. *See* Determination No. 90-288, 10 Wash. Tax Dec. 314 (1990) (CP 874-78). Instead, the issue did not come to the fore until this case.

The Association also argues that Congress had a similar goal in amending the definition of "mortgage related securities" in 1984 as part of the Secondary Mortgage Market Enhancement Act of 1984 ("SMMEA"), Pub. L. 98-440, 98 Stat. 1689 (1984). Amicus Br. at 11. As the Association argues, Congress was focused on expanding the types of investments banks could invest in. *Id.*

Although the legislative history of SMMEA does suggest that Congress intended to increase participation in investments in the secondary market for mortgages, its principal focus was on allowing

private entities to issue complex mortgage-backed securities at a time when Fannie Mae, Freddie Mac, and Ginnie Mae accounted for the vast majority of public secondary mortgage activity. S. Rep. No. 98-293, at 3 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2809, 2811; Pittman, 64 Notre Dame L. Rev. at 512-13. Those government-sponsored entities had a competitive advantage, and SMMEA leveled the playing field for entry of private issuers such as Wells Fargo or JP Morgan Chase.

Regardless of Congress's goals in enacting SMMEA in 1984, however, the statute at issue here is a state tax statute, with no relation to any broad legislation concerning the secondary mortgage market. This Court's interpretation should turn on the intent of the Legislature as evidenced by the words it used in RCW 82.04.4292.

The Legislature expressed its clear intent that a qualifying investment be "secured by first mortgages or trust deeds" on residential property. Before 1970, when the Legislature enacted this deduction, and continuing through the present, a mortgage "'creates . . . a lien in support of the debt which it is given to secure.'" *Bain v. Metropolitan Mortgage Group, Inc.*, 175 Wn.2d 83, 92, 285 P.3d 34 (2012) (quoting *Pratt v. Pratt*, 121 Wash. 298, 300, 209 P. 535 (1922)). By its choice of language, the Legislature thus intended that the deduction apply only to investments or loans secured by first liens on real property.

The word "first" in RCW 82.04.4292 underscores this conclusion because it relates to a claim on the real property title. A "first" mortgage or deed of trust is one that has seniority over second mortgages and other

more junior claims against the title of property pledged to secure the debt. Interpreting the statute as the Department has, and as the trial court and the Court of Appeals have affirmed, gives effect to this important indicator of legislative intent. *See Lakemont Ridge Homeowners Ass'n v. Lakemont Ridge Ltd. Partnership*, 156 Wn.2d 696, 699, 703, 131 P.3d 905 (2006) (court must construe statutes to give effect to all language). Because Cashmere's investments in REMICs and CMOs were not secured by first mortgages and trust deeds, they do not qualify for the deduction.

3. RCW 82.04.4292 does not apply to any mortgage-backed security merely because the value of the security is related to payment by mortgage borrowers.

The Association cites a number of federal cases for the point that the value of a mortgage-backed security, whether a simple mortgage pass-through certificate or a more complex multi-tranche REMIC or CMO, depends upon the quality and characteristics of the mortgages that are the source of cash flow to the investor. Amicus Br. at 15-18. However, the same can be said of any "asset-backed" security where income to the investor in the security is to any degree dependent upon income coming into the security from a group of assets. The Association does nothing more than state the obvious.

What the Association has not done is provide authority for the proposition that a REMIC investment's connection to the value of mortgage loans underlying the securities that comprise the REMIC assets is the legal equivalent of the REMIC certificate being "secured by" mortgages and deeds of trust. In the case of simple mortgage-backed

securities where investors have a fractional undivided interest in a fixed mortgage pool, the investment can be thought of as "secured by" those mortgages and trust deeds because of the direct connection between those investments and those mortgages. REMICs and CMOs lack that same connection. Investors in REMICs and CMOs do not have a fractional undivided interest in the trust assets. Instead, they have only a right to certain cash payments from the certificate issuer. While the investment may be relatively safe, particularly if payment is guaranteed by Freddie Mac or Fannie Mae, the REMIC tranche investment is not "secured by" mortgages or trust deeds.

Under RCW 82.04.4292, something more than tracing value to a mortgage loan is required.[6] The common and ordinary definition of a debt "secured by" other property is one where the debtor provides rights to a separate asset in the event the debtor defaults. *See Security Pacific*, 109 Wn. App. 795, 808 (distinguishing between a promissory note or mere promise to pay and a secured loan). The Association has not offered a reason to water down this traditional meaning or demonstrated that the Legislature intended to do so.

The Association also cites a number of federal cases involving mortgage-backed securities where the courts have used the words "backed by," "supported by," or "secured by" in reference to the underlying

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[6] The Court of Appeals commented that Cashmere's tracing theory, which is similar to the Association's value argument, gives rise to a "tranche train" spectre, in which there is no stopping point for what qualifies as "secured by" mortgages or trust deeds, so long as the cash flow (or value) is traceable back through multiple layers of REMICs. *Cashmere*, 175 Wn. App. at 415.

mortgages, or which make no distinction between mortgage pass-through certificates and multi-tranche investments like REMICs and CMOs. Amicus Br. at 6, 13-15. The vast majority of those cases address motions to dismiss related to securities fraud, breach of fiduciary duties, standing, or statutes of limitations. *See, e.g., Federal Housing Finance Agency v. UBS Americas, Inc.*, 858 F. Supp. 2d 306 (S.D.N.Y. 2012) (motion to dismiss regarding securities fraud claims), *aff'd*, 712 F.3d 136 (2d Cir. 2013); *In re Washington Mutual Mortgage-Backed Securities Litigation*, 276 F.R.D. 658 (W.D. Wash. 2011) (addressing standing and class certification). Most of them do not discuss in detail the investments at issue, providing only a summary of what the complaint in the action alleges. *See In re Bear Stearns Mortgage Pass-Through Certificates Litigation*, 851 F. Supp. 2d 746, 751-52 (S.D.N.Y. 2012) (summarizing allegations of third amended complaint); *In re Wells Fargo Mortgage-Backed Certificate Litigation*, 712 F. Supp. 2d 958, 961 (N.D. Cal. 2010) (summarizing complaint in securities fraud case).

None of the Association's cases focuses on what rights the investor has in mortgages and trust deeds, which is understandable, since the claims primarily are against issuers, underwriters, etc. *See In re Lehman Bros. Mortgage-Backed Securities Litigation*, 650 F.3d 167, 170 (2d Cir. 2011) (claims against rating agencies); *In re Wells Fargo*, 712 F. Supp. 2d at 961-62 (claims against mortgage lender, rating agencies, and underwriters). In short, the casual references in these cases to the

underlying mortgages does not provide useful assistance in interpreting the phrase "secured by first mortgages or trust deeds" in RCW 82.04.4292.

4. REMIC and CMO investors purchase rights to cash flow, rather than rights in real property.

What *is* clear from the cases the Association cites and from other cases and authorities is that what an investor in a REMIC or CMO purchases is rights to *cash flow*. *See In re Lehman Bros.*, 650 F.3d at 171 (the depositor secures "rights to cash flows from the loans so that those rights can be sold to investors"); *Federal Housing Finance Agency*, 858 F. Supp. 2d at 311 (defining residential mortgage-backed securities as securities "entitling the holder to income payments from pools of residential mortgage loans held by a trust"); *In re Wells Fargo*, 712 F. Supp. 2d at 961 ("rights to loan revenues" sold to investors).[7]

The Department recognized in 1990 that while investments in mortgage pass-through securities gave investors sufficient interest in real property to allow the deduction in RCW 82.04.4292, investments in multi-tranche investments such as CMOs did not qualify for the deduction. Investments in CMOs "are an additional step removed" from rights against

[7] *See also In re Countrywide Financial Corp. Mortgage-Backed Securities Litigation*, 932 F. Supp. 2d 1095, 1104 (C.D. Cal. 2013) ("A certificate entitled the holder to a portion of the cash-flow from the pool of underlying mortgages."); *Franklin Sav. Corp. v. U.S.*, 56 Fed. Cl. 720, 722 n.3 (Fed. Cl. 2003) ("A mortgage backed security is a security in which the creditor is entitled to payments (cash flow) from a pool of mortgage loans secured by real estate."); Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity, and Systemic Risk*, 64 Stan. L. Rev. 657, 672 (2012) (in multi-tranche investment, each tranche has "a different set of rights to the cash flows from the underlying [mortgage pass-through securities]"); Adam J. Levitin, *The Paper Chase: Securitization, Foreclosure, and the Uncertainty of Mortgage Title*, 63 Duke L. J. 637, 672 (2013) (mortgage-backed securities are debt securities "backed by the cash flow from the mortgages").

the real property because payment obligations under the bond are "separate and distinct" from borrower obligations under the loans. 10 Wash. Tax Dec. at 317-18 (CP 877-78). Cashmere and the Association dismiss the notion that CMOs and REMICs should be treated any differently than mortgage pass-through securities, but others recognize the distinction. In contrast to a mortgage pass-through security, a multi-tranche security "permanently transforms the relationship between the underlying asset and the investors with economic rights to the cash flows from that asset . . . ." Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity, and Systemic Risk*, 64 Stan. L. Rev. 657, 676 (2012).

The rights to cash flow from the mortgage loans are separated from other rights under the mortgages, such as the right to foreclose. Investors in REMICs and CMOs "do not own the loans, but they own the right to receive payment based on the loan payments." Diane E. Thompson, *Foreclosing Modifications: How Servicer Incentives Discourage Loan Modifications*, 86 Wash. L. Rev. 755, 763 (2011). Cashmere's expert economist, Alan Hess, agreed that what investors purchase are cash flows, with other mortgage-related rights remaining with the issuer. CP 570-71. This arrangement benefits investors, who are able to choose the maturity and risk category of the bond suitable to their investment needs. CP 852 (2000 Bank Tax Guide). Likewise, Professor Hess emphasized that from an economic standpoint, "separating ownership of the cash flow receipts

from contract enforcement is one of the many gains of securitization." CP 230; CP 571.

To qualify for the deduction in RCW 82.04.4292, the investment must be "primarily secured by first mortgages and trust deeds" on residential property. CMO and REMIC investments are not secured by mortgages and deeds of trust.

C. The Trust Structure Of REMICs And CMOs Does Not Determine Whether The Investment Is "Secured By Mortgages And Trust Deeds."

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 Br. at 18 (emphasis in original). The Association argues that the Court of Appeals failed to recognize the significance of this trust relationship. *Id.* These arguments are ineffective because REMIC payments to investors do not simply "flow through" from trust assets to the investors, unlike investments in mortgage pass-through securities. Rather, REMIC payments are dictated by the particular bond class in which an investor holds a certificate.[8] In addition, the Association gives controlling weight to the investment being a trust vehicle, rather than to

[8] For instance, in the REMIC example in the record, Cashmere and other Z tranche investors received interest at a fixed rate of 7.00% on their bonds in the form of additional principal, to be paid after all principal to the VA and VB tranches had been paid. CP 355, 359, 367, 369. In contrast, investors in the F tranche received regular interest payments under a floating interest rate calculated by reference to the London Interbank Offered Rate (LIBOR). CP 355, 359.

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). The trust arrangement is not determinative of whether a trust beneficiary's investment is secured by mortgages.

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. Pittman, 64 Notre Dame L. Rev. at 502-03. The type of mortgage-backed security in which income to investors *does* "flow through" the trust from the trust assets to the trust beneficiaries (investors) is a mortgage pass-through security. The Court of Appeals distinguished mortgage pass-through securities from REMICs. The court noted that investors in mortgage pass-through securities have an undivided interest in a pool of mortgages, while REMIC investors have the contractual rights stated for a particular certificate class to specific cash flows from loans, mortgage pass-through securities, or certificates from other REMICs, but no legal interest in the mortgages themselves. *Cashmere*, 175 Wn. App. at 410-13; *see also* Pittman, 64 Notre Dame L. Rev. at 499; 7 J. William Hicks, *Exempted Transactions Under the Securities Act of 1933*, § 1:92 (2012); CP 339; CP 761-62.

To support its argument that REMIC investors are "secured by" mortgages merely because the trustee (Fannie Mae in the case of the example in the record) states that it owns the notes in trust, the Association

quotes *Oklahoma Police Pension & Ret. Sys. v. U.S. Bank N.A.*, 291 F.R.D. 47 (S.D.N.Y. 2013). The district court in that case stated: "The structure of the [CMO] trusts gives certificate holders *an interest* in the underlying evidence of indebtedness, namely the MBS in which the certificates participate." *Id.* at 62 (emphasis added). The Department does not disagree with that statement, but it begs the question of what, exactly, that interest is. As the cases set forth above in Part II.B.4. show, that "interest" is an interest in cash flow, rather than a lien on real property.

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 Br. at 19-20.[9] However, given the latent conflicts of interest created by multi-tranche securities, this absence of rights is equally dictated by the nature of the investment vehicle.[10] Likewise, the specific details concerning actions to address a delinquent mortgage loan are commonly found in a pooling and

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[9] On page 19 of its brief, the Association effectively cites to itself as legal authority for why a trust beneficiary generally has no direct recourse against third parties who have liability to the trust. The citation is to the Supplemental Brief of Petitioner (Cashmere) at 6. Page 6 of Cashmere's Supplemental Brief contains a long block quotation of three paragraphs from the Association's Memorandum of Amicus Curiae in Support of Petition for Review at 9-10.

[10] The Seventh Circuit has noted that creating multiple tranches of investment bonds having different rights and carrying different interest rates creates latent conflicts of interest, which are highlighted in the event of borrower default. *CW Capital Asset Management, LLC v. Chicago Properties, LLC*, 610 F.3d 497, 500 (7th Cir. 2010). The servicer may prefer modifying a mortgage to 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." *CW Capital*, 610 F.3d at 500.

servicing agreement between the trustee of a REMIC or other mortgage-backed security and the loan servicer (but not the investor). *CWCapital Asset Management, LLC v. Chicago Properties, LLC*, 610 F.3d 497, 501 (7th Cir. 2010). 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.

III. CONCLUSION

For the foregoing reasons and those set forth in the other briefs, the Department requests that this Court affirm the Court of Appeals and the trial court.

RESPECTFULLY SUBMITTED this 15th day of May, 2014.

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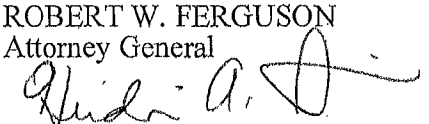

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I certify under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

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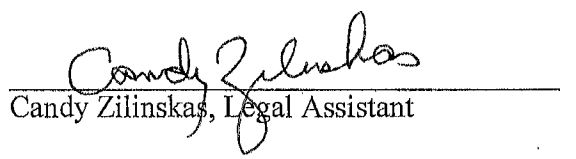

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