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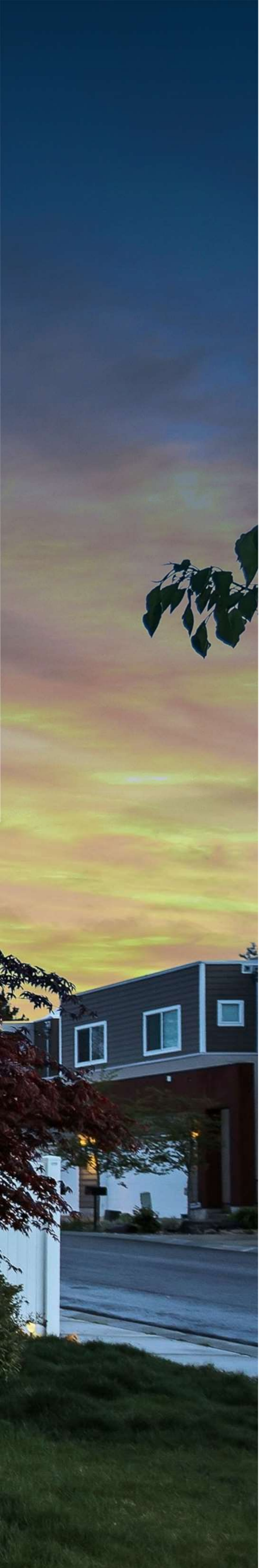
Keys to Unlocking Value in US Housing



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Introduction

As we begin 2024, the housing market is in uncharted waters, with plummeting housing starts, new listings at historic lows, mortgage interest rates up sharply over the past two years and a marked decrease in homes for sale. These conditions have burdened nearly all industries whose success is highly correlated with an active housing market, such as mortgage lending and real estate services, as well as related verticals like storage and home improvement. Given this context, it's no surprise that some of the more esoteric corners of the housing market, such as home equity, mortgage servicing and residential transitional lending, are having their day.

Inevitably, this cycle, like every other one before it, will reverse when interest rates moderate and unleash years of pent-up demand for home sales and purchases, mortgage refinancing and new housing starts. According to the National Association of Realtors, the US is still short 5-6 million units of available housing. This number is likely to grow, as baby boomers are living longer and increasingly prefer to age-in-place (and by doing so hold onto a meaningful share of housing units that if made available to the market would help reduce the shortfall). Smart operators and investors, especially those in the forward mortgage and single-family rental markets, are refining and expanding their platforms, investing in new technologies and developing new products that will help accelerate growth when the market turns.

In the pages that follow, Mayer Brown colleagues with decades of experience in the industry unpack these unique market dynamics and offer a set of insights on the current landscape. The article compilation explores three pivotal themes: market trends, investment pitfalls, and new and innovative investment products. Our clients expect us to help them stay ahead in the fast-evolving housing market, which requires a keen understanding of the forces shaping the markets, adept navigation of potential challenges and an appetite for innovation. In this compilation, our aim is to help you tap into all three by providing actionable insights to unlocking value in the US housing market.

Jon Van Gorp

Chair, Mayer Brown

Flipping Out: The Evolution of Residential Transition Loan Securitizations

By Haukur Gudmundsson, Darius Horton, Russell Nance and Ross Butler

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Since the proliferation of residential transition loans ("RTLs," also known as "fix-and-flip" loans or residential bridge loans) began in recent years, securitizations of these types of loans have become increasingly frequent. Loans intended for the purpose of financing speculative real estate construction have existed for many years, but in the residential space, these loans were typically originated by local "hard money" lenders. In the years following the global financial crisis, nation-wide origination platforms have been developed to service this market. These large originators have naturally turned to the capital markets for securitization leverage.

The first large revolving RTL securitization was issued in 2018, and since then, the asset class has grown significantly. In 2022, it is estimated that total origination volumes in the United States approached $10 billion. Given the conditions of the housing market in the United States, it is no surprise that RTL origination volumes have increased so significantly. The demand for housing in the United States continues to outstrip supply. As the supply of new housing stock falls short of demand, homeowners will instead look to purchase legacy homes that have been modernized and refurbished. An entire industry of home flippers has emerged to satisfy this demand, and the credit markets have responded accordingly.

RTL securitizations have many characteristics that distinguish them from the securitization of more traditional mortgage loans secured by residential properties. Many of these differences arise from the features of the loans themselves, whereas others arise from the relatively recent emergence of this asset class.

This Legal Update first surveys the unique features of RTLs as compared to traditional, consumer-purpose residential mortgage loans. We then turn to the characteristics of RTL securitizations that are necessary to adapt to features of the underlying RTL assets. We conclude with observations about possible improvements on these transactions and speculations about further developments.

Residential Transition Loan Overview; Underwriting and Regulatory Policies

RTLs are a means by which real estate investors ("REIs") may obtain financing for construction, repairs and other rehabilitation and renovation projects on a related mortgaged property. Each loan is generally secured by a first lien on the non-owner-occupied property and is usually of a short duration (up to 36 months) with interest-only payments until maturity. Principal on the loan is due in a balloon payment at maturity.

Given the commercial nature of RTLs, loan borrowers, who are often businesses or other non-natural persons, may not qualify for traditional agency, government or private label mortgage loans due to the rehabilitation or construction needs of the property, loan size, lower credit scores of the borrower or general business purpose of the loan. Because RTLs are business purpose loans, they are also not subject to certain consumer protection regulations such as the Consumer Financial Protection Bureau's Ability-to-Repay/Qualified Mortgage Rule ("ATR/QM Rule")[1] and TILA-RESPA Integrated Disclosure Rule ("TRID Rule").[2]

[1] 12 CFR 1026.43.
[2] 12 CFR 1026.19.

RTLs, therefore, have been developed by loan originators with a unique set of underwriting standards to accommodate the purpose of these loans but result in a product that is more costly for borrowers, in part due to the inherently increased risks and sometimes speculative nature of the underlying property improvement projects. On the other hand, these broader underwriting standards are typically more flexible than traditional standards for residential mortgage loans underwritten by government-sponsored enterprises ("GSEs"). RTLs are underwritten on the assumption that, after the completion of the related construction or rehabilitation projects, the borrower will either sell the mortgaged property or otherwise refinance to repay the RTL. The balloon principal payment compels borrowers to complete the related rehabilitation or construction project on schedule in order to realize any gains on the sale of the property.

Loans being made in anticipation of renovations or repairs to the related mortgaged property are often assigned an estimated after-repair value ("ARV") by a third-party valuation provider to help determine the potential future value of the property after the planned projects have been completed. Because RTL loans generally involve some amount of construction, a portion of the principal balance of the loan is typically held back and not disbursed at origination ("Rehabilitation Holdback Amounts"). Rehabilitation Holdback Amounts are disbursed to the borrower only upon satisfactory completion of phased projected evaluations. Rehabilitation Holdback Amounts can either be fully funded at closing and held in an escrow account pending disbursement to the borrower, or they can be funded at the time of disbursement.

RTL Securitization Characteristics

RTL securitizations have developed to accommodate the unique features of RTLs. Due to the short-term nature of the RTLs, securitizations of this product are almost always revolving. During a securitization's funding period (typically between one and three years), the sponsor of the securitization is permitted to sell or contribute new loans into the deal. These new loans are acquired using proceeds from the repayment of existing RTLs held by the securitization issuer. These new loans are subject to certain eligibility criteria and concentration limits. Operating within the scope of these limitations, however, sponsors are generally permitted to cause the securitization to acquire any loans chosen by the sponsor.

A revolving structure also presents greater flexibility in the timing of closing the securitization. For example, a sponsor might expect a significant volume of new originations in the near future. However, the sponsor desires to price and close a securitization now due to favorable market conditions. In this case, the sponsor might choose to close the securitization with a percentage of the proceeds of the sale of the bonds held in a pre-funding account to acquire new loans as they are originated.

Because RTLs generally have Rehabilitation Holdback Amounts, the securitizations need to be structured to fund these amounts. This is straightforward with respect to Rehabilitation Holdback Amounts that are held in escrow accounts. The securitization servicer can withdraw funds from the related escrow account when the Rehabilitation Holdback Amounts are required to be disbursed to the related underlying borrower. However, with respect to unfunded Rehabilitation Holdback Amounts, the securitization issuer will need a source of funds to either fund the Rehabilitation Holdback Amounts directly or reimburse the servicer for such amounts. Sources of funds could include proceeds from prepayments on the RTLs, a reserve account, or a funding commitment from the securitization sponsor. The securitization might also issue a variable funding note (either to the sponsor or to a third party) that can be drawn on to fund Rehabilitation Holdback Amounts. Regardless of the source of funds, being able to fund Rehabilitation

Holdback Amounts as they are due is vital for the success of an RTL securitization. If the underlying borrowers do not receive expected Rehabilitation Holdback Amounts, it could lead to a failure to complete the related rehabilitation project in a timely manner. This in turn could cause the underlying borrower to be unable to sell the mortgaged property or refinance the RTL at maturity.

Servicing

The unique structural features of RTL securitizations give rise to servicing responsibilities that are not typically found in a standard residential mortgage loan securitization. For example, the servicer (sometimes working in conjunction with an asset manager or the securitization sponsor) is responsible for monitoring requests for disbursement of Rehabilitation Holdback Amounts. Rehabilitation Holdback Amounts are generally only disbursed upon satisfaction by the underlying borrower of certain construction benchmarks, and the servicer is responsible for confirming that these benchmarks have been met. In addition to traditional tax, insurance and other protective advances, a servicer of an RTL securitization might be obligated to advance Rehabilitation Holdback Amounts to the extent the securitization has insufficient funds to fund such amounts.

It is a fact of life that construction and rehabilitation projects are often delayed. Because of this, it is not unusual for underlying borrowers to request an extension of the RTL maturity date. The servicer (sometimes in consultation with an asset manager) is required to evaluate requests for maturity extension. The terms of the securitization might also limit a servicer's discretion to grant such an extension.

Tax Considerations for Revolving Mortgage-Backed Securitizations

By their very nature, RTL securitizations present interesting tax challenges. As with any securitization of mortgage loans, RTL securitizations are potentially subject to the taxable mortgage pool ("TMP") rules. Under the TMP rules, a pool of mortgage loans (other than a pool treated as Real Estate Mortgage Investment Conduit, a "REMIC") that supports two or more classes of debt, the payments on which bear a relationship to collections on the mortgages, will generally be treated as a corporation for U.S. federal income tax purposes. These punitive rules were intended to encourage the use of REMICs by mortgage loan securitizers. REMICs, however, are generally not a suitable vehicle for revolving deals such as RTL securitizations because, typically, new assets cannot be contributed to a REMIC more than 90 days after its formation. As a result, RTL securitizations are generally structured without the necessary relationship between the timing and amount of mortgage loan collections and the timing and amount payments on issued securities (colloquially referred to as "breaking the relationship"). Often this is accomplished by structuring the deal so that subordinate tranches receive principal payments on a fixed date or series of fixed dates after the senior tranche is repaid. Additionally, RTL securitizations often include a significant interest rate step-up on the senior tranche if the tranche is not redeemed by the sponsor by a certain date. This feature can act as the effective repayment date of the senior tranche for tax purposes, allowing the fixed repayment dates of the subordinate tranches to be earlier in time.

Although these methods can be successful in achieving the desired tax treatment, they are often sub-optimal from a business perspective. More recent RTL securitizations have utilized a revolving REMIC structure, where a new REMIC election is made every 90 days, allowing the securitization vehicle to acquire additional RTL loans during the reinvestment period. This innovative, though complex, structure could prove increasingly attractive to RTL sponsors in the future because it allows sponsors to take advantage of the structuring flexibility of a REMIC while still being able to contribute new loans into the securitization more than 90 days after its inception, although it also introduces additional administrative burdens that are absent from other structures.

Conclusion

To date, no RTL securitization has been rated by a nationally recognized rating agency. The novelty of the asset class, combined with the challenges discussed above (such as the broad flexibility of the securitization to acquire new collateral and the need to fund Rehabilitation Holdback Amounts), have proved challenging for rating agencies. However, we expect that as the asset class matures and underwriting and servicing standards become increasingly uniform, an RTL securitization will eventually receive an investment grade rating from a rating agency. Once a set of rating agency criteria has been established, RTL securitizations should only continue to increase in volume in the coming years.

Residential Mortgage Loans: Capital Relief Through Synthetic Securitization

By Brian Kuhl, Matt Bisanz, and Paul Jorissen

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Banking organizations looking to reduce the amount of risk-based regulatory capital required to support residential mortgage loan portfolios can use synthetic securitization to convert the capital treatment of their exposures from wholesale or retail exposures to securitization exposures. In this Legal Update, we discuss how regulatory capital requirements impact banking organizations that hold portfolios of residential mortgage loans and how synthetic securitization can help mitigate the capital charge associated with these portfolios.[3]

Bank Regulatory Capital Overview

Under US regulations, banking organizations must comply with minimum capital requirements intended to protect a bank's solvency. These regulations require banking organizations to maintain certain minimum amounts of capital compared to the value of the bank's exposures, which are weighted based on the level of risk associated with the type of exposure. In general, the more liquid and less volatile an asset or exposure is, the lower its risk weight will be. Risk weights are defined in the regulatory capital requirements and reflect the regulators' assessment of the comparative risk levels of different types of assets and exposures.

When it comes to residential mortgage loans, banking organizations using the standardized approach[4] calculate the minimum capital they are required to hold for a residential mortgage loan by multiplying the amount of the mortgage loan by its associated risk weight. The value assigned to a residential mortgage loan is generally the carrying value for that mortgage loan under generally accepted accounting principles ("GAAP"). For a pool of residential mortgage loans, a banking organization would be required to calculate the minimum capital it must hold based on a risk-weight of 100% or 50% of the value of the entire pool of loans, depending on whether the loans are qualifying first-lien exposures.

However, banking organizations may be interested in reducing the required capital by converting the pool of residential mortgage loans into a different type of exposure that is given a reduced risk-weight. For instance, the risk-weight assigned to a senior securitization exposure may be as low as 20% of the value of the senior tranche—as much as an 80% reduction from the risk weight assigned to a pool of residential mortgage loans. Banking organizations can take advantage of this significant reduction in risk-based capital requirements by converting a pool of residential mortgage loans into a senior securitization exposure through a synthetic securitization. To illustrate in a simplified manner, a synthetic securitization of a pool of residential mortgage loans in which the bank retains a senior tranche valued at 87.5% of the unpaid principal balance of the pool and a third party investor purchases a junior tranche valued at 12.5% can effectively transform the type of asset the banking organization holds on its balance sheet from a pool of residential mortgage loans into a securitization exposure, thereby reducing the capital the bank must hold based on the 80% difference in risk-weight assigned to these two different types of assets.

Synthetic securitizations leverage existing features of the regulatory capital requirements and can be completed by almost any banking organization. But in order to realize the benefits in reducing risk-based capital requirements, a transaction needs to comply with the definition of synthetic securitization and also

[3] We discussed synthetic securitizations extensively in our 2019 series of articles.

[4] Certain larger and internationally active banking organizations calculate risk-weighted assets under the advanced approach. There are relatively few of these organizations and typically the standardized approach is the more relevant analysis for determining the viability of a synthetic securitization.

needs to conform with the initial and ongoing operational and due diligence requirements for synthetic securitizations.[5]

Requirements of a Synthetic Securitization

As an initial matter, in order to constitute a "synthetic securitization," a transaction must meet the following requirements:

a. all or a portion of the credit risk of one or more underlying exposures is retained or transferred to one or more third parties through the use of one or more credit derivatives or guarantees (other than a guarantee that transfers only the credit risk of an individual retail exposure);

b. the credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;

c. performance of the securitization exposures depends upon the performance of the underlying exposures; and

d. all or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities).

In addition, banking organizations may recognize the reduction in risk-weight resulting from a synthetic securitization only if the following operational requirements are satisfied:

a. the credit risk mitigant is financial collateral, an eligible guarantee, or an eligible credit derivative;

b. the banking organization transfers credit risk associated with the underlying exposures to one or more third parties, and the terms and conditions in the credit risk mitigant used do not include certain prohibited provisions;

c. the banking organization obtains a well-reasoned opinion from legal counsel that confirms the enforceability of the credit risk mitigant; and

d. any clean-up calls relating to the securitization meet certain specific requirements.

Benefits of Synthetic Securitizations Under United States Bank Capital Regulations

If the transaction conforms to the definition of "synthetic securitization" and the operational criteria are met, the banking organization can reduce the capital charge it is required to hold on a portfolio of residential mortgage loans.

As discussed above, portfolios of residential mortgage loans generally will be subject to a 100% or 50% risk-weight. This would typically result in a very high capital charge because the banking organization must hold capital against the entire adjusted amount of the portfolio. However, if a banking organization synthetically securitizes the portfolio, it can reduce its capital charge by as much as 80%.

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[5] The calculation of the specific risk-weight for a securitization exposure is a highly quantitative process that is beyond the scope of this article.

To illustrate, a portfolio of residential mortgage loans not subject to a synthetic securitization will be given a risk-weight of 100% or 50%. A banking organization generally would be required to maintain a total capital ratio of 8% for such assets. For a portfolio of loans valued at $1 billion, then, the banking organization could be required to maintain regulatory capital equal to $80 million (*i.e.* the product of 8% capital ratio x 100% risk-weight x $1 billion value of the portfolio).

If the banking organization attaches that $1 billion portfolio of loans to a synthetic securitization, the regulatory capital requirement could be reduced from $80 million to $14 million. To achieve this, the banking organization would issue a junior tranche (or tranches) to a third party valued at $125 million. The risk-weight of this junior tranche could be as low as 0% if it was properly collateralized,[6] so the banking organization's required capital hold for the junior tranche would be $0. The bank would then also issue a senior tranche valued at $875 million, which the bank would retain. Because a securitization exposure is given a risk-weight of 20%, the banking organization's required capital hold for the senior tranche would be $14 million (*i.e.* the product of 8% capital ratio x 20% risk-weight x $875 million value of the securitization exposure).

So by attaching that $1 billion portfolio of residential mortgage loans to a synthetic securitization, the banking organization reduces its regulatory capital requirement by $66 million (from $80 million to $14 million).

Types of Synthetic Securitizations

There are three primary types of synthetic securitizations, each with its own benefits and drawbacks.

The first type is a standard credit default swap or guarantee. The primary advantage of this arrangement is that it is bilateral and relatively simple. But the downside is that the credit default swap or guarantee is illiquid and cannot be sold or leveraged, which negatively impacts the pricing. Additionally, a credit default swap or guarantee must satisfy certain additional eligibility requirements that often are difficult to satisfy as a practical matter.

A second type of synthetic securitization is credit-linked notes issued by a special purpose vehicle. A credit-linked note ("CLN") is a security with an embedded credit default swap or guarantee that permits the issuer to shift specific risk to credit investors. In these deals, the CLNs are fully funded at issuance and the proceeds of the CLN issuance are deposited into a trust account for the benefit of the bank and the CLN investors.[7] If the cash in the trust account is used to make credit protection payments to the bank, payments on the CLNs are also reduced. Transactions containing CLNs issued by special purpose vehicles are more common outside of the United States. These structures are more liquid than bilateral credit

[6] It should be noted that because a synthetic securitization does not remove the underlying residential mortgage loans from the balance sheet of the banking organization, the organization would technically need to look at the regulations to determine the risk-weight of the exposure the organization holds in relation to the junior tranche held by a third party. However, this is normally a zero risk-weight because the exposure may be secured by financial collateral (*i.e.* cash on deposit). Or, for synthetic securitizations that use a credit derivative or guarantee rather than financial collateral as the risk mitigant, the risk-weight associated with the exposure on the junior tranche will be based on the risk-weight associated with the party providing the guarantee or credit derivative.

[7] The proceeds are then typically invested in eligible financial collateral, which generally includes cash, gold, certain investment grade securities, publicly traded equities, publicly traded bonds, and certain shares of money market funds in which the banking institution has a perfected, first-priority security interest or the legal equivalent thereof.

default swaps or guarantees, but may raise additional costs and legal issues when compared to CLNs issued by a bank, which is the third common transaction type.

Bank-issued CLN transactions are very similar to transactions involving CLNs issued by special purpose vehicles, except that the CLNs are unsecured debt obligations of the bank rather than limited recourse debt obligations of the special purpose vehicle. Transactions with bank-issued CLNs are more common in the United States. These transactions are also more liquid than bilateral credit default swaps and guarantees, but also do not raise some of the legal issues and additional costs that arise in deals involving CLNs issued by a special purpose vehicle.

Why Choose a Synthetic Securitization Over a Cash (Traditional) Securitization?

Synthetic securitizations offer banking organizations an easier method of receiving capital relief when compared to more traditional cash securitizations. In a cash or traditional securitization, the bank will receive capital relief only if it is able to de-recognize the risk-weighted assets transferred into the securitization under GAAP. However, achieving GAAP derecognition may be difficult due to changes that were made to the GAAP rules after the global financial crisis of the late 2000s. To achieve derecognition, the assets must be considered removed from the bank's balance sheet from a GAAP accounting standpoint, which is different and a more difficult analysis than simply legally transferring the assets to a special purpose vehicle. This is particularly true if the bank retains tranches and/or "control" of the securitization vehicle, which is a common feature of cash securitizations.

In a synthetic securitization, on the other hand, the risk-weighted assets remain on the bank's balance sheet. Therefore, synthetic securitization allows a banking organization to achieve capital relief without any GAAP analysis about derecognition of assets.

Conclusion

Banking organizations that hold residential mortgage loan portfolios on their balance sheets should consider the benefits of using a synthetic securitization transaction to convert the capital treatment of their exposures from wholesale or retail exposures to securitization exposures. A synthetic securitization would reduce the amount of risk-based regulatory capital that the banking organization is required to hold in support of the residential mortgage loan portfolio by as much as 80%, allowing the banking organization to free up cash for other purposes.

Mayer Brown regularly works with our banking clients on various strategies to reduce our clients' regulatory capital charges, including representing our clients in synthetic securitizations of portfolios of residential mortgage loans. Our clients seek our counsel because these transactions often involve complex interpretations of regulatory capital requirements under both US and European laws and regulations. Additionally, many banking organizations rely on us to submit memorandums regarding their compliance with the European Union capital requirements regulations in connection with their synthetic securitizations. Please contact the authors of this article or your preferred Mayer Brown contact if you are interested in using synthetic securitization to help manage capital charges from portfolios of residential mortgage loans.

Freddie Mac Issuance Trends: Multi PCs, MSCR Notes and Q-Deals

By Eric M. Reilly, Miller J. Smith and Jon A. Schlotterback

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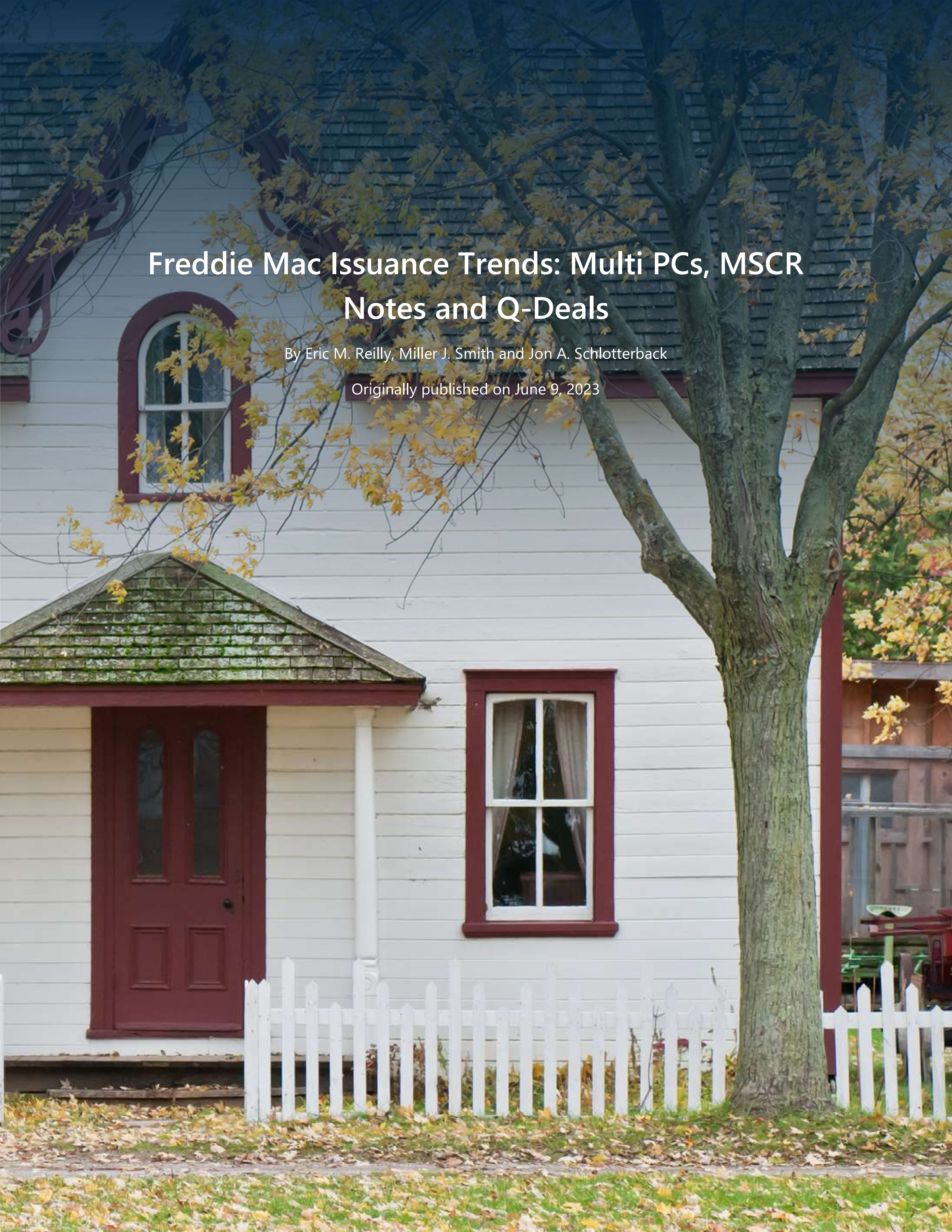

In March 2022, the United States Federal Reserve (the "Federal Reserve") began a series of aggressive rate hikes in an effort to tame an 8.5% year-over-year inflation rate[8] that peaked at 9.1%, the highest rate in roughly 40 years.[9] In just over one year, the Federal Reserve raised the federal funds rate by 500 basis points ("bps"), a historic campaign for its speed and magnitude.[10] As a result, commercial real estate collateralized loan obligation ("CRE CLO") issuance, which experienced a blockbuster 2021 and strong start to 2022, has slowed considerably.[11] With less favorable market conditions and slowing originations, some issuers have sought alternatives to CRE CLOs. Two Freddie Mac ("Freddie") offerings, Multifamily Participation Certificates ("Multi PCs") and Q-Deals, represent potential avenues for CRE CLO issuers seeking an exit strategy for mortgage loans secured by multifamily properties. Following the increased issuance of Multi PCs, Multifamily Structured Credit Risk ("MSCR") Notes, which reference Multi PCs (among other reference obligations), have seen a sharp rise in recent activity that may continue as Freddie utilizes this credit risk transfer ("CRT") program with respect to its Multi PC platform. Further, with significantly tighter spreads than CRE CLO issuances[12] and a lower weighted average cost of capital for issuers,[13] issuers can continue to take advantage of Freddie's Q-Deal program to securitize eligible loans.

I. Multi PCs/MSCR Notes Background

Multi PCs are single-tranche securities often representing a single mortgage loan. They are fully serviced by Freddie, supported by the agency's guarantee and issued either simultaneously with, or soon after, the loan's purchase.[14] These securities are backed by several different categories of multifamily properties, including "standard multifamily housing, student housing, seniors housing, manufactured housing communities, cooperative housing and Targeted Affordable Housing", each of which satisfies Freddie's requirements that the housing contains five or more units and is designed primarily for residential use.[15] Typically, Freddie requires DSCR/LTV of 1.25–1.40x/80% for first mortgage-only loans and 1.15x/85% for first mortgage and subordinate mortgage loans.[16] Particularly attractive for investors, Multi PCs have a "high level of call protection".[17]

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[8] Gwynn Guilford, *U.S. Inflation Accelerated to 8.5% in March, Hitting Four-Decade High*, WALL ST. J. (Apr. 12, 2022), https://www.wsj.com/articles/us-inflation-consumer-price-index-march-2022-11649725215.

[9] Gabriel T. Rubin, *U.S. Inflation Hits New Four-Decade High of 9.1%*, WALL ST. J. (July 13, 2022), https://www.wsj.com/articles/us-inflation-june-2022-consumer-price-index-11657664129?mod=article_inline.

[10] Taylor Tepper, *Federal Funds Rate History 1990 to 2023*, FORBES ADVISOR, https://www.forbes.com/advisor/investing/fed-funds-rate-history/ (last updated May 3, 2023).

[11] *CRE CLO Issuance in the First Quarter*, GREEN STREET COM. MORTG. ALERT, Apr. 7, 2023, at 16 (reporting a 92.7% year-over-year drop in first quarter CRE CLO issuance from $15,268.8 million in Q1 2022 to $1,120.2 million in Q1 2023); *see CMBS Limps Along While CRE CLOs Dry Up*, GREEN STREET COM. MORTG. ALERT, Feb. 24, 2023, at 1, 7.

[12] *Crickets in New-Issue CMBS Market*, GREEN STREET COM. MORTG. ALERT, Dec. 9, 2022, at 4 (noting the $315.8 million Arbor Realty Trust Q-Deal, ARBOR 2022-Q021, priced "at 93 bp over one-month SOFR at par, far tighter than" the Rialto Capital and FS Investments CRE CLO, FSRIA 2022-FL7, which priced at 310 bp over one-month SOFR); *see NewPoint JV Taps Freddie Q Program*, GREEN STREET COM. MORTG. ALERT, May 26, 2023, at 5 (reporting that the senior notes of the $198.6 million NewPoint JV Q-Deal, NWPT 2023-Q022, priced at 77 bp over one-month SOFR).

[13] *ACRE Closes $424M Freddie Mac 'Q-Series' Transaction*, CITYBIZ (Nov. 8, 2022), https://www.citybiz.co/article/345375/acre-closes-424m-freddie-mac-q-series-transaction/.

[14] FREDDIE MAC MULTIFAMILY, MULTI PC PROGRAM HANDOUT (2022), https://mf.freddiemac.com/docs/multi_pc_overview.pdf.

[15] *Multi PCs*, FREDDIE MAC MULTIFAMILY, https://mf.freddiemac.com/investors/pcs (last visited May 22, 2023).

[16] *Id.*

[17] *Id.*

Freddie's MSCR Notes program is a vehicle of the agency's CRT program, providing "unique Multifamily exposure" to private investors.[18] MSCR Notes are unguaranteed securities based on a reference pool of Multi PCs, other fully guaranteed Multifamily certificates and credit enhancement on affordable multifamily-backed bonds issued by state and local housing finance agencies and issued with the intent to transfer mortgage default risk from US taxpayers to capital markets investors.[19]

In creating a Multi PC reference pool for an MSCR issuance, loans underlying the relevant Multi PCs are evaluated under the pool's eligibility criteria that may exclude loans that are 30 days or more delinquent from the date of acquisition, are in forbearance, have a DSCR less than 1.25x for conventional loans (1.15x for Targeted Affordable Housing Loans) or have an LTV greater than 80% for conventional loans (90% for Targeted Affordable Housing loans).[20]

After designation of the reference pool, a third-party trust issues unguaranteed notes to investors and invests the sale proceeds into eligible investments. The trust makes principal and interest payments to investors, typically based on an uncapped 30-day SOFR Average floating-rate coupon, and receives monthly credit premiums from Freddie.[21] In return, Freddie receives protection on "defined credit or modification events on the reference pool".[22] In the event these defined credit or modification events occur on the underlying mortgage loans, Freddie receives payments that would have gone to the noteholders. In order to "further align [its] interest with investors through the life of the offering", Freddie retains the senior risk and first-loss piece as well as a minimum 5% vertical slice of each tranche.[23] As discussed below, Multi PCs have seen a dramatic rise in issuance, and this increase has provided support for the continued growth of the MSCR Notes program.

II. Q-Deals Background

Q-Deals bear similarities to Freddie's K-Deals but differ in that the loans held by the third-party trust were not underwritten by Freddie at origination and may not have been sold to Freddie before they were securitized.[24] In the Q-Deal securitization process, after Freddie re-underwrites the loan collateral and grants credit approval, the lender sells multifamily mortgage loans to a third-party depositor, and the depositor places the loans in a third-party trust. Once purchased by the third-party trust, the trust issues securities backed by the loans. Freddie then purchases and guarantees senior amortizing bonds as well as interest-only bonds and re-securitizes them by issuing Structured Pass-Through Certificates (here, "Q-Certificates").[25] While alternative structures may be issued, Freddie typically provides two different deal structures for fixed Q-Deal offerings: a Senior/Subordinate structure and a Guaranteed structure. In the Senior/Subordinate structure, Freddie does not guarantee certain subordinate bonds, typically

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[18] Freddie Mac Multifamily, Multifamily Structured Credit Risk Program Overview (MSCR Notes) (2023), https://mf.freddiemac.com/docs/mscr_notes_investor_presentation.pdf.
[19] *Id. See also MSCR Notes*, Freddie Mac Multifamily, https://mf.freddiemac.com/investors/structured-credit-risk (last visited May 22, 2023).
[20] *See, e.g.*, Freddie Mac Multifamily, Preliminary Term Sheet, Series 2022-MN4 (2022), https://mf.freddiemac.com/docs/MSCR_2022-MN4_term_sheet.pdf.
[21] Multifamily Structured Credit Risk Program Overview (MSCR Notes), *supra* note 11. *See also MSCR Notes*, *supra* note 12.
[22] *MSCR Notes*, *supra* note 12.
[23] *Id.*
[24] *Q-Deals*, Freddie Mac Multifamily, https://mf.freddiemac.com/investors/q-deals (last visited May 22, 2023).
[25] *Id.* While alternative structures may be issued, this represents a typical deal structure.

representing the bottom 15–25% of the pool,[26] which are issued by the third-party trust and either retained or sold to private investors.[27] In the Guaranteed structure, Freddie guarantees all bonds and enters into an agreement with the sponsor that the sponsor will reimburse Freddie for losses up to a negotiated portion of the deal.[28]

Freddie's Q-Deal securitization program is highly selective. The agency focuses on affordable housing, strict underwriting and geographic diversity, and as many as two-thirds of all loan pools examined are excluded from the Q-Deal program.[29] Freddie typically seeks a minimum pool size of $150 million in aggregate unpaid principal balance ("UPB") and employs a REMIC structure.[30] Furthermore, loans eligible for the Q-Deal program include taxable small balance loans, loans supported by properties with 9% Low-Income Housing Tax Credits or Land Use Restrictive Agreements and rehab loans for affordable properties.[31] While issuers must pay Freddie a guarantee fee ranging from 65 to 90 bps,[32] recent Q-Deal spreads have been far tighter than recent CRE CLOs with the latest Q-Deals pricing at 77 bps,[33] 87 bps[34] and 93 bps[35] over one-month SOFR. This stands in contrast to the Class A bonds in a recent CRE CLO pricing at 230 bps over SOFR.[36] Finally, Q-Deals have been reported to have significantly lower securitization costs for issuing firms as compared to CRE CLOs.[37] Q-Deals represent a lower-cost alternative to CRE CLOs with better pricing for issuers holding affordable housing loans that align with Freddie's goals and guidelines.

III. Issuance Trends in the Freddie Multifamily Capital Markets

As issuers have shied away from CRE CLOs under current market conditions, Multi PCs and MSCR Notes have seen a sharp increase in issuance volume. While data does not yet show a concurrent increase in issuance for Q-Deals, their relatively low securitization costs and tighter spreads may begin to draw typical CRE CLO issuers to securitize under the Q-Deal program.

With a history stretching back to the 1980s, Multi PCs have performed strongly with 99.9% of loans by outstanding UPB current as of April 2023 and no loans experiencing realized losses.[38] Since the program's reinvention in 2014, Freddie has issued 1,647 Multi PCs through March 2023 with a combined issuance of $35.6 billion.[39] Issuance has increased sharply in recent years with at least $29 billion in volume issued since 2019.[40] Industry professionals have speculated that Freddie has increased Multi PC issuance to

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[26] Freddie Mac Multifamily, Q-Deal Program Overview (2023), https://mf.freddiemac.com/docs/qdeal_investor_presentation.pdf.
[27] *Id.*
[28] *Id.*
[29] *Freddie Q Deals Provide CLO Issuers an Exit*, GREEN STREET COM. MORTG. ALERT, Oct. 14, 2022.
[30] Q-Deal Program Overview, *supra* note 19.
[31] *Id.*
[32] *Freddie Q Deals Provide CLO Issuers an Exit*, *supra* note 22; *see also ACRE Closes $424M Freddie Mac 'Q-Series' Transaction*, *supra* note 6 (reporting a guarantee fee of approximately 98 bps on the A-Bond of a $424 million, November 2022 Q-Deal transaction).
[33] *NewPoint JV Taps Freddie Q Program*, *supra* note 5.
[34] *ACRE Closes $424M Freddie Mac 'Q-Series' Transaction*, *supra* note 6.
[35] *Crickets in New-Issue CMBS Market*, *supra* note 5.
[36] *Debt Databases – CRE CLO*, Green Street, https://my.greenstreet.com/data-analytics/debt-db/cre-clo-database/deal/20235033 (last visited May 22, 2023).
[37] *Freddie Q Deals Provide CLO Issuers an Exit*, *supra* note 22, at 18.
[38] Freddie Mac Multifamily, Multi PC Performance Data (2023), https://mf.freddiemac.com/docs/multi_pc_performance.pdf.
[39] Freddie Mac Multifamily, Multi PC Program Overview (2023), https://mf.freddiemac.com/docs/pc_investor_presentation.pdf.
[40] *See id.*

enhance borrower flexibility and reduce interest rate risk, a considerable advantage in light of the Federal Reserve's recent activity.[41]

Introduced in 2016, Freddie enhanced the MSCR Notes program in 2021 in order to align the program more closely with other CRT offerings.[42] Like Multi PCs, MSCR Notes have seen a meteoric rise in total issuance volume. MSCR Notes issued in 2016 and 2017 were generally just under $1 billion in cut-off date loan balance for each deal, while MSCR Notes issued in 2021 and 2022 were between $4 and 6 billion in cut-off date loan balance for each deal. This increase in deal size has been driven, in part, by a sharp increase in the number of loans included in each reference pool. In 2016 and 2017, MSCR Notes included between 48 and 69 loans in each pool as compared to over 200 loans per pool in most 2021 and 2022 issuances.[43] While money managers make up a significant proportion of investors, hedge funds represent nearly half of investors in MSCR Notes by total UPB since inception.[44]

A relatively new program, Freddie began issuing Q-Deals in 2014 and, through April 2023, Freddie has completed 21 transactions for a total issuance of $7.60 billion.[45] Similar to Freddie's Multi PCs, Q-Deals have an exceptional track record with 99.9% of loans current as of April 2023 with no realized losses and no REO properties.[46] While the number of Q-Deals closed each year has varied, five deals closed in 2022 alone.[47] Additionally, the number of unique senior bond investors participating in Q-Deals has risen.[48] Money managers and banks make up the greatest proportion of investors, but pension plans and insurance companies have emerged in recent years with greater participation.[49]

Despite current market trends in the CRE industry, including interest rate hikes and a corresponding decrease in originations, Multi PCs and MSCR Notes have seen elevated execution levels. Furthermore, as borrowers continue to seek prepayment flexibility in the current interest rate environment, there may be increasing interest in the Multi PC program. As market uncertainty continues, institutional CRE CLO issuers may seek securitization alternatives, including Freddie's Q-Deal program, to tap capital markets. Finally, Freddie's strong underwriting standards and guarantee provide assurances to issuers and investors that each product's strong performance history will continue.

[41] *Freddie Mac Upping Multi PC Deal Volume*, Green Street Com. Mortg. Alert, Dec. 9, 2022, at 1, 10.
[42] Multifamily Structured Credit Risk Program Overview (MSCR Notes), *supra* note 11.
[43] *Id.*
[44] *Id.*
[45] Freddie Mac Multifamily, Q-Deal Performance Data (2023), https://mf.freddiemac.com/docs/q_deal_performance.pdf.
[46] *Id.*
[47] *Id.*
[48] Q-Deal Program Overview, *supra* note 19.
[49] *Id.*

Look Before You Lend: Commercial Lessors Holding Security Deposits in Trust May Open the Door to Lessee Conversion Suits

By Eric M. Reilly, Miller J. Smith & Jon A. Schlotterback

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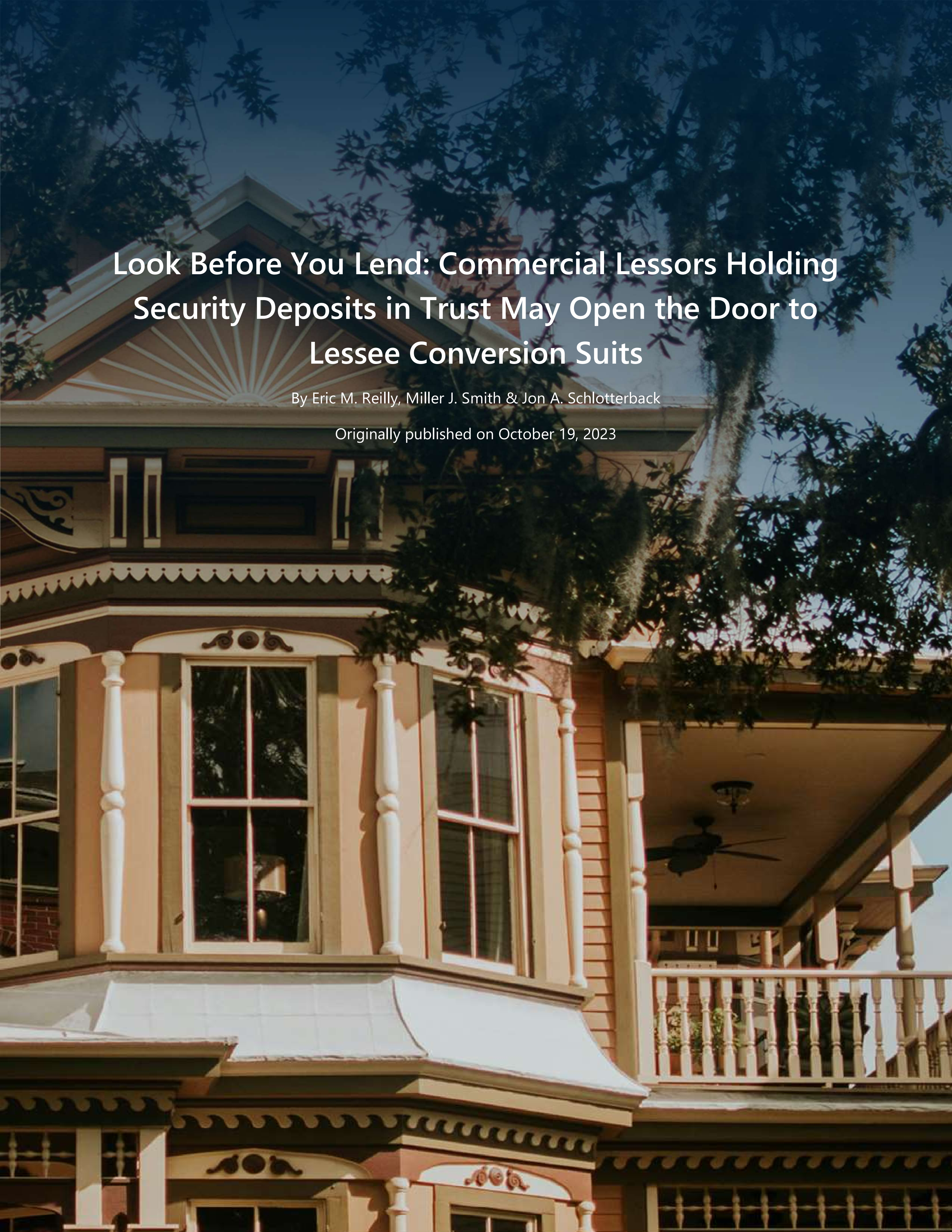

A decision from the U.S. District Court for the Southern District of New York should spark the attention of secured lenders whose borrowers hold commercial lessee security deposits.[50] The opinion issued by Judge Valerie Caproni, *10FN, Inc. v. Cerberus Business Finance, LLC*,[51] dismissed a commercial tenant's (the "Tenant" or the "Sub-Lessee") claims of conversion and negligence against the bankrupt sub-lessor's (the "Debtor" or the "Sub-Lessor") executives and unjust enrichment and conversion against the Debtor's secured lenders (the "Secured Lenders") after concluding the Tenant's security deposit was an unsecured loan to the Debtor.

I. 10FN, Inc. v. Cerberus Business Finance, LLC

In *10FN, Inc.*, the Debtor's predecessor was a lessee under a commercial lease in Chicago, Illinois. The predecessor entered into a sub-lease agreement (the "Sub-Lease") with the Tenant in 2016, pursuant to which the Tenant provided a security deposit of $271,092.87. After the predecessor and Tenant entered into the Sub-Lease, the Debtor purchased the predecessor, and in connection with the acquisition, borrowed funds from the Secured Lenders.[52] Under the lending arrangement, the Debtor granted the Secured Lenders "first-priority liens on 'substantially all [of] the Debtor's assets'"[53] and executed account control agreements permitting the Secured Lenders to sweep the Debtor's accounts.[54] The Debtor subsequently filed a Chapter 11 bankruptcy petition on March 29, 2019. Prior to the Debtor's bankruptcy petition, however, the Secured Lenders swept funds, including "some or all of" the Tenant's security deposit, from the Debtor's accounts pursuant to the cash sweep provisions of the account control agreements. After the Debtor's bankruptcy petition, the Debtor rejected the Tenant's Sub-Lease as permitted under the Bankruptcy Code.[55]

After the Debtor rejected the Sub-Lease, the Tenant unsuccessfully tried to recover its security deposit.[56] On February 18, 2022, the Tenant filed an amended complaint against the Secured Lenders on theories of conversion and unjust enrichment and against the Debtor's executives for conversion and negligence. The court quickly rejected the Tenant's negligence claim against the Debtor's executives after concluding the executives did not owe any duty to the Tenant, an essential component of a negligence claim.[57] While the *10FN, Inc.* court also analyzed subject matter jurisdiction and certain conflict of laws issues, the court's analysis and discussion of the Tenant's conversion and unjust enrichment claims provide the most impactful lessons for secured lenders.

A. The Court Dismissed the Tenant's Conversion Claim Because Neither State Law Nor the Sub-Lease Required the Debtor to Hold the Security Deposit in Trust.

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[50] The information contained in this article is not, and is not intended to be, legal advice. Each situation is different, and an attorney should be contacted for any questions or consultation with respect to your individual matter.
[51] No. 1:21-cv-05996-VEC, 2022 U.S. Dist. LEXIS 190766 (S.D.N.Y. Oct. 18, 2022).
[52] *Id.* at *2.
[53] *Id.* (internal citation omitted).
[54] A cash sweep provision typically provides that funds in one or more accounts may be "swept" to another account upon the occurrence of a specified event or in accordance with a schedule set forth in the financing documentation. Such funds may then be held as additional cash collateral or applied to pay down the outstanding loan balance, if permitted by the terms of the financing documentation.
[55] *10FN, Inc.*, 2022 U.S. Dist. LEXIS 190766, at *2–3; *see also* 11 U.S.C. §§ 365(a); 1107.
[56] *10FN, Inc.*, 2022 U.S. Dist. LEXIS 190766, at *3.
[57] *Id.* As this article focuses on claims against the Secured Lenders, the court's analysis concerning the Tenant's conversion claim against the Debtor's executives will not be discussed here.

In its consideration of the Tenant's conversion claim, the *10FN, Inc.* court ruled that, although New York law governed the claim, Illinois law controlled the Tenant and Debtor's Sub-Lease.[58] Under New York law, the court described conversion as "any unauthorized exercise of dominion or control over property by one who is not the owner of the property which interferes with and is in defiance of a superior possessory right of another in the property."[59] The court described the two key elements of conversion as "(1) the plaintiff's possessory right or interest in the property and (2) the defendant's dominion over the property or interference with it, in derogation of the plaintiff's rights."[60] To determine whether the deposit could form the basis for a conversion suit, the court looked to the nature of the Tenant's interest in the security deposit, which required an analysis of the Sub-Lease's terms.

The Sub-Lease permitted the Debtor to draw upon the deposit after the occurrence of a default by the Tenant under the Sub-Lease and did not, by its terms, require the Debtor to segregate the Tenant's security deposit or hold it in trust, diminishing the Tenant's arguments that the deposit was held in trust. For additional support, the court next looked to both Illinois state law and the Chicago Municipal Code. The court noted that courts applying local law have found that lessors must hold *residential* tenants' security deposits in trust, but it did not find any authority stating that commercial tenants' security deposits were subject to similar requirements.[61] To the contrary, the court found persuasive authority holding that a lease or state law treating security deposits as loans from the lessee confers upon the lessee the status of unsecured creditor when the lessor declares bankruptcy.[62] Here, as the Sub-Lease did not require the Debtor to hold the security deposit in trust and permitted the Debtor to draw on the Tenant's security deposit upon the occurrence of a default by the Tenant under the Sub-Lease, the court held that the Tenant gave the Debtor an unsecured loan.[63] As the Tenant was the Debtor's unsecured creditor, the Tenant's only avenue for recovery was to file a claim in the Debtor's bankruptcy case. Accordingly, the court rejected the Tenant's conversion suit against the Secured Lenders.[64]

B. The Court Dismissed the Tenant's Unjust Enrichment Claim because the Sub-Lease Directly Addressed the Security Deposit.

Next, the *10FN, Inc.* court analyzed the Tenant's claim that the Secured Lenders unjustly enriched themselves by unfairly retaining the security deposit knowing it belonged to the Tenant.[65] A claim for unjust enrichment in New York must include an allegation that "(1) [the] defendant was enriched; (2) the enrichment was at plaintiff's expense; and (3) the circumstances were such that equity and good conscience require [the] defendant[] to make restitution."[66] An unjust enrichment claim is barred, however, if a valid contract governs the focus of the dispute.[67] While the court noted that the Tenant had no

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[58] *Id.* at *10.
[59] *Id.* (quoting *Moses v. Martin*, 360 F. Supp. 2d 533, 541 (S.D.N.Y. 2004)).
[60] *Id.* (quoting *Zamora v. FIT Int'l Grp. Corp.*, 834 F. App'x 622, 629 (2d Cir. 2020)).
[61] *Id.* at *11–12 (citing 765 ILL. COMP. STAT. ANN. 715; 815 ILL. COMP. STAT. 165/3; CHIC. MUN. CODE § 5-12-080).
[62] *Id.* at *12–13 (citing *In re McGee*, 353 F.3d 537, 539 (7th Cir. 2003)).
[63] *Id.* at *13.
[64] *Id.* at *14 (citing *Karimi v. 401 N. Wabash Venture, LLC*, 952 N.E.2d 1278, 1285 (Ill. App. Ct. 2011) (following the "general rule" that "an action for conversion may not be maintained for money representing a general debt or obligation")).
[65] *Id.* at *15–17.
[66] *Id.* at *16 (citing *Labajo v. Best Buy Stores, L.P.*, 478 F. Supp. 2d 523, 531 (S.D.N.Y. 2007)).
[67] *Id.* at *16–17 (citing *Vista Food Exch., Inc. v. Champion Foodservice, LLC*, 124 F. Supp. 3d 301, 312 (S.D.N.Y. 2015) and *Coty, Inc. v. L'Oreal S.A.*, 320 F. App'x 5, 6 (2d Cir. 2009) ("[I]t is black-letter law in New York that recovery on an equitable theory of unjust enrichment is not permitted where the matter at issue is covered by a valid, enforceable contract.")).

contractual relationship with the Secured Lenders, the Sub-Lease between the Tenant and the Debtor expressly governs the disposition of the security deposit. Accordingly, the court rejected the Tenant's unjust enrichment claim.

II. Key Takeaways for Secured Lenders

Secured lenders using cash sweep provisions in lending agreements with borrowers holding commercial security deposits can take several lessons from *10FN, Inc.* to protect themselves in the event the borrower declares bankruptcy. As shown by the Debtor's position as sub-lessor in *10FN, Inc.*, these lessons apply not only to traditional banks lending to commercial property owners, but also to any secured lender with a borrower holding commercial lessee security deposits, such as short-term office rentals or wedding venue reservations. While lenders cannot directly negotiate leases between their borrowers and the borrowers' commercial lessees, lenders can, through their lending agreements, require borrowers to include certain provisions in leases. When secured lenders sweep cash—including commercial lessees' security deposits—from a borrower's accounts, *10FN, Inc.* provides guidance to secured lenders in avoiding a lessees' potential conversion and unjust enrichment claims.

A. Contract Provisions Governing the Treatment of a Security Deposit Can Protect Secured Lenders from Unjust Enrichment Claims.

To negate a lessee's unjust enrichment claim, secured lenders should consider requiring that all of a borrower's leases include provisions directly discussing the treatment of the lessee's security deposit. In certain jurisdictions, unjust enrichment claims cannot survive if their subject matter is directly addressed by an enforceable contract.[68] While state law may differ in the approach to unjust enrichment claims, a lease directly providing for the security deposit's treatment can defeat unjust enrichment claims. Secured lenders, therefore, can protect themselves against unjust enrichment claims by requiring that their borrowers expressly provide for the treatment of commercial security deposits in commercial lease agreements.

B. Secured Lenders Can Require Borrowers to Treat Security Deposits as General Obligations to Safeguard Against Lessee Conversion Claims.

Secured lenders can protect themselves against conversion claims by requiring that their borrowers structure lease agreements such that a court is likely to consider a security deposit a general obligation of the lessor rather than a deposit held in trust. Conversion claims can require claimants to prove: (1) the claimant's "ownership or right to possession of the property" and (2) the "defendant's conversion by a wrongful act."[69] Further, conversion claims can fail when the dispute arises from a breach of contract or a failure to repay a general obligation.[70] A conversion claim based on funds swept from a trust, however,

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[68] *See, e.g.*, *Charter Commc'ns Operating, LLC v. SATMAP Inc.*, 569 S.W.3d 493, 512 (Mo. Ct. App. 2018) ("Because express contract terms govern the issue in dispute, the terms of the contracts apply and unjust enrichment is not applicable as a matter of law."); *City of Scottsbluff v. Waste Connections of Neb., Inc.*, 809 N.W.2d 725, 740 (Neb. 2011); *Lehigh Gas-Ohio, LLC v. Cincy Oil Queen City, LLC*, 66 N.E.3d 1226, 1233 (Ohio Ct. App. 2016).

[69] *Plummer v. Day/Eisenberg, LLP*, 108 Cal. Rptr. 3d 455, 460 (Cal. Ct. App. 2010); *see also Repin v. State*, 392 P.3d 1174, 1187 (Wash. Ct. App. 2017); *PNC Multifamily Cap. Institutional Fund XXVI Ltd. P'ship v. Bluff City Cmty. Dev. Corp.*, 387 S.W.3d 525, 553 (Tenn. Ct. App. 2012).

[70] *Pioneer Comm. Funding Corp. v. United Airlines, Inc.*, 122 B.R. 871, 884 (S.D.N.Y. 1991); *Capital Factors v. Homeline Corp. (In re Gen. Plastics Corp.)*, 158 B.R. 258, 287 (Bankr. S.D. Fla. 1993); *Larew v. Hope Law, P.L.C.*, 977 N.W.2d 47, 63 (Iowa 2022) ("In general, no

may have more success because of the claimant's stronger interest in the funds. The primary method by which secured lenders can avoid rulings that security deposit funds are held in trust is through their lending agreements.

1) Lending Agreements Can Require that Leases Disclaim Any Intent to Form an Express Trust.

First, lending agreements can prohibit borrowers' leases from expressly holding lessee security deposits in trust. While the law differs between states, express trusts are generally created through a variety of differing, but overlapping, elements, including: (1) an express intent to create a trust; (2) an ascertainable object; and (3) a sufficient designation of a beneficiary.[71] Further, courts often consider the intent to create a trust the most important factor in the analysis.[72] Accordingly, at least one court has ruled

> [a] transfer of money to be applied for certain purposes is not by itself sufficient to create an express trust. Otherwise, conceivably all security deposits could be considered held in trust, as every security deposit is meant to be applied for certain purposes, specifically to protect the recipient of the deposit in the event that the depositor fails to carry out its obligations.[73]

While lease agreements lacking an intent to create an express trust may be sufficient, agreements explicitly disclaiming any intent to form a trust will likely better safeguard secured lender interests. Even if a court finds that a lease agreement does not create an *express* trust for the deposit, however, it could nonetheless impose a *constructive* trust depending on the nature of the parties' relationship.

While state laws vary slightly, the elements of a constructive trust generally include: (1) a confidential or fiduciary relationship; (2) an express or implied promise; (3) a transfer of property made in reliance on the promise; and (4) unjust enrichment.[74] A constructive trust is a "potent [remedy] in bankruptcy because it gives the successful claimant 'priority over the defendant's unsecured creditors' to the extent of the property subject to the trust."[75] Accordingly, creditors are incentivized to seek a constructive trust in bankruptcy proceedings. Since imposing a constructive trust "can wreak such havoc with the priority system ordained by the Bankruptcy Code, bankruptcy courts are generally reluctant 'to impose constructive trusts without a substantial reason to do so.'"[76] Some bankruptcy courts even require a creditor seeking a constructive trust to make a showing of fraud or other egregious conduct,[77] an unlikely prospect where a secured lender has merely invoked its rights under the cash sweep provisions of its lending agreement. Although bankruptcy courts disfavor constructive trusts, secured lenders can further

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conversion claim exists where the dispute arises solely out of contractual obligations."); *Karimi v. 401 N. Wabash Venture, LLC*, 952 N.E.2d 1278, 1285 (Ill. App. Ct. 2011) ("[A]n action for conversion may not be maintained for money representing a general debt or obligation.").

[71] *Blixseth v. Blixseth (In re Blixseth)*, 459 B.R. 444, 458–59 (Bankr. D. Mont. 2011); *Braden Trust v. Chavez*, 430 B.R. 890, 894 (Bankr. D. Ariz. 2010) (citation omitted); *Int'l Fid. Ins. Co. v. Marques*, 358 B.R. 188, 194 (Bankr. E.D. Penn. 2006).

[72] *Braden Trust*, 430 B.R. at 894 (citation omitted).

[73] *Intelius Sales Co., LLC v. Idearc Inc.*, No. 3:11-CV-339-B, 2011 U.S. Dist. LEXIS 73057, at *15–16 (N.D. Tex. July 7, 2011).

[74] *See, e.g.*, *Superintendent of Ins. v. Ochs (In re First Cent. Fin. Corp.)*, 377 F.3d 209, 212 (2d Cir. 2004); *Bird v. McCauley (In re McCauley)*, 549 B.R. 400, 414–15 (Bankr. D. Utah 2016); *Castetter v. Henderson*, 113 So. 3d 153, 155 (Fla. Ct. App. 2013).

[75] *Haber Oil Co. v. Swineheart (In re Haber Oil Co.)*, 12 F.3d 426, 436 (5th Cir. 1994) (citing Emily L. Sherwin, *Constructive Trusts in Bankruptcy*, 1989 ILL. L. REV. 297, 305 (1989)).

[76] *Id.* (citing *Neochem Corp. v. Behring Int'l, Inc. (In re Behring Int'l, Inc.)*, 61 B.R. 896, 902 (Bankr. N.D. Tex. 1986)); *see Amendola v. Bayer*, 907 F.2d 760, 763 (7th Cir. 1990) ("[T]he grounds for imposing a constructive trust must be so clear, convincing, strong and unequivocal as to lead to but one conclusion.").

[77] *Was, LLC v. Coll (In re DC Energy, LLC)*, 555 B.R. 786, 792 (Bankr. D.N.M. 2016); *see also In re Coffman*, 273 B.R. 137, 138 (Bankr. S.D. Ohio 2001) (requiring in some cases "egregious and/or fraudulent behavior" to impose a constructive trust).

protect themselves from lessee claims by requiring borrowers to structure lease agreements to ensure security deposits are more likely to be considered general obligations.

2) Lending Agreements Can Require Lessors to Treat Security Deposits as General Funds.

Secured lenders can require that borrowers hold security deposits in their general expense or emergency maintenance accounts rather than holding deposits in separate, segregated accounts. While segregation does not, standing alone, establish a constructive trust, courts have found segregated funds to be a strong indicator of a trust.[78] Ensuring all security deposits are held in general accounts that contain funds from other unsecured lending sources, therefore, would bolster the argument that the lessee's security deposit was an unsecured loan to the borrower to be returned at the end of the lease. Other than expressly disavowing that funds are held in trust, requiring security deposits to be held in general expense accounts likely provides the greatest protection for secured lenders against lessee conversion claims. If, however, accounts are in place prior to the secured loan or market conditions do not permit secured lenders to hold security deposits in general expense accounts, lenders could alternatively require that borrowers hold all security deposits in a single, commingled account. While this may not provide the same level of protection as placing deposits in a general expense account, a single account holding all security deposits would reduce the likelihood that the deposits are considered to be held in trust as compared to individual accounts for each deposit.

Finally, secured lenders can support an argument that a security deposit is a general obligation by requiring that borrowers treat security deposits as unsecured loans in their lease agreements. When considering whether the parties' lease agreement treats a security deposit as an unsecured loan, courts may analyze whether the lessor can draw upon the deposit during the lease term in the event of lessee default, such as failure to timely pay rent or damage to the property.[79] Furthermore, a lease agreement that requires lessors to return the lessee's deposit, less any default damages, is indicative of a general unsecured loan.[80] Courts may find that if a lease "treats the deposit as a form of loan to the [lessor] in order to create the possibility of a setoff if the [lessee] later incurs a debt to the [lessor], then the [lessee] becomes an unsecured creditor in bankruptcy."[81] Secured lenders requiring that borrowers' lease agreements treat security deposits as unsecured loans for purposes of setoff upon a lessee's default, therefore, can improve their chances that a lessee's claim will be considered a general obligation.

Lenders should be mindful that a minority of jurisdictions require that all security deposits, whether commercial or residential, must be held in trust.[82] If the state or municipal law governing the lease agreement between borrower and lessee requires commercial security deposits to be held in trust, lenders must be wary before sweeping the lessee's security deposit in the event of a borrower bankruptcy filing.

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[78] *EBS Pension L.L.C. v. Edison Bros. Stores, Inc. (In re Edison Bros., Inc.)*, 243 B.R. 231, 238 (Bankr. D. Del. 2000) (finding "segregation is merely one factor in determining whether the parties intended to create a trust; it is not dispositive").

[79] *In re McGee*, 353 F.3d 537, 539 (7th Cir. 2003); *Chriswell v. Alomari (In re Alomari)*, No. 10 B 47008, 2011 Bankr. LEXIS 3187, at *9 (Bankr. N.D. Ill. Aug. 15, 2011).

[80] *In re Alomari*, 2011 Bankr. LEXIS 3187, at *8 (citing *In re McGee*, 353 F.3d at 540).

[81] *In re McGee*, 353 F.3d at 539.

[82] *See, e.g.*, N.Y. GEN. OBLIG. LAW § 7-103(1); *see also* JAMES ROGERS & CLARISSA MEDRANO, SECURITY DEPOSIT LAWS (COMMERCIAL LEASE): STATE COMPARISON CHART (2020), https://www.akerman.com/a/web/65420/Security-Deposit-Laws-Commercial-Lease-State-Comparison-Chart.pdf (noting that New York requires commercial deposits to be held in trust while most states do not prohibit commingling, a key consideration in trust formation).

While the *10FN, Inc.* court did not hold that a conversion claim based on periodic or event-driven cash sweeps could succeed, lessees could argue the decision implies that result.

III. Conclusion

In light of the *10FN, Inc.* decision, secured lenders invoking cash sweep provisions of lending agreements should consider structuring their lending agreements, if permitted under state and municipal law, to protect themselves from lessee conversion and unjust enrichment claims. By requiring borrowers to directly address lessees' security deposits in lease agreements, secured lenders will likely frustrate lessees' unjust enrichment claims. Furthermore, secured lenders can require that borrowers act to prevent deposits being considered trust property.

By expressing an intent that deposits are not held in trust, holding deposits in general expense accounts, and permitting lessors to draw upon the deposit in the event of lessee default, lease agreements can be crafted to classify deposits as general obligations of the borrower, thus limiting lessee conversion claims.

Exploring all Options: Home Equity Option Contracts are Poised for a Rating

By Darius Horton and Holly Spencer Bunting

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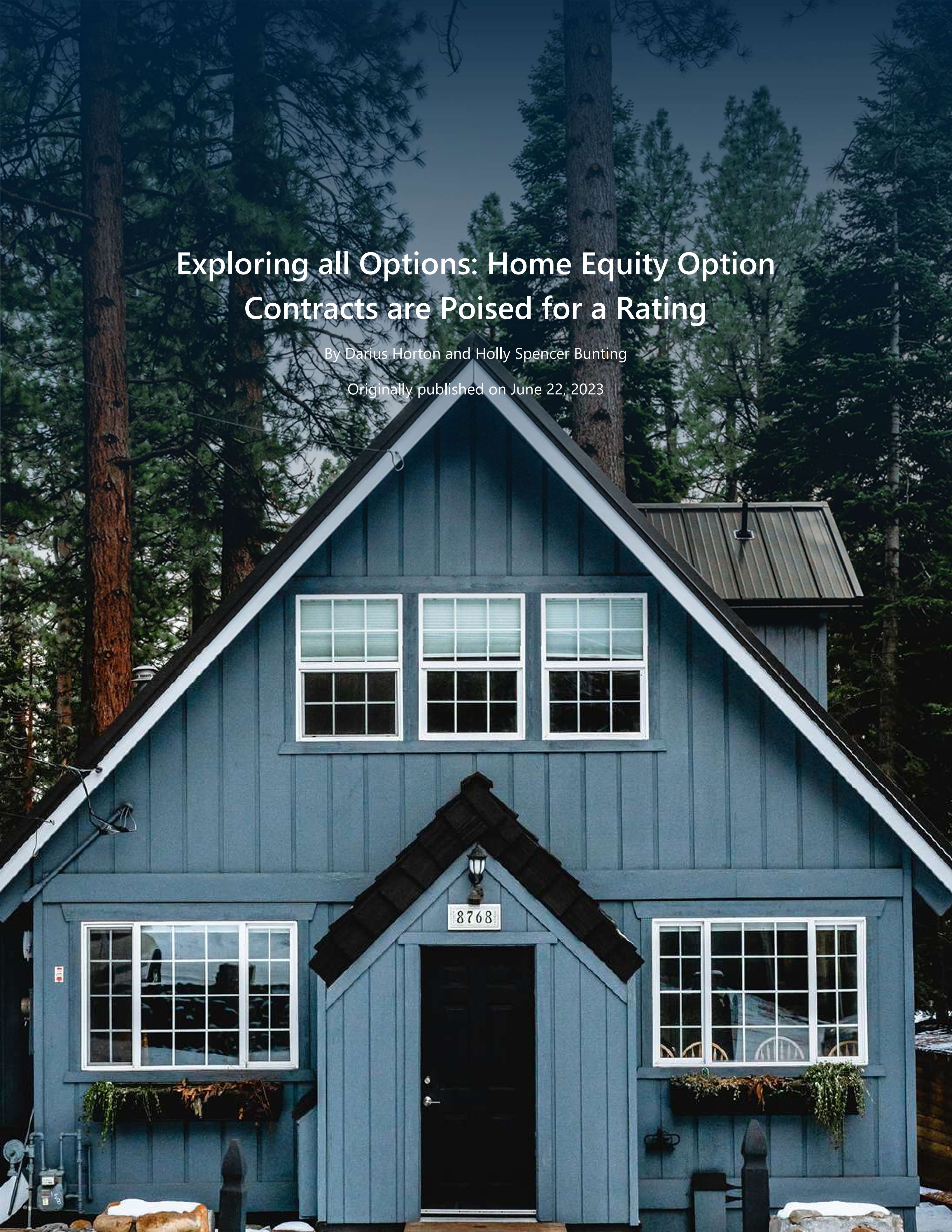

Higher interest rates are making home equity option contracts an increasingly attractive option for consumers who want to tap equity without selling their home, or require liquidity and seek to avoid the incurrence of home equity loans, credit card debt or other debt. And homeowners in the United States continue to enjoy historically high levels of home equity. According to one recent estimate, in the third quarter of 2022, 48.5% of the homes in the United States were secured by debt with a total value of no more than 50% of the estimated value of related properties. Home equity option contracts present consumers with another option for monetizing that equity. Any increase in the volumes of such contracts in the market will require additional capital for providers including from securitizations. Following its securitization debut in 2021, home equity option contract securitizations appear ripe for rating in the near future.

This article first describes how home equity option contracts operate and the differences across product design. We then discuss court decisions that have considered the home equity option product and analyzed the product as a real estate option contract, which then triggers certain regulatory requirements. We also compare salient features to evolving asset types such as litigation funding, merchant cash advances and income sharing agreements. We conclude that the regulatory requirements associated with real estate option contracts should not be an insurmountable obstacle to rated securitizations.

A. Product Features

While shared appreciation mortgages have existed for some time, modern home equity option contracts emerged as an increasingly popular product around 2006. In its simplest form, in exchange for an upfront payment, a homeowner grants an option to acquire an interest in their property. For example, for an upfront payment of $50,000, a homeowner with a home appraised at $500,000 grants an option to purchase 30% of the home for $150,000. The remaining portion of the option payment is settled at the time of option exercise. The option can be exercised upon the occurrence of various events during the term of the contract that include sale of the property, the expiration of the stated term of the option (typically between 10 and 30 years) and an optional early settlement elected by the homeowner. If the property is to be sold for $600,000 after five years, the option holder can acquire its 30% interest in the property for $150,000, having pre-paid $50,000 at the time the option was granted. When the home is sold for $600,000, the option holder receives 30% of the proceeds, *i.e.*, $180,000 and, in this example, realizes a gain of $30,000 ($180,000 minus $150,000). If the property was sold at a price less than $500,000, the option holder would share in the loss. For example, at a sale price of $400,000, the total payments by the option holder would be $150,000, but the option holder would only receive proceeds of $120,000 and suffer a loss of $30,000, *i.e.*, 30% of the $100,000 excess of the $500,000 appraised value of the home over the $400,000 sale price. In either case, the homeowner enjoyed the use of the $50,000 upfront payment for five years without an obligation to repay any specified portion of the $50,000 in the future.

Other home equity investment products are styled as forward sale contracts or home equity appreciation contracts but achieve a similar result. For example, in exchange for the right to acquire 15% of the future home value, a homeowner with a home appraised at $500,000 receives $50,000 as an option payment. If the home is sold for $600,000 after five years, the option holder has the right to receive $90,000 of the proceeds, *i.e.*, 15% of $600,000. Under this contract, the “exchange rate” would be 1.5, *i.e.*, the 10%

upfront payment divided by the right to share 15% of the future value. Upon a sale for $300,000, the option holder would receive $45,000, which represents a loss of $5,000.

Other product features may include a "risk adjustment" that could typically range between 2% and 25% of the initial appraised value of the property. A risk adjustment reduces the "strike price" from which gains or losses are measured. For example, if a property is appraised at $500,000 and is subject to a 20% risk adjustment, the option price would be calculated assuming that the property was worth $400,000. This risk adjustment provides additional upside potential and downside protection. Features like the exchange rate described above and any material risk adjustment may be paired with an annual return cap to protect homeowners from exposure to sharing outsized gains with the option holder.

The option holder's rights under the home equity option contract are typically protected by a mortgage or deed of trust that, subject to the rights of any senior mortgage lender, could be foreclosed upon if the homeowner were in material default under the terms of the option contract.

B. Judicial and Regulatory Treatment of the Product

Real estate option contracts are not a new concept, and case law is prevalent regarding these contracts generally. As home equity option products have become more prevalent in the market, courts also have had occasion to consider the structure of the product and the regulatory characterization. Consumers have challenged the product as a "loan" and took the position that federal consumer protection statutes, such as the Truth in lending Act ("TILA"), apply to the product as a form of consumer credit. However, to date, courts have respected the form and function of the product as a real estate option contract and not a loan under TILA.

For example, in *Foster v. EquityKey*, the plaintiff alleged in California court that the home equity option contract at issue was a "disguised high cost mortgage" originated using "deceptive efforts" and asked the court for [rescission and damages]. As such, the case squarely posed the question of whether the options were "loans" under California law or subject to TILA or unfair to consumers. Granting a motion to dismiss the plaintiff's claims, the court first examined relevant state law defining "real estate option contracts". Analyzing the intent of the parties and form of the contract, the court found that it comported with the state law definition of an option contract (*i.e.*, "a contractual right [held by the option holder] that could become an interest in property when exercised"). The court also held that the contract was not a "loan" as it did not guarantee repayment of any portion of the upfront payment. Turning to TILA, the court observed that the federal statute contains an express exclusion for "option contracts" and "investment plans" in which the party extending capital to the consumer risks the loss of capital advanced. Having found the contracts to be real estate option contracts under California law, the court found TILA to be inapplicable to the home equity option product. In reaching its decision, the court emphasized: (i) the intention of the parties to enter into an option contract; (ii) the fact that there was no guarantee that the option price payment would ever be returned or that the option exercise would yield a profit; and (iii) the fact that the agreement did not provide title or possession rights to the property.

In December 2022, a California federal district court granted a motion to dismiss in a case against another company offering a home equity option contract similar to the EquityKey product. *See Goldwater Bank, N.A. v. Elizarov*, No. 521-CV-00616-JWH-SPX (C.D. Cal. Dec. 12, 2022). In that order, the court, citing to

Foster, noted the product was "almost identical" to the EquityKey product and rejected the plaintiff's characterization of the product as a "lending program." The court stated the company's product materials supporting and describing the product "…make clear that the Option Agreement was not a loan."

As a real estate option contract, the contract relies on long standing real property case law and is governed by the terms of the agreement and general contract law. The *Foster* court described the option contract in the context of real estate as a contractual right that may become an interest in property when it is exercised. Federal and state consumer regulatory laws also remain applicable to the product. For instance, state law, whether statutory or judicial, imposes requirements on real estate option contracts and the rights and protections of the parties entering into such contracts. State laws may specially regulate the contract or define credit or a loan in a manner that is different than the federal TILA. As an example, Connecticut's Mortgage Lenders, Correspondent Lenders, Brokers and Loan Originators Act defines "residential mortgage loan" to include a "shared appreciation agreement," which is defined as "a nonrecourse obligation in which an advance sum of monetary value is extended to a consumer, as a lump sum or otherwise, in exchange for an equity interest in a dwelling, residential real estate or a future obligation to repay a sum upon the occurrence of an event, including but not limited to, the transfer of ownership, repayment maturity date, death of the consumer or as outlined and explicitly agreed to within said agreement." Conn. Gen. Stat. §§ 36a-485(27), (30). The Maryland General Assembly also recently adopted legislation that, effective July 1, 2023, amends the definition of "mortgage loan" to include "a loan in which funds are advanced through a shared appreciation agreement." Md. House Bill 1150 (2023). "Shared appreciation agreement" is separately defined in the legislation. In addition, as a product offered to a consumer, federal and state laws protecting consumers against unfair and deceptive acts and practices ("UDAP") implicate how the product is structured, documented, and marketed to consumers. To the extent companies consider a consumer's credit history before entering into a home equity option contract, requirements arise under the federal Fair Credit Reporting Act, to name another example of an applicable law. If the courts continue to characterize the home equity option contract as a real estate option contract, companies providing these products can identify the regulatory requirements applicable to such contracts and structure a compliance management system for ongoing compliance with these laws.

Home equity option contract securitizations are also subject to the risk that the option contracts could be found to be "swaps" under the Commodity Exchange Act. If the option contracts were found to be swaps, the securitization issuer, as owner of the option contracts, could be considered a commodity pool for which a registered or exempt commodity pool operator would be required. If the securitization issuer were a commodity pool, it could also be found to be a "covered fund" for purposes the Volcker Rule issued under the Dodd-Frank Act.

C. Similar Products Have Been Rated

While the characterization of, and regulatory requirements applicable to, a real estate option contract are reasonable based on available precedent, courts and regulators have the power to recharacterize an option as a loan, which is an inherent risk associated with such products. However, that's a risk for various products. As an example, Merchant Cash Advance ("MCA") products involve the purchase of a portion of a business's future receivables in exchange for an up-front lump sum payment. Courts that have considered the MCA product treat it as a purchase and sale transaction, and not a loan. *See, e.g., Golden Atlanta Site Dev., Inc. v. Nahai*, 683 S.E.2d 166 (Ga. Ct. App. 2009). Similarly, plaintiffs have alleged that loan originated through bank partners should be recharacterized such that the marketplace platform should be considered to the be the creditor. Courts have come up with various test for determining the true lender in such transactions and generally have upheld the characterization of the bank as the true lender, Such recharacterization risk has not stopped rating agencies from rating products similar to the home equity option contract. For example, third-party litigation funding is a product involving the purchase of a plaintiff's right to proceeds generated from a pending civil lawsuit in exchange for an up-front payment. Again, courts that have considered the product treat it as a purchase and sale transaction, and not a loan. *See, e.g., Ruth v. Cherokee Funding, LLC*, 820 S.E.2d 704 (Ga. 2018). Comparable to that of a home equity option contract, courts have emphasized that MCAs and third-party litigation funding typically lack an absolute obligation to repay the up-front payment. Despite a risk that these products could be recharacterized as a loan, rating agencies have given investment-grade ratings to bonds issued in connection with litigation financing securitizations. Given the similarities with these products, as well as the judicial treatment of the home equity option contract to date, it would seem the home equity option contract is poised to receive similar treatment from rating agencies.

Home equity option contracts represent an exciting development in the residential housing space. Under current market conditions, it is likely that home equity option contracts will continue to grow in popularity in the short-and-medium term. A rated home equity option contract securitization would greatly expand originators' access to capital and improve liquidity. This in turn will enable originators to meet the growing demand for their product. Given the ratings for securitizations of asset classes that present similar regulatory issues, we expect such a rated securitization to eventually occur.

MSR Fund Investments: 7 Aspects to Consider

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While residential mortgage lenders are facing tough headwinds driven by rising interest rates and low housing volume, the current market presents opportunities for savvy investors looking at mortgage servicing rights ("MSRs"). The current mortgage market is supported by non-bank mortgage originators and servicers who lack the same access to capital and liquidity as traditional banks. To continue growing, non-bank entities have had to be creative with respect to capital sources.

Non-bank owners of MSRs are seeking asset-specific alternative private capital vehicles to fund MSR portfolios. However, unlike whole mortgage loans, MSRs cannot be easily created and sold to investors. Fortunately, through creative thinking and structuring, investors are able to use non-bank, non-servicer, alternative capital sources to participate in the economics of MSRs. This articleprovides an overview of the phases and areas of consideration related to private capital vehicles that offer investment opportunities in MSRs. [83]

1. State and Federal Agency Approvals

When investing in MSR assets, a threshold consideration is ensuring that the entity holding the loans and MSRs, as well as the entity that is engaged in the mortgage servicing activities, holds the requisite state licenses and federal approvals to hold such assets and engage in such activities. Each investing strategy for these assets brings with it state licensing and other considerations that need to be evaluated at the outset of the investment. If the goal of the investment is to be directly involved in mortgage servicing, then one needs to invest in a mortgage servicer or an entity that is authorized to purchase and hold residential mortgage loans and the associated MSRs. These entities may be created or acquired, and each option comes with unique investment considerations from a licensing perspective. In either circumstance, the planning for and timing of these licensing and approval considerations are crucial for a successful investment.

State Licenses

Any entity purchasing or holding residential mortgage loans or MSRs or engaging in residential mortgage loan servicing needs to evaluate the state licensing requirements that may apply.

A significant and growing number of states require a license to purchase, acquire or hold a residential mortgage loan even if the purchaser or holder does not hold MSRs or engage in actual servicing activities. Certain states also require a license to hold MSRs even if the actual servicing activities are outsourced to a third-party mortgage loan servicer, while other states require a license to engage in mortgage servicing activities.

To acquire these licenses, the entity must meet each state's requirements, which can include submitting audited financial statements, creating policies and procedures regarding the licensable activities, establishing in-state offices and designating qualified individuals who have the requisite industry experience to meet each state's specific criteria to engage in the licensable activity. The application process may also require officers and directors to complete personal disclosures, which may include personal financial statements and fingerprints and can be burdensome and intrusive. Depending on the jurisdiction, personal disclosures may be required from individuals holding more than the requisite threshold of indirect ownership interests of the licensee and/or of an entity seeking to acquire an interest

[83] This is an update of an article published on December 21, 2020.

in a licensee. Once the requisite state licenses are obtained, the licensed entity will be subject to certain additional requirements, including certain business practice requirements, such as maintaining books and records, maintaining the requisite net worth, filing quarterly and annual reports with the regulator and renewing the license annually. The licensed entity will also be subject to regulatory supervision and examination by each state regulator.

Federal Agency Approvals

If the goal is to invest in MSRs involving loans sold to or securitized by government-sponsored entities Fannie Mae or Freddie Mac (the "GSEs") or loans in Ginnie Mae pools, the entity purchasing, acquiring or holding residential mortgage loans or engaging in loan servicing activities will also need to secure approvals from the GSEs and Ginnie Mae to engage in these activities even if the purchaser will not engage in actual servicing activities. These approvals also require the entity to, among other things, provide audited financial statements, demonstrate compliance with the investor's minimum capital and liquidity requirements, and demonstrate the requisite operating history.

Existing Entity Acquisition

Given the hurdles associated with obtaining the state licenses and federal approvals required to purchase and hold residential mortgage loans, either alone or with the MSRs, and potentially engage in actual mortgage servicing activities, many entities explore the acquisition of an existing entity that already holds the required licenses and/or approvals. This strategy comes with its own set of licensing considerations. First, the entity will be subject to "change of control" approval as it relates to Ginnie Mae, the GSEs and certain state residential mortgage finance licensing laws, which may require personal disclosures of the ultimate indirect owners of the licensee. Depending on the jurisdiction, even acquisition of non-voting stock or non-voting equity interest investments may be subject to these requirements. The determination of whether the change of control provisions apply may be based on the form of the licensee's organization or entities in the chain of ownership. Debt structures also may warrant change of control analysis depending on the extent of the debt holder's ability to exercise control over or directly manage the policies of the licensee. Any changes to the existing entity's name as a result of the purchase or restructuring may also require regulatory filings or approvals. While several jurisdictions require only advance notice of such changes of control, some important jurisdictions, including New York, and certain federal agencies require prior approval, which can take additional time to secure.

Agency Cross Default Provisions

Finally, depending on how the proposed investment will be structured, the parties may need to consider whether the GSE or Ginnie Mae cross default provisions will apply. The Ginnie Mae Mortgage-Backed Securities Guide (the "Ginnie Mae Guide"), Fannie Mae's Selling and Servicing Guides, and Freddie Mac's Seller/Servicer Guides (together with the Ginnie Mae Guide, the "Guides") include cross default provisions applicable to parties under common ownership or control. The cross default provisions provide that a default under the applicable Guide or servicing agreement by one entity may be deemed to be a default with respect to another entity under common ownership or control. The determination as to what constitutes common ownership or common control varies among Ginnie Mae and the GSEs and, therefore, is an important consideration to evaluate for an acquiring entity that is already invested in MSRs within its structure. In addition to the cross default provisions set forth in the Ginnie Mae Guide, Ginnie Mae in the past has exercised its discretionary authority to limit or prohibit common ownership or control of multiple issuers with the same issuer approval type regardless of whether the parties enter into a cross default agreement.

2. "Build" or "Buy" Strategies

In consideration of the licensing and approvals requirements noted above, investors in MSR funds often debate whether to form a new entity and obtain licenses on a de novo basis (the "build" strategy) or acquire an existing licensed entity through a stock or equity purchase (the "buy" strategy). Each approach carries advantages and disadvantages.

Build

The "build" approach has been popular based primarily on timing considerations and execution speed. An investor interested in the de novo licensing approach is likely to need 12 to 24 months to ramp up to full operating capacity, including licensure in a material number of states and Ginnie Mae or GSE approvals. During this time, the investor would identify a management team, inject capital into the entity and ramp up operations on a rolling basis upon receipt of state and agency approvals.

Buy

By contrast, an acquisition generally may be consummated in 6 to 8 months (assuming that the target entity does not hold licenses in New York). During that time, an investor would identify a target entity with the desired state and federal licenses, perform due diligence, negotiate definitive purchase documents, obtain regulatory "change of control" approvals and close the acquisition.

Weighing the Two Approaches

While the "buy" strategy allows for increased speed to execution, the investor should carefully consider the potential for legacy liabilities associated with the target. In equity transactions, a buyer assumes the assets *and liabilities* associated with an acquired entity. Buyers may face claims post-closing arising from events pre-closing, including loan repurchases or legacy employment claims. Legacy liability risk may be mitigated through legal due diligence as well as indemnity protections in the definitive agreements from a well-capitalized indemnitor. Legacy liability risk is typically not a concern with the "build" approach if licenses are obtained *de novo* and operations are built organically because a newly formed entity would not have the same "tail liability" arising from prior operations.

Legal and licensing fees are likely to be higher for a "buy" versus "build" approach as a result of expenses related to due diligence, negotiation, drafting and "change of control" approvals. When investors consider the pros and cons of build/buy strategies, such costs and potential legacy liability exposure are often weighed against the speed of execution presented by a stock or equity deal.

3. Alternative Arrangements

Establishing or acquiring a licensed and agency-approved servicer can be costly and time-consuming. As a result, investors may look to alternative approaches to MSR investments, either during the setup period or permanently. Generally, these consist of entering into contractual arrangements with third-party or affiliated servicers pursuant to which the servicer acquires and retains the related MSRs, but the economics associated with holding the MSRs are transferred to the investor. Generally, these types of arrangements expose the investor to additional risks related to the servicer counterparty, such as bankruptcy risk, the risk of termination of the related MSRs and other operational counterparty risks.

Excess Servicing

The most common way to accomplish this economic transfer is by the sale of the "excess servicing" to the investor, pursuant to which the servicer sells an economic participation interest in a portion of the servicing income to the investor. These arrangements can be secured by a security interest in the related MSRs and must be approved by Fannie or Freddie, in the case of GSE MSRs, and Ginnie, in the case of arrangements that are secured by the related MSRs. The agencies impose several requirements and restrictions on the related terms as a condition of this approval, including limiting the size of the portion of the servicing fee income that can be sold. As result of these limitations, excess servicing sales are an imperfect proxy for the entire economics of the MSRs because the portion of the servicing fee that the servicer is required to retain is still often significantly greater than the cost of servicing. Since the agencies prohibit any further participation interests (or other interests in the MSRs) being sold to the investor, the remaining economics will need to be transferred pursuant to unsecured contractual arrangements, usually between the parent of the servicer and the investor. These can include preferred shares or tracking stock in the servicer or its parent, credit-linked notes or other derivative-type instruments pursuant to which the investor, in exchange for an upfront payment to the servicer or its parent, is entitled to receive ongoing payments approximating the economics of the remaining portion of the MSRs and generally calculated based on the difference between the servicing fee income received by the servicer with respect to the MSRs, on one hand, and the cost of servicing and the excess servicing fee sold to the investor, on the other hand.

4. Use of Fund Structures

Given the complexity of investing in mortgage servicing rights, formation of a private investment vehicle is a good option to bring together servicers and investors. A typical structure involves setting up a Delaware limited partnership or limited liability company as a pooled investment vehicle or "fund" that is managed by an investment adviser (an "IA") or its subsidiary. The IA enters into an investment management agreement with the fund to provide advice with respect to the making of investments. A fund structure allows the IA to interface with counterparties related to the underlying investments on behalf of fund investors. It also offers the fund investors limited liability protection under Delaware law and comfort through the regulatory oversight of the IA by the Securities and Exchange Commission and fiduciary obligations of the IA arising under the US Investment Advisers Act of 1940, as amended (the "Advisers Act").

Investment Adviser Compensation

A fund formed to invest in MSRs will look much like any private pooled investment fund formed to invest in a specific type of asset. Generally, the IA will be entitled to receive both a management fee and carried interest or other form of performance compensation from the fund. The market terms for fees and performance compensation can vary; it is common to see management fees based on a percentage of invested capital, but fees may also be based on net asset value of the portfolio or other measures. Performance compensation may be structured as a traditional carried interest taken out of profits of the fund once the investor achieves a certain IRR or a preferred return performance threshold.

Governance Terms

As with any private investment fund, the IA and the investor(s) will need to agree on general governance terms. Two primary areas of negotiation are how much discretion the IA will have over the fund and the underlying investments and what rights the investors have to terminate the relationship with the IA. In a "fund of one" separately managed account structure, the investor is more likely to retain tighter control over approval of investments and other investment terms and lower-tier service providers than in a pooled investment vehicle with multiple investors. Such rights may extend to reporting and other information the IA is obligated to deliver to the investor. Similarly, a single investor will likely have more meaningful rights to remove the IA or terminate the fund than in a pooled investment vehicle, which would require more parties to agree. Because margins on MSR investments can be narrow, investors typically retain more control over expenses that can be incurred by the fund—often through an annual cap on expenses or a budget approval process—than they would have in funds investing in other asset classes.

Investment Adviser Obligations

The IA advising the fund will want to make sure that the fund documents contain provisions allowing it to meet its obligations under the Advisers Act. For example, if an affiliate of the IA is either warehousing investments for the fund or serving as an intermediary when purchasing the underlying MSRs, the IA will need to satisfy the principal transaction restrictions under the Advisers Act. This can be accomplished by building in a requirement of investor consent for those specific transactions or a batch consent-type structure where approval is given for transactions within certain parameters. If the IA is advising more than one client investing in MSRs, the IA will need to make sure that the investments allocated to each client are done so on a fair and equitable basis over time or that the client who is not given equal or priority access to investment opportunities has specifically consented to the process by which it will be allocated investments.

5. Fund Leverage

Of course, it may be desirable to lever the fund investments in hopes of boosting the return to investors. There are several ways to do this.

Subscription Financing Facilities

First, the fund can enter into a subscription financing facility, which is secured by the capital commitments of the various investors. These arrangements are fairly common in the funds space and do not depend in any material respect on the type on investments made by the fund.

MSR-Backed Financing Facilities

In addition to or instead of a subscription financing facility, the fund could enter into an MSR-backed financing facility. MSRs are generally difficult assets to finance because of their nature as collateral. They are difficult to value, difficult to foreclose on and can evaporate if the servicer breaches its obligations under the servicing agreement. Nevertheless, MSR financings are fairly common and range in complexity from relatively simple bilateral credit agreements secured by a lien on the MSRs or the servicing income to fairly complicated securitization-like structures pursuant to which the servicer sells excess servicing rights to a special purpose master trust that issues variable funding notes to bank lenders and term notes to capital markets investors that are secured by the related MSRs.

In the federal agency MSR context, a key document is the related agency acknowledgment agreement, entered into by the applicable agency, the servicer and the lender or collateral agent, depending on the context. Pursuant to the acknowledgment agreement, the lender will agree that its interest in the MSR collateral is subordinated to the interests of the applicable agency. The acknowledgment agreement will also set forth the procedures for foreclosing on the collateral in the event of a default under the facility.

Servicing-Advance Facilities

Finally, funds may consider servicing-advance facilities to finance the obligation to make servicing advances required by the MSR. Servicing advances are cash advances by the servicer on behalf of the borrower to cover delinquent mortgage, tax, insurance and escrow payments. Servicing advances are significantly better collateral than MSRs. Compared to MSRs, their eventual repayment is relatively certain and the right of reimbursement, at least to a certain extent, survives the termination of the servicer under the servicing agreement. The most common way to finance servicing advances is by selling the servicing advance receivables to a bankruptcy-remote special purpose master trust that issues one or more advance-backed variable funding notes to one or more bank lenders and that may also issue term notes to capital market investors.

6. Servicing Rights Purchases

Whether an investor will take ownership of MSRs directly through its own approved servicer or will invest in the MSRs indirectly though purchases of “excess servicing” or other structures, someone will need to obtain the desired MSRs.

Origination or Acquisition

If the investor controls a mortgage loan origination platform, the investor may create MSRs when it delivers the applicable whole loans to investors on a servicing-retained basis. Owning an origination platform may provide an investor with a controllable and predictable source of MSRs.

On the other hand, an investor may prefer to focus on its investment in the MSR asset and not take the regulatory and business risks associated with operating an origination business. If so, the investor will need to enter into agreements with third-party sellers of MSRs. There are two principal types of transactions for acquiring MSRs: one-time “bulk” purchases and “flow” transactions under which sellers deliver newly created MSRs on an ongoing basis over a period of time.

Bulk Purchases and Sales

In a bulk transaction, the seller puts a specific portfolio of MSRs out to bid, and prospective buyers review the provided data and perform other due diligence on the loans. The buyers may decide which MSRs to buy and the price that they are willing to pay. Because a bulk sale involves an existing MSR portfolio, it may include loans with less desirable characteristics. For example, some loans may be delinquent, in foreclosure or in bankruptcy. These loans will cost more to service. Compounding that cashflow problem, the owner of the MSRs will not receive a servicing fee for these loans during periods of delinquency because the servicing fee is paid from the collections on the loans, and there are no current collections on those loans. The servicer will also need to fund and carry the servicing advances on these loans.

A bulk offering may include those less-desirable MSRs, but buyers may have the opportunity to exclude them, depending on the terms of the transaction. However, a buyer may not exclude undesirable MSRs from a bulk purchase of Ginnie Mae MSRs because Ginnie Mae requires all of the MSRs backing a securitized pool of loans to be sold together, so a buyer has to take any problematic loans in a pool along with the performing loans.

A bulk transaction typically has a number of procedural steps. First, there's a sale date on which the economic benefits of the MSRs are transferred and a significant portion of the purchase price is paid. Then an interim servicing period follows, during which the seller of the MSRs continues to perform the servicing of the loans for the benefit of the buyer. The interim servicing period ends with a transfer date, when the seller physically transfers the servicing work to the buyer or its subservicer, which includes transfers of loan data, loan documents and custodial funds and notices to borrowers and other relevant parties. In addition, on or shortly after the transfer date, the buyer makes another payment of a smaller portion of the purchase price and reimburses the seller for the advances on the loans. Those include advances of principal and interest made to the investor in the loans when borrowers do not make payments, payment of taxes and insurance that have not been funded by the borrower, and expenses related to actions taken to preserve the value of the loans or to foreclosure in the event of loan delinquencies and defaults.

Flow Purchases and Sales

A flow transaction, by contrast, involves a commitment of the parties to buy and sell MSRs related to newly originated loans in the future. The loans and MSRs don't exist at the time the parties enter the agreement, so there is no existing portfolio for the buyer to review and price. The buyer may review the seller's historic origination of loans to get a sense of what it may deliver in the future. Moreover, the buyer may include terms and limitations in the agreement that will set parameters and requirements for the MSRs that should be delivered. Those terms, often called the "buy box," typically include a pricing matrix that provides pricing multiples and adjustments to properly value the MSRs based on their characteristics and incentivize the delivery of the types of MSRs the buyer prefers. Although it's difficult to review and set pricing for flow purchases, flow transactions avoid the issue of delinquent, defaulted, foreclosure and bankruptcy loans. All the loans in a flow transaction will be new originations and generally need to be performing in order to be sold to or pooled with an investor.

Within the category of flow transactions there are two types. One type is typically referred to as a "mini-bulk" or "forward bulk" sale—which operates as a series of smaller bulk transactions, each with the separate steps of a sale date, interim servicing period and a transfer date but occurring on a repeated basis over a period of time. For example, a "mini-bulk" transaction may call for monthly sale dates of the MSRs related to loans sold to or pooled with the investor during the preceding month, followed by quarterly transfer dates for the physical transfer of the MSRs sold over the preceding quarter.

The other type of flow transaction is generally referred to as a "co-issue" MSR purchase. (The agency investors in the loans use different terms for these sales.) In a co-issue transaction, the seller delivers the MSRs to a buyer simultaneously with the sale or pooling of that loan with a given investor. That may be attractive to sellers because it provides a "one-stop shop" for the disposition of the loan asset and MSR. The seller never has to service the loan for the investor, and the seller doesn't need to deal with the multiple steps and interim servicing obligations needed in bulk or mini-bulk sales. Indeed, each of Fannie Mae and Freddie Mac have programs to further simplify and expedite these transactions by facilitating unified data exchange and payment structures, and these programs have become increasingly popular in recent years.

For a buyer, however, a co-issue sale presents an unusual circumstance in that the buyer does not know what it is purchasing until the loan and MSR have been delivered. Because the seller is making decisions on which loans to sell or pool on a day-to-day basis, the seller may not know what MSRs it has acquired until the time of sale, or even after the sale. In addition, in a co-issue sale, the buyer takes over the physical servicing immediately upon the delivery of the loan to the investor, or nearly so. There is no investor-recognized interim period of servicing, and all documents and data on the loans have to be transferred very quickly.

There is one other aspect of purchases of Fannie Mae and Freddie Mac MSRs that many readers will be familiar with but may be surprising to new investors in MSRs: A buyer of Fannie Mae and Freddie Mac MSRs generally assumes liability to those agencies for all of the origination, sale, pooling and prior servicing of the related loan. There are some exceptions to that rule, involving what is referred to as a "bifurcation" of those liabilities. Those exceptions rely on specific programs or special approvals from Fannie Mae and Freddie Mac, however, and while increasingly popular, "bifurcated" transactions still make up a minority of sales.

Assuming the parties don't arrange a bifurcated transaction, the buyer of the MSRs inherits responsibility to the investors for all there were errors in the origination, sale, pooling or prior servicing, and Fannie Mae and Freddie Mac will first look to the current owner to satisfy the related repurchase, indemnification and make-whole remedies. A buyer of MSRs should, of course, have matching remedies back against the seller of the MSRs under its purchase agreement, but those remedies will be of little use if the seller no longer exists when they remedies are needed. This is an especially significant concern in light of the more difficult current economic environment for originators and servicers.

7. Subservicing

The other principal transaction for many MSR owners is a subservicing agreement. The MSR owner may, of course, perform the servicing of the loans itself. Investors in MSRs may prefer to operate a servicing business, opting to instead outsource the day-to-day servicing work associated with the mortgage loans. However, the owner of MSRs may not simply delegate the servicing obligations to a subservicer and ignore the servicing work given its economic obligations and the oversight responsibilities imposed by investors and regulators.

Financial Obligations

The MSR owner continues to bear significant economic burdens and risk associated with the MSRs even if it contracts out the day-to-day work. Compensation of subservicers is paid in the form of flat monthly and other fees for each loan and each task performed. Those fees increase as the subservicer has to perform more work on a loan and, therefore, escalate rapidly as the loan becomes more delinquent or enters default, foreclosure or bankruptcy. Meanwhile, as discussed above, those loans do not provide the MSR owner with any servicing fees when payments aren't made. As a result, there is a significant economic outlay associated with servicing loans as they grow more delinquent. In addition, more and more servicing advances are required as these loans grow more delinquent. While a subservicer will administer the servicing advance process for the MSR owner, the subservicer will require monthly reimbursements or prefunding of those advance amounts. An MSR owner, therefore, retains significant economic risk associated with the performance of the servicing even when outsourced to a subservicer.

Oversight

In addition, there are significant investor and regulatory requirements regarding the oversight of subservicers. The Consumer Financial Protection Bureau and Office of the Comptroller of the Currency and state regulators all require MSR owners to take an active role in the monitoring and oversight of subservicers as consumer-facing vendors. Examinations by these regulators will include a review of the MSR owner's oversight practices, so even a somewhat passive owner of MSRs that engages a subservicer will need to have internal experts who understand the MSR asset and related loans and who actively oversee and monitor the subservicer's activities. In addition, for the fund structures discussed above, managers of an MSR investment may need to engage in a certain amount of oversight in order to meet applicable securities and investment advisory requirements.

Refinance Risk and Recapture

One last issue that involves subservicers (but is not limited to context of their use) is refinance risk and potential refinance recapture opportunities. When a loan pays off, the owner of the loan receives the principal balance received and can redeploy that capital. The MSR owner is not as fortunate, however. When that loan pays off, the related MSR asset evaporates and leaves the investor with nothing. Recent increases in mortgage interest rates have made MSRs somewhat less vulnerable to refinance activity, but increased home values have provided borrowers with increased equity that they may want to access through a "cash-out" refinance, supporting a significant level of refinance activity. Smart MSR owners, therefore, actively solicit borrowers for refinancing or other transactions (such as second lien loans or home equity lines of credit) to preserve their MSR assets. In other words, the MSR owner tries to refinance the loans (or provide those other options to tap into equity) and thereby recapture or maintain the MSR asset.

MSR owners who also have an origination platform can, of course, use that origination platform to solicit the borrowers for refinance or other loan products. If the MSR investor has chosen not to operate a loan origination platform, it can't undertake that activity for itself. If the MSR owner's subservicer can originate loans, however, it may be possible to leverage that capacity to engage in the necessary refinance or other lending activity. How that can be structured is beyond the scope of this summary. There are numerous regulatory concerns, and the use of a subservicer is not the only option. Fund manager incentive fees are often directly tied to the success of these recapture programs.

Takeaways

Investing in MSRs involves more than merely investing in an income stream. While investors grapple with a complex set of relationships and considerations involving a highly regulated asset class, we find that legal and business issues may be resolved through creative structuring and subject matter expertise.

Treatment of Mortgage Loans and Mortgage Servicing Rights Under the Hart-Scott-Rodino Act

By Scott Perlman, Oral Pottinger, Lauren Pryor, Michael Serafini

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Transactions involving the purchase and sale of residential mortgage loans and mortgage servicing rights ("MSRs") frequently raise the question of whether they require submitting premerger notification filings to the Federal Trade Commission ("FTC") and the Department of Justice ("DOJ") under the Hart-Scott-Rodino Act ("HSR Act"). This Legal Update provides an overview of how residential mortgage loans, MSRs and related assets are treated for HSR purposes in the context of asset or servicing platform sales and equity transactions pertaining to entities that hold mortgage loans or MSRs, including residential mortgage servicers.

The acquisition of mortgage loan portfolios as well as entities that hold mortgage loans and related assets, but few other assets, are categorically exempt from HSR filing requirements. MSR acquisitions are exempt if either the MSRs are acquired together with the related mortgage loans or sold independently in the ordinary course of business by sellers that will continue in the servicing business. A sale of all or substantially all of the MSRs held by a seller, however, would not qualify for the ordinary course exemption and generally will be reportable if the applicable transaction meets the HSR Act's dollar thresholds discussed below.

HSR Thresholds

Under the HSR Act, parties to transactions that meet certain dollar thresholds must submit premerger notification filings to the FTC and DOJ and observe a waiting period—usually 30 days—before the transaction may close. Transactions are reportable if the transaction meets both the "Size-of-Persons" and "Size-of-Transaction" thresholds, unless an exemption applies.

- The "Size-of-Persons" threshold is met if one of the counterparties to the transaction is a "person" with $222.7 million or more in total assets or annual net sales and another counterparty to the transaction is a "person" with $22.3 million or more in total assets or annual net sales. A "person" for the purpose of this analysis is the ultimate parent of each counterparty to the transaction. Total assets and sales are determined based on the ultimate parent's fully consolidated financial statements.
- The "Size-of-Transaction" threshold is satisfied if the value of the mortgage loans, MSRs or equity acquired exceeds $111.4 million.[84]

Transactions valued in excess of $445.5 million are reportable regardless of the size of the persons.

HSR Treatment

MSRs Sold With The Applicable Loans

HSR Act Section 7A(c)(2) exempts all acquisitions of mortgage loans. The FTC Premerger Office, which is responsible for interpreting the HSR Act and the regulations promulgated under the Act (the "Rules"), has taken the position that MSRs that are sold in tandem with the related mortgage loans are also covered by

[84] In an asset acquisition, such as an acquisition of MSRs, the value is the higher of the purchase price or the fair market value as determined by the buyer. In an equity acquisition, the value is the purchase price, or if there is no agreed-upon price, the fair market value as determined by the buyer. 16 C.F.R. § 801.10 ("HSR Rule 801.10"). Note that cash and unreimbursed advances or servicing advances are not counted towards the Size-of-Transaction threshold. See Informal Interpretation 1302001 (Feb. 5, 2013).

the Section 7A(c)(2) exemption.[85] In addition, HSR Rule 802.4 exempts equity transactions involving entities that hold mortgage loans and exempt MSRs and that do not hold non-exempt assets with a current fair market value of more than $111.4 million.

MSRs Sold Independently

MSRs sold independently from the mortgage loans to which they relate are not exempt under Section 7A(c)(2).[86] This scenario arises most frequently with respect to mortgage servicers that hold MSRs and service mortgage loans held by third-party investors. Acquisitions of these MSRs may be exempt from filing, however, as a sale in the ordinary course of business under HSR Act Section 7A(c)(1) if the ultimate parent of the servicer continues to hold MSRs (directly or indirectly through controlled subsidiaries[87]) after the related transaction closes. In addition, to qualify for the exemption, a transaction may not be a phase or installment sale in connection with a series of related transactions leading to the total divestiture of all the MSRs by the servicer.

Sale of All or Substantially All of MSRs Held by Seller

On the other hand, if the MSRs being sold constitute all or substantially all of the MSRs held by the ultimate parent and the applicable servicer or the transaction is part of a series of transactions intended to result in the ultimate parent's exit from the servicing business, the ordinary course exemption is not available, and the sale will be reportable if it meets the Size-of-Persons and Size-of-Transaction thresholds and no other exemption applies. For most of these transactions, other exemptions are unlikely to be available.

HSR Form

When a filing is required, each party must submit an HSR Form that includes the following information:

- Copies of the most recent financial statements
- Revenues from US operations for the most recent fiscal year broken out by North American Industry Classification System ("NAICS") codes
- Documents that analyze the transaction with respect to markets, competition or synergies
- Information relating to subsidiaries, minority equity holders and minority investments in certain third-party entities

Filing Fees

The buyer is required to pay a filing fee that ranges from $30,000 (for transactions valued in excess of $111.4 million up to $161.4 million) to $2.25 million (for transactions valued at $5 billion or more).[88]

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[85] See ABA *Premerger Notification Practice Manual* (Fifth Ed. 2015), Interpretation No. 106.

[86] *Id.*

[87] Under the HSR Rules, control for a corporation is defined as holding 50% or more of the corporation's voting securities or having the right to appoint 50% or more of the corporation's board of directors, while control of a non-corporate entity, such as a limited liability company or partnership, is defined as having the right to 50% or more of the entity's profits or 50% or more the entity's assets upon dissolution. HSR Rule 801.1(b).

[88] Under new HSR filing requirements proposed by the FTC in June 2023, the information required on the HSR form would be expanded significantly, including more details about the parties' corporate relationships, the products and services involved,

Remedies for Failure to File

A failure to make a required HSR filing may result in an investigation, fines of up to $50,120 per party for every day in which the parties are in non-compliance, and other remedies up to and including rescission of the transaction.

Takeaway

While many transactions involving mortgage loans and MSRs are exempt from HSR filing requirements, parties to these transactions should confer with HSR counsel to confirm that an HSR filing would not be required. Mayer Brown's antitrust practice has extensive experience advising clients with respect to these transactions.

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projected revenue streams, previous acquisitions, and labor market impacts. The FTC estimates this will increase the time required to prepare a filing by four-fold. See FTC Notice of Proposed Rule Making, June 29, 2023 at 16 CFR Parts 801 and 803: Premerger Notification; Reporting and Waiting Period Requirements | Federal Trade Commission (ftc.gov).

Mortgage M&A: Hot Topics in Due Diligence

By J.P. Bernard, Krista Cooley, Lauren Pryor, Tori Shinohara and Stephanie Vasconcellos

Originally published on August 21, 2023

We are seeing continued consolidation in the residential mortgage market following recent interest rate increases and low housing volume across the United States. Investors in residential mortgage companies should be keenly focused on a few critical items when evaluating a target. Whether you are considering a minority investment or a whole company carve-out transaction, buyers and sellers should be aware of the following issues that may present transaction risks for US mortgage company investments.

Financial Condition of the Target

Originators and servicers are under immense financial pressure in the current market. Many mortgage companies are looking at stock and asset deals as a way to weather the economic storm. However, mortgage M&A transactions require state and federal agency “change of control” approvals that may take several months to obtain. The target entity needs to remain in good financial health during this time in order to avoid covenant defaults under agency requirements and warehouse lending facilities. Buyers and sellers may need to consider creative solutions to help bridge the gap, including cost-cutting measures and convertible debt structures. Buyers should consider the impact of these measures on the overall economics of the transaction and sellers should consider the possibility of additional capital infusions. Buyers and sellers should discuss these alternatives with their legal and financial advisors.

Warehouse Lender Consents

Reductions in warehouse lending capacity across the industry are putting additional pressure on mortgage originators. Certain warehouse loan providers have reduced their participation in this market in light of the current banking environment, and a national bank and major player in the warehouse space recently announced that it plans to exit the warehouse lending business altogether. The decision by any significant financing party to reduce its participation in, or exit, the business puts additional pressure on mortgage originators to obtain new warehouse facilities and lean more heavily on other existing warehouse lines. Buyers should carefully consider available warehouse capacity post-closing.

Moreover, most warehouse agreements require lender consent in the event of a change of control and other such material events pertaining to the mortgage originator. In the context of an M&A transaction, buyers and sellers should anticipate that warehouse lenders could use the consent requirement as leverage to negotiate additional or more favorable terms. Negotiating new warehouse lending terms on the eve of closing adds further transaction risk in an already volatile mortgage M&A market.

Fair Lending Risk

Federal and state fair lending laws prohibit discrimination in connection with mortgage lending. Federal regulators, including the Consumer Financial Protection Bureau (“CFPB”) and the US Department of Justice (“DOJ”), have been stepping up their enforcement on fair lending issues in recent years. As a result, understanding and evaluating potential fair lending legal and reputational risks in connection with a potential transaction may be prudent.

Common fair lending risks associated with mortgage lending including pricing discrimination, improper denials and geographical “redlining.” The CFPB and DOJ have recently entered into a number of public and non-public settlements related to alleged fair lending violations that have resulted in significant monetary penalties and required other remedial actions (including changes to business practices).

Depending on the structure of the transaction, a buyer may take on the liabilities of the target company, which could include liability for violations of fair lending laws that are subsequently identified by a government agency. Buyers could be responsible for defending a multiyear fair lending investigation and/or the payment of civil money penalties or other required restitution. Fair lending settlements can also require changes to business practices, such as changes to pricing practices or the opening of a new branch or loan production office, which could have significant business ramifications.

Because of these potential risks, buyers may consider engaging a third-party consultant to perform a statistical analysis of a target's historical lending performance prior to consummating the transaction. Even in asset transactions where a buyer does not assume all liabilities of the target, there may be reputation risk to consider in connection with a potential fair lending lawsuit or settlement.

Employee Classification

Employers are obligated to designate employees as either "exempt" or "nonexempt" from the overtime regulations of the federal Fair Labor Standards Act[89] ("FLSA") and similar state laws. Employees are classified depending on their applicable job duties and on the basis of their salary and income level. An exempt or nonexempt classification determines whether an employee is entitled to receive overtime pay for hours worked over 40 in a week (or eight in a day in some jurisdictions).

The determination as to whether an employee is exempt or nonexempt is based on a somewhat subjective analysis and can be difficult. The US Department of Labor ("DOL") has focused specifically on the misclassification of mortgage loan officers and issued guidance in 2010 stating that generally mortgage loan offers should be classified as non-exempt.[90] The 2010 guidance overturned a 2006 DOL opinion letter holding that mortgage loan officers may be classified as exempt. The classification analysis for loan officers and underwriters is particularly tricky, because it is possible that persons in these roles may fall within either the "administrative" exemption or the "outside salesperson" exemption. The administrative exemption requires that the employee's duties include the exercise of independent judgment and discretion. This is a fact-specific inquiry that depends on the loan officer's actual duties and responsibilities. Similarly, the outside sales exemption requires that the employee's primary duty is "making sales" (as defined by the FLSA) and "who is customarily and regularly engaged away from the employer's place or places of business in performing such primary duty."[91] This, too, is a fact-specific inquiry.

Independent contractors or consultants can also be the subject of misclassification. Whether a service provider is correctly classified as an independent contractor is based on whether the factual circumstances fall within one or more tests. For example, the Internal Revenue Service ("IRS") website states that all information that provides evidence of the degree of control and independence must be considered in determining whether an individual is an independent contractor. These "common law" factors are

[89] 29 C.F.R. Part 541.
[90] https://www.dol.gov/agencies/whd/opinion-letters/administrator-interpretation/flsa/2010-1
[91] 29 U.S.C. 213(a)(1).

behavioral and financial. This would include considerations related to who controls what the worker does, how the worker is paid, whether expenses are reimbursed, who provides tools/supplies, etc. and the type of relationship. Here, too, certain states, such as California and New Jersey, impose narrower restrictions on the facts that support an independent contractor classification.

If an business misclassifies employees or independent contractors, the business may be at risk for individual claims or class action lawsuits. A common remedy for FLSA violations is the payment of back pay—the difference between the pay the employee actually received and the amount that the employee should have received— looking back over a two- or three-year period. In addition, liquidated damages in the amount of twice the backpay amount may also be available. Certain state laws impose even stronger penalties. For instance, the California Labor Code[92] provides for monetary penalties for waiting time violations, wage statement violations, meal and break period violations and pay period violations.

Because taxes are not withheld from independent contractors and paid over to the taxing authorities by the business, one of primary risks of a business engaging an independent contractor is the obligation to provide unpaid federal, state and local income tax withholdings and Social Security and Medicare contributions, and unpaid unemployment insurance taxes, both to the federal government and the state government, in the event the worker should have been classified as an employee. Further, the federal, state, and local taxing authorities may issue penalties; for example, the IRS penalty for failure to withhold and pay over income and other taxes is an amount equal to 100% of the tax. In addition, workers who were misclassified as independent contractors but should have been classified as employees may be eligible for unpaid overtime compensation and/or minimum wages, unpaid work-related expenses, and unpaid sick and/or vacation pay.

A worker who was misclassified as an independent contractor but should have been classified as an employee may become eligible for or entitled to receive benefits under the employer's benefit plans. Whether benefits may be provided only prospectively, or must be provided retroactively, should be reviewed under the terms of the applicable plans. There have been cases under which companies were required to provide retroactive benefits as a result of the retroactive reclassification of independent contractors. As a result, many plans now contain language providing that an individual will not be retroactively eligible to participate in the plan even if that individual is reclassified retroactively. An employer should also review misclassification issues under the Affordable Care Act, which generally requires that employers provide affordable, minimum value coverage to its full-time employees or pay an "employer shared responsibility payment" if the employer fails to do so. A failure to offer coverage to one or more individuals who are determined to be full-time employees could trigger significant penalties—in some cases, determined on an entity-wide basis.

When considering an equity investment in a mortgage company, even for a minority stake, buyers may carefully review the target's employee census to consider how employees are classified. If employees are misclassified, buyers may consider requiring the seller to take mitigating steps to reduce risk, request a special indemnity in the purchase agreement, or make adjustments post-closing.

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[92] Cal. Lab. Code.

Note that misclassification of employees may also present concerns for purchasers in *asset* sales. Buyers of substantially all of the assets of a mortgage company (or a significant portion thereof) should be aware of the potential for successor liability in employment actions because courts have held transferees in asset sales liable for employee misclassification claims under the FLSA and similar state laws.[93]

Non-Voting Stock and Change of Control Approvals

It may be surprising to learn that the acquisition of non-voting stock or non-voting equity interest investments also may require "change of control" approval as it relates to Ginnie Mae, Fannie Mae, Freddie Mac and certain state mortgage finance licensing laws and may require personal disclosures of the ultimate indirect owners of the licensee. The determination of whether the change of control provisions apply may be based on the form of organization of the licensee or entities in the chain of ownership. Debt structures also may warrant change of control analysis depending on the extent of the debt holder's ability to exercise control over, or direct the management or policies of, the licensee.

Some states require approvals for any change of 10% or more in the direct or indirect ownership of a licensee, including in connection with preferred, non-voting interests. Other states draw the line at a change of 25% or more in the indirect or direct ownership of the licensee. Some states further require personal disclosures (e.g., personal financial statements, fingerprints, etc.) from any individuals holding more than the requisite threshold of indirect ownership interests of the licensee and/or of an entity seeking to acquire an interest in a licensee. Some states exempt public shareholders up the ownership chain.

Personal disclosures may be burdensome and intrusive, so buyers and their investors may carefully consider what information is required to be disclosed and by whom. Hedge funds, strategic investors, and private entity firms should analyze this issue carefully because their principals may be required to make such disclosures. Licensing counsel should help navigate the change-of-control analysis and consider whether disclosures will be required based on the form of investment proposed, the organizational charts of both buyer and seller and the state licensees held by the licensee. Similarly, sellers should carefully evaluate whether the proposed ownership structure poses transition risk in the event that certain of a potential buyer's direct or indirect owners may be hesitant to provide personal disclosures, which could delay or adversely impact the issuance of state approvals necessary to proceed with the transaction.

Conclusion

Mayer Brown's mortgage M&A lawyers navigate these and other material issues on a daily basis. We look for creative solutions to help clients achieve successful transaction outcomes while mitigating risk. We look forward to working with you on your next mortgage M&A deal.

[93] *See, Teed v. Thomas & Betts Power Solutions*, 711 F.3d 763, 764 (7th Cir. 2013).

RESPA Enforcement is Back! The CFPB Takes Aim at Marketing and Promotional Activities

By Holly Spencer Bunting

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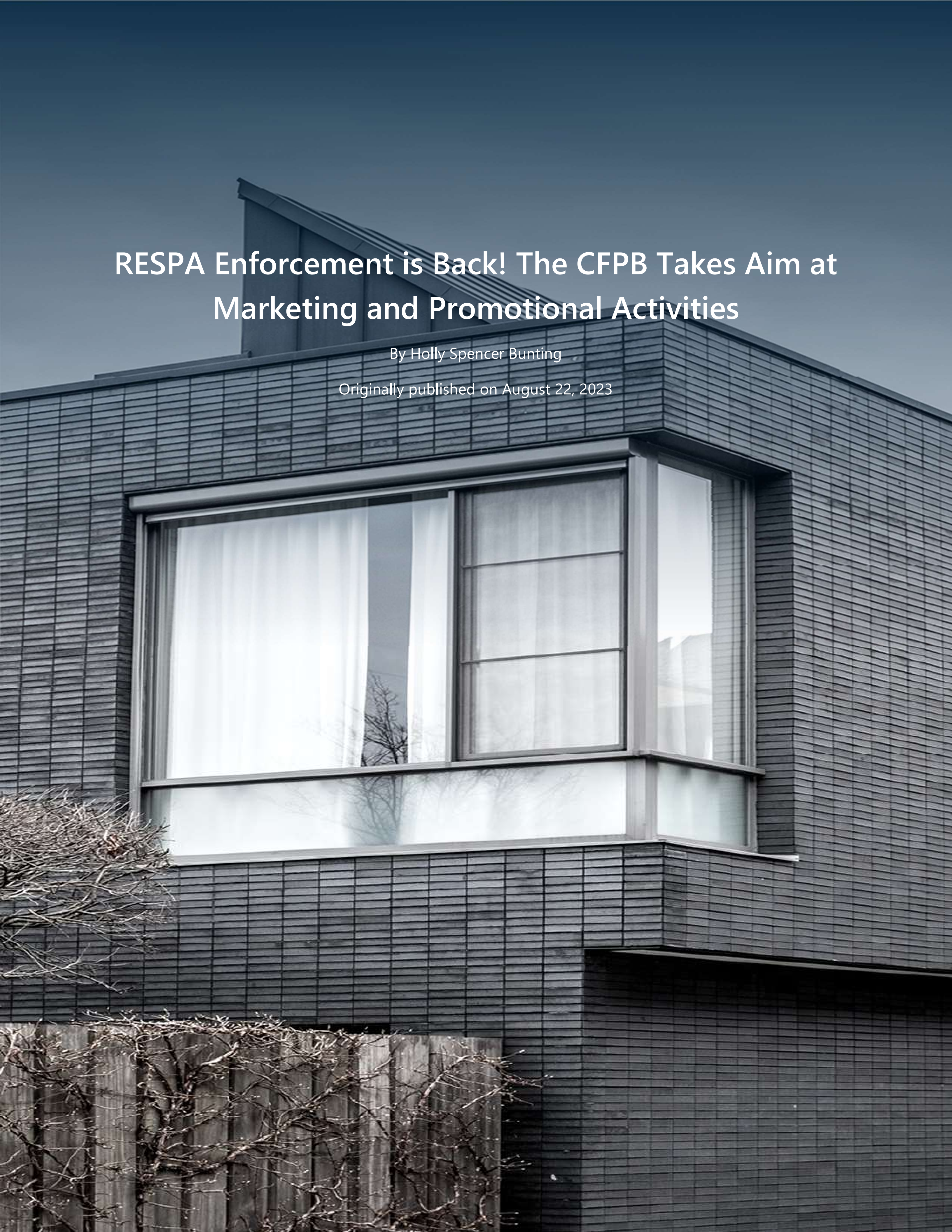

It has been more than five years since the Consumer Financial Protection Bureau ("CFPB") has issued a consent order based on alleged violations of Section 8 of the Real Estate Settlement Procedures Act ("RESPA"). On August 17, 2023, the CFPB announced a consent order with a non-bank mortgage lender and a consent order with a real estate brokerage company—totaling nearly $2 million in combined penalties—based on allegations that the mortgage company provided things of value and the real estate brokerage company received things of value in violation of Section 8 of RESPA. Perhaps it should come as no surprise that the activities at issue in the consent orders are promotional events and marketing services agreements, two arrangements about which the CFPB provided guidance in its Frequently Asked Questions in October 2020.

The consent orders highlight three specific activities that the CFPB claims to constitute the provision of improper things of value by the mortgage company to the real estate brokerage company in return for referral of mortgage origination business. First, the consent orders state that the mortgage company paid thousands of dollars per month for a subscription service that the mortgage company provided to the brokerage's (and other) real estate agents for free to allow the agents to access property reports, sales comparables and foreclosure data. The CFPB notes that, had the real estate brokers and agents paid for their own subscriptions, the retail price to the agents would have been $300 per month. In some cases, the CFPB states that the mortgage company required a real estate agent to be paired with a mortgage company loan officer before the agent could gain free access to the service. The real estate brokerage's agents made more than 400 referrals of mortgage loan business to the mortgage company during the time the subscription service was made available to real estate agents.

Second, the consent orders state that the mortgage company hosted and subsidized events for real estate brokers and agents, including events where the mortgage company paid for food, beverages, alcohol and entertainment. The mortgage company also provided free tickets to sporting events, charity galas or other events where the brokers and agents would have otherwise paid for the tickets and the food and beverages consumed at the events. As an example, the brokerage company's consent order states that the mortgage company paid more than $6,300 to host an event at a local bar for real estate agents and brokers, which covered the cost of food, alcohol, and other entertainment during the event. The CFPB states the mortgage company invited a select guest list of agents who were chosen because they referred the most mortgage origination business to the mortgage company, or who were new agents with whom the mortgage company hoped to build relationships. Without providing any detail on the marketing efforts undertaken by the mortgage company at these events, the consent orders claim that the mortgage company paid for these events, and that the real estate brokers and agents accepted things of value from the mortgage company as part of a pattern or course of conduct to create and maintain referral relationships.

Third, the consent orders assert that the mortgage company maintained marketing services agreements ("MSAs") with more than 40 real estate brokerage companies, one of which was the real estate brokerage company that entered into one of the consent orders. According to the order, the mortgage company made payments under those agreements ranging from a few hundred dollars to thousands of dollars per month for marketing services. Yet, the CFPB claims the mortgage company used the MSAs as a mechanism to pay referral fees, rather than to pay for marketing services. While acknowledging that certain marketing services performed by the real estate brokerages were directed to consumers, the consent orders highlight the performance of services directed to the brokerage's real estate agents and employees. As an example, the consent orders indicate that real estate brokerages were required to send direct mail and email campaigns with the lender's marketing content to real estate agents in addition to the members of the general public. In addition, the agreements allowed the mortgage company's loan officers to promote themselves at internal sales meetings and to host training events for real estate agents. The CFPB states "[b]y its own terms, the MSA focused on [the mortgage company] getting referrals from [the brokerage's] brokers and agents, rather than marketing [the mortgage company] to the public."

One consent order also asserted that the real estate brokerage company did not perform the marketing services it had agreed to perform, noting that the brokerage company was supposed to send 15,000 emails per month, with 50% of the email content dedicated to the mortgage company, but the brokerage company did not send any emails. In addition, the MSA required the real estate brokerage company to maintain three locations with video kiosks showing the mortgage company's ads, but the brokerage company never set up such kiosks. According to the order, the brokerage company also did not create 75 property websites per month that included the lender's content as it had agreed to do under the MSA. These MSAs also included co-advertising activities, although the CFPB claims the mortgage company performed most of the actual marketing services by maintaining a professional design team and licensed software to create marketing copy and using its own print shop to generate hard copies of co-branded advertisements. As it relates to the one brokerage company, the consent order states the brokerage company's role "was limited to making minor design suggestions and paying the postage for the co-branded mailers." Based on these assertions, the CFPB alleged the payments made for marketing bore no reasonable relationship to the services performed and, instead, were provided and received as part of a pattern of conduct to create and maintain referral relationships.

The circumstances described in these consent orders raise a number of questions based on the CFPB's own Frequently Asked Questions that provide guidance on the creation and operation of compliant promotional activities and MSAs. And without a complete picture of how these marketing activities were undertaken, it is difficult to discern what facts the CFPB focused on when deciding on the penalties imposed in the consent orders. It is also difficult to assess what facts would need to have changed for the CFPB to have reached a different conclusion. For instance, if the mortgage company had invited every real estate agent in town to the event at the bar, rather than a select group of agents, would the CFPB have viewed this event as an acceptable promotional activity under Section 8? These are the questions that are certain to be debated in the weeks to come, but all of them underscore the importance of closely scrutinizing every marketing and promotional arrangement under RESPA. The CFPB's own Frequently Asked Questions acknowledge that marketing and promotional activities can be done compliantly. But, as is generally the case with RESPA, these recent consent orders highlight that the specific facts matter.

New Applications of Master Trusts: Financing Single Family Rental (SFR) and I-Buyer Properties

By Paul Jorissen and David Linley

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Executive Summary:

As the market for financing single-family residential rental properties (SFR) and high-velocity purchase and sale arrangements for residential properties (I Buying) matures, stakeholders are looking for efficiencies in the financing process. Sponsors and originators, servicers, property managers, rating agencies, warehouse banks and securitization investors are looking to streamline the financing process to reduce overall execution expense, speed up the availability of warehouse and term financing, and free up capital to reinvest in new assets. Master trusts, familiar in other asset classes, provide a basis for seeking these efficiencies without sacrificing the fulsome information transparency and collateral security that rating agencies, lenders and investors expect. Securitizations financing SFR in particular have historically adopted the "large loan" approach long used in commercial mortgage backed securitizations. While relatively robust, the securitization of a single borrower loan is less flexible than a securitization backed directly by the real estate. By using this familiar master trust technology, and adapting it for the SFR and I Buying market spaces, stakeholders can drive the efficiencies that benefit all of the market participants.

This article first describes the historic "large loan" structure and its key attributes. We then turn to the key features of a master trust structure and its benefits. We conclude with observations about possible application in the future, including combinations with other structuring techniques, such as titling trusts.

The Current Securitization Approach: Description of a Typical Large Loan Structure

In the typical structure for securitization of SFR, the properties are transferred to a special purpose vehicle (SPV) that will act as the borrower. At the closing of the securitization, an accommodation lender, typically an affiliate of the investment bank that is structuring the securitization, originates a mortgage loan (an "accommodation loan") and extends the proceeds to the SPV borrower. The accommodation lender is never out-of-pocket. The accommodation loan is sold to a securitization depositor that forms a trust that is the securitization issuer, and contributes the accommodation loan to the trust in exchange for the securitization securities. The depositor, through the securitization placement agents, offers the securitization securities to investors in a typical 144A/Reg S offering. The proceeds of the securitization offering are transferred to the depositor to put it in funds sufficient to pay the accommodation lender for the acquisition of the accommodation loan.

To provide the most efficient form of financing, the securitization trust issues multiple classes of securities each bearing a different rating, interest rate, and credit attachment and detachment points. The accommodation loan is componentized at origination to match the various classes of securities (i.e., the Class A Certificates are supported by the cash flow from Component A on the loan, the Class B Certificates are supported by the cash flow from Component B on the loan, and so on). Accordingly, rent received by the SPV borrower on the SFR properties is segregated and applied in a monthly waterfall to meet the SPV borrower's interest obligations and other payment amounts under the loan. As the securitized financial asset, the loan proceeds are then used to pay the investors holding the securitization securities.

Because the accommodation loan can be structured as a qualified mortgage loan, the securitization trust typically makes a REMIC election over loan. While REMIC qualification results in a tax-efficient structure, using a REMIC tends to limit the financing flexibility. As a consequence of needing the loan to be REMIC eligible, the securitization issuer holds a single loan and issues one series of securitization securities. REMIC securitization structures generally have little or no pre funding period, and no revolving period absent certain limited substitutions including for ineligible properties. Since the securitization securities are backed by the loan, they are usually viewed as asset backed securities under applicable Federal regulations and, accordingly, the U.S. Credit Risk Retention rules apply.[94]

Master Trust Structures: Firm, Familiar and Flexible

Master trusts have a long history in the capital markets, being used in multiple asset classes for decades. They have been used for warehouse and securitization arrangements, rated and unrated transactions, and are supported by a fully built infrastructure of active trustees and vendors necessary for their efficient deployment. Master trusts provide a solid and robust structure that is well known in the market, and yet is flexible enough to be readily adaptable to SFR and I Buyer financing.

In the most common version of a master trust structure, there is no need for an accommodation loan; the master trust holds the assets directly as issuer in the financing. Master trusts can and do issue additional securities in multiple series from time to time as more assets are transferred to the issuer trust. This is so whether the assets being transferred to the trust are familiar and frequent users of master trusts (such as credit card receivables) or leased "hard" assets (such as railcars or containers). The same principle applies for SFR and I Buyer properties; as properties are acquired by the issuer trust, new securities are issued to fund their acquisition, subject to compliance with preagreed eligibility guidelines and advance rates.

One point of flexibility in a master trust is that each new series can be collateralized by all the properties in the trust, or be segregated such each new series finances as defined subset of properties (e.g. properties under renovation, or properties that have become seasoned). Each series can encompass different classes and tranching, different interest rates (including fixed or floating rates) and use different credit enhancement, all as the market conditions warrant. To mimic the flexibility of a credit line, master trusts can issue series in the form of a variable funding note, alongside traditional term debt.

Master trusts, by their nature, are not bound by the need to have a certain asset type. So long as the cash flows are captured and applied in a waterfall, a master trust can accommodate single-family residential properties (including their lease income and, when used as a form of warehouse financing, proceeds of sale such as to a joint venture or permanent financing vehicle) or I Buyer properties pending sale where the proceeds of sale are reinvested in new, eligible properties or used to repay the debt.

Master trusts are generally structured as debt for tax rather than as a REMIC and, accordingly, are not bound by the requirements of a REMIC. Master trusts can have unlimited revolving or prefunding periods, subject only to investor appetites and sponsor needs. Within the bounds of eligibility and advance rate requirements, generally properties can be added to and removed from the master trust; when properties are sold, their asset value is replaced with cash and accordingly master trust investors are always fully

[94] Historically, SFR securitizations have been marketed to Reg. S investors in the European Union and United Kingdom, although no specific compliance with the transparency requirements has been undertaken by issuers or sponsors. With recent European Commission guidance on the EU Securitisation Regulation, compliance by affected European investors with the EU Securitisation Regulation will be difficult in the context of SFR securitizations. See: European Commission Report on the functioning of the EU Securitisation Regulation. Whether there will be a divergence between the EU Securitisation Regulation and the United Kingdom's approach remains to be seen, as the UK is looking to revoke its retained EU financial services law, and replace it with UK domestic law. See: Proposed Reforms to the UK Securitisation Regulatory Framework.

collateralized. Combining these flexible features mean that master trusts can be utilized in lieu of traditional warehouse financing, or serve as term financing.

Master trusts typically use master program documents (such as an indenture) and short supplements (for each series). For capital markets transactions, this is often mirrored by a base prospectus or other offering document, and a prospectus supplement or similar document that describes the particular features of the series. As such, the time to market and the inherent expense of each offering should be materially less than would be the case with repeat large loan securitizations.

In a master trust structure as described, the assets held by the trusts would be SFR or I Buyer properties; that is, physical real estate. U.S. Credit Risk Retention rules generally would not be expected to be applicable as the securities issued by the master trust would not be "asset backed securities" in that they are not repaid primarily with the proceeds of a self liquidating financial asset.

Possible Further Adaptations for Master Trusts for SFR and I Buyers

Master trust structures to date in the SFR and I Buyer spaces have been structured primarily as warehouse financing, and, accordingly, have not been rated and have not utilized mortgages. In a rated, term securitization of SFR properties, it has been desirable that the properties be secured by mortgages to better support the ratings sought on the securities.

Delaware statutory trusts are widely used as titling trusts, to own and facilitate financing of assets assigned to a separate series of the trust that is generally treated as separate from other series under law. In order to be a financeable asset, the property must be owned by the borrower; however, there is friction and significant expense involved in retitling assets through the warehouse and securitization or term-financing phases. While use of a "recycled SPV" that meets rating agency requirements can ameliorate this issue to a degree, it nevertheless represents a significant execution cost in forming every securitization pool. Using a titling trust—the premise of which is this segregation among series but no change in the trust's legal title ownership—would significantly simplify the warehouse financing of assets and the subsequent formation of each securitization pool and its financing. Each series of the trust would issue a beneficial interest that can be held by a bank or be used as collateral for a term-financing or securitization of the properties. The individual properties can be moved from one series (e.g., a bank warehouse line) to another series that is a master trust or other securitization on the books and records of the trust without a new deed, recordation or related taxes.

Conclusion

With the maturation and development of the market for financing SFR and I Buyer properties, stakeholders are looking for efficiencies in the financing process. Master trusts can provide efficient financing structures that can be tailored to the needs of sponsors and issuers while providing investors and lenders with the robust collateral security they require. Master trusts can help provide a seasoned and well understood method of financing by series in a manner that achieves the optimal outcome with the least friction (in time and money) possible.

Structured Finance Solutions for Financing Real Estate Related Fintech Companies

By Susannah Schmid, Terry Schiff, Jenna Hartnett and Katherine Stevens

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Introduction

In recent years, there has been a rise in the number of financial technology (***Fintech***) companies looking to apply technological innovations to improve aspects of the residential real estate market. These innovations include (i) using technology to streamline the process of buying and selling real estate, (ii) utilizing digital platforms to better predict real estate values, (iii) creating programs to better align tenants' housing needs with desired rental properties and (iv) creating unique ownership structures to allow second home ownership. One obstacle faced by Fintech companies which acquire real property as part of their business model is that acquiring and maintaining such real property requires a sizeable capital investment in order to efficiently operate, commercialize technology and grow their business. Like other startups and early stage companies, Fintech companies generally obtain capital initially from traditional Fintech company venture capital sources, which include venture capital funds, working capital lines of credit, general corporate debt, or preferred equity issuances, before moving onto the established asset-based financing and securitization markets for financing. These traditional Fintech company funding sources can be expensive, and restrict growth by requiring significant concessions in control rights, including consent rights over obtaining new debt, creating new subsidiaries, and/or the creation of all assets liens. Given the foregoing, real estate focused Fintech companies would be well advised to consider whether their business model lends itself to utilizing asset-based financings, similar to non- real estate focused Fintech companies, to leverage their real estate assets to access more efficient and cost effective forms of capital, in lieu of solely relying on traditional venture capital sources.

Traditional Capital Sources for Startups

Early-stage Fintech companies typically rely on traditional venture capital sources, such as venture capital funds, working capital lines of credit, general corporate debt and preferred equity issuances.

Obtaining capital from traditional venture capital sources is important for startup companies, and has the potential to provide several key benefits. In addition to providing needed capital, providers of venture capital may confer "credibility" through their investment, assist in attracting talent and help with networking in relevant industries, among other benefits. However, these benefits can come at a steep cost. Traditional venture capital funding sources often only provide capital in exchange for an equity stake in the company and a variety of other concessions, giving providers significant control of the company, such as a board seat or veto rights over actions of the company. Providers of venture capital frequently structure their investments in the form of preferred equity or discounted convertible debt, which allows such capital providers to receive proceeds (and often a preferred return) prior to the holders of common shares, *pro rata* rights in order to maintain their ownership percentage, veto rights over certain company actions, rights of first refusal or the option to sell their shares at the same time as the founders, and strong anti-dilution rights, among other privileges. Other capital options for startups include working capital lines of credit, incurring general corporate debt, and preferred equity issuances. However, these options typically come with terms that may restrict growth of such Fintech companies, such as high interest rates on debt, and usually require an all assets lien on the company's assets (which may include intellectual property), as well as consent rights over new lines of credit and the creation of new subsidiaries.

While traditional venture capital sources are a critical part of any startup, Fintech companies—whose business models involve acquiring and owning real property and related assets—have tangible assets easily valued in the market which non-venture capital providers, including banks, are generally comfortable financing. As a result of their ownership of such assets, these Fintech companies have a unique opportunity to diversify their capital sources in order to finance the acquisition and maintenance of real property and related assets, like non-Fintech companies, rather than solely relying on traditional venture capital sources.

Asset-Based Financing

Forms of Asset-Based Financing

Asset-based facilities are financings where the lender will lend to a bankruptcy remote special purpose vehicle (***SPV***) that owns certain collateral, while the lender will have limited or no recourse to the related parent operating company. Typically, the advance rates provided in asset-based facilities are higher than with respect to a loan made directly to the operating company, because such financings are structured with the intent of isolating the collateral from the credit quality and bankruptcy risk of the operating company. Unlike venture capital funding sources, asset-based financing sources generally do not place restrictions on the ability of the parent or affiliates of the SPV to incur debt or conduct their business, nor do asset-based financing sources typically require an equity stake in the parent as a condition of the asset-based financing; however, they do rely heavily on the value and condition of the assets they finance. The following subsections highlight two forms of asset-based financing well suited to financing real property and related assets: asset-based credit facilities and securitizations.

Asset-Based Credit Facilities

Under an asset-based credit facility, an SPV, or a series of SPVs, will enter into a loan agreement with a bank or other lender and pledge its interest in the collateral to the lender. An advantage of an asset-based credit facility is that it is usually less document intensive, and easier to amend over time, than the securitization structures described below. Generally, these facilities include eligibility requirements for the characteristics, sometimes including the value, of the real estate that can be pledged to the facility and concentration limits that restrict real estate with certain characteristics, an example of such are geographical restrictions. In addition, the availability under the facility is typically tied to a borrowing base, which is a calculation of the value of eligible real estate multiplied by the applicable advance rate, and the borrower is required to maintain sufficient collateral pledged to the facility to satisfy the borrowing base. In addition, most facilities have performance related triggers and events of defaults that are negotiated between the borrower and the lenders.

Securitizations

While securitization structures are generally more document intensive and more difficult to amend than the asset-based credit facility structures described above, there are advantages.[95] The investor base that purchase securities issued under a securitization may be a separate set of institutions from those that enter into asset-based credit facilities described above. This is significant because, unlike obtaining financing from a bank or other financing provider—each of which likely have limits on the aggregate amount that can be lent to a company—securitizations are limited by market appetite and the amount of

[95] Securitizations often trigger additional reporting and regulatory requirements on the part of the transaction parties.

assets owned by the SPV. In addition, a securitization would provide a Fintech company with term financing for the expected life of the asset as compared to an asset-based credit facility, which typically does not provide funding for the asset's entire term, which can create liquidity issues for borrowers if a facility is not extended.

Under one typical securitization structure, an SPV holds the collateral and issues notes backed by that collateral to investors. Income streams on the collateral, such as rental payments or proceeds from the sales of the real property, are used to make payments on the notes issued by the SPV issuer. Under another example of a securitization structure, a bank (*lender*), usually an affiliate of the lead underwriter for the securitization, will make an interest-only bullet maturity accommodation loan (*loan*) to an SPV that holds the collateral (*borrower*) secured by the borrower's pledge of such collateral. The borrower generally uses rent payments or proceeds from sales of the collateral to pay interest and principal on the loan. The lender will not transfer any of its own funds to the borrower, but will sell its rights to the loan to a SPV (*issuer*). The issuer will issue notes backed by the borrower's obligation to make payments under the loan, and the proceeds from the sale of the notes will be paid to the borrower as the proceeds of the loan.

SPV/SPEs and Guaranties

A key feature in the two proposed financing structures outlined above is the utilization of one or more SPVs to hold the relevant collateral. Lenders, investors and financing parties will often require the use of SPVs to further insulate the financed collateral from creditors of the parent operating company. An SPV is a direct or indirect, wholly owned subsidiary of the parent operating company—typically a limited liability company or a trust—that is formed by the parent operating company for the limited business purpose of holding the assets that are to be financed and which, through various restrictions on the SPV, is intended to be protected from any bankruptcy or insolvency of the parent operating company. From the perspective of a parent operating company this has the advantages of (i) generally limiting its exposure to the lender by isolating the assets subject to the lien of a lender from such parent operating company's other assets (including its intellectual property), (ii) generally limiting the recourse of a lender to the assets of the SPV, and (iii) obtaining better financing terms. Lenders in these financing structures generally rely on the quality of the assets owned by the SPV and their ability to foreclose and take possession of those assets in a default scenario rather than primarily relying on the credit of the parent operating company.

Lenders will also typically request a limited guaranty from the parent operating company. Under a limited guaranty the parent operating company would only be obligated for losses suffered by the lender as a result of certain bad acts by the SPV (e.g., fraud or willful misconduct or bankruptcy of the SPV). These guaranties usually do not require the guarantor to post any collateral, but may have certain financial covenants the related guarantor is required to maintain.

Certain Considerations for Transfers of Real Property when Using Asset-Based Financings

To utilize forms of asset-based financing, the real property must be transferred by the parent operating company to an SPV or acquired directly by an SPV. There are costs associated with transferring real property to an SPV, particularly after it has been acquired by another affiliated entity, including costs related to changing title and related transfer fees and taxes. These costs increase when there are frequent transfers of assets between SPVs. The transfer process requires parent operating companies to prepare deeds for the related real property in the name of the applicable SPV. Some of these costs and expenses can be mitigated by using a tilting trust structure. A titling trust is a series trust created in accordance with the Delaware Statutory Trust Act (***Act***). Under this structure, assets can be transferred to the trust and allocated to different special units of beneficial interest (***SUBIs***) within the trust. There can be multiple SUBIs created in each trust and each SUBI, pursuant to the Act, is intended to be insulated from the liabilities of any other SUBIs created under the same trust. The advantage of using a titling trust structure is that the real property can be conveyed from one SUBI to another SUBI without having to be re-titled, and properties can be transferred between financing facilities with different lenders which finance different SUBIs. For a more in depth look at titling trusts and their advantages please see "Beyond Auto Leasing: The Use of Titling Trusts in Structured Finance Transactions"[96]

Certain Considerations for Fintech Companies when Using Asset-Based Financings

While the business model of any particular Fintech company may not lend itself to using asset-based financing, a real estate Fintech company would almost certainly be able to benefit from asset-based financing. In particular, while a real estate parent operating company may need to value its intellectual property rights for purposes of analyzing the creditworthiness of any limited guaranty, the real estate assets of a real estate Fintech company should be able to be valued by an independent third party, and therefore be isolated to provide meaningful security for the financing. As such, the asset composition of the real estate Fintech company may allow such Fintech company to leverage its real estate related assets in a more efficient and cost effective format and in a manner similar to non-Fintech companies. In addition, structuring such an asset-based financing so as to be eligible for investment by real estate investment trusts may permit an even greater investor base, thereby allowing for greater flexibility and efficiency.

Conclusion

Traditional venture capital sources are an important part of a startup's early stage financing and have many advantages and disadvantages, but Fintech companies that own or plan to acquire real property may also be able to utilize asset-based financings to access more efficient and cost-effective forms of capital. As demonstrated above, there may be asset-based structured finance solutions available for Fintech companies looking to finance the acquisition or maintenance of real property and related assets. Fintech companies would be well advised to consider their business strategy, as well as their short- and long-term goals, in the context of the advantages and disadvantages of each asset-based finance product outlined above to determine the application to their business.

[96] Van Gorp, *Beyond Auto Leasing: the Use of Titling Trusts in Structured Finance Transactions*, 25, The Journal of Structured Finance; (2020), https://eprints.pm-research.com/17511/25533/index.html?39880

The Promise and Potential of Blockchain and New UCC Article 12

By Paul Jorissen and David Linley

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Can blockchain and the 2022 UCC amendments work together to simplify the current, clunky custodial arrangements for electronic HELOCs?

Executive Summary:

In the summer and fall of 2022, electronic transactions were undergoing a sea change, but riding different tides: in the summer, the Uniform Law Commission approved a set of amendments to the Uniform Commercial Code (UCC), including recommending adoption of a new UCC Article 12, designed and built for electronic transactions. By the fall, market values for cryptocurrencies (crypto) and non-fungible tokens (NFTs) were plummeting, and major industry players failing.

Investors paying attention only to the meltdown in crypto and NFT prices could have been forgiven for thinking that blockchain had had its 15 minutes of fame, and that it was now suitable only for those with a considerable appetite for risk. But while crypto and NFTs generally run on blockchains, the technology of blockchain is much more robust and adaptable than its crypto and NFT use cases would suggest. In fact, by working with the 2022 UCC amendments, blockchain technology may revolutionize secured transactions. Versions of the 2022 UCC amendments have been enacted in 11 states (including California), and enacting bills have been introduced in 17 states and the District of Columbia (including Texas and New York, but not Florida).

Outline:

This Legal Update focuses on the residential mortgage market, and specifically mortgages that were originated electronically. Part I provides some context regarding the existing laws on electronic transactions known as UETA[97] and ESIGN,[98] differentiates electronic notes (eNotes) from electronic home equity lines of credit (eHELOCs) and describes the current approach for perfecting a security interest in a HELOC. Part II summarizes the 2022 UCC amendments.[99] Part III reviews the promises of blockchain in light of the 2022 UCC amendments, and discusses both the benefits and potential challenges. Finally, we end with some conclusions to be drawn and observations for the future.

Part I: eNotes, eHELOCS and the Current UCC Perfection Analysis

Traditional home mortgage loans require a promissory note in which the mortgagor promises to pay the mortgagee (or its assignee) the principal amount of the debt, plus interest as agreed. Since 2005, Freddie Mac and Fannie Mae have had published criteria for electronic promissory notes (eNotes).[100] Paper

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[97] Published in Official Text by the Uniform Law Commission in 1999, and subsequently adopted in 49 of the 50 states (with variations in some cases). New York adopted its own statute, the Electronic Signatures and Records Act (ESRA), which differs materially from UETA.

[98] The Electronic Signatures in Electronic Transactions Act (codified at 15 U.S.C. §§ 7001-31).

[99] Adopted by the Uniform Law Commission at its meeting in July 2022 in Philadelphia, PA. Official text can be found at www.uniformlaws.org.

[100] For an explanation from Fannie Mae, see www.singlefamily.fanniemae.com/applications-technology/eclosings-emortgages, and for Freddie Mac, see https://sf.freddiemac.com/working-with-us/electronic-loan-documents/emortgages.

promissory notes for home mortgages are designed to be "negotiable instruments" under Article 3 of the UCC, and the industry has historically required these to be indorsed on the instrument or an allonge, and perfected in these instruments by possession,[101] usually via a document custodian that acknowledges that it is holding possession for the secured party's benefit.[102]

The federal Electronic Signatures in Global and National Commerce Act (ESIGN) and Uniform Electronic Transactions Act (UETA) provide two important statutory supports for eNotes. First, they codify the enforceability of electronically signed contracts, subject to meeting their requirements, and second, they create the concept of a "transferable record." If a person has "control" of the transferable record (as prescribed in the statute), under ESIGN and UETA, they are deemed to be the holder, as defined in UCC 1 201(20), of the transferable record, and to have the same rights and defenses as holder of an equivalent record under the UCC, including—if the applicable requirements are met—the rights and defenses of a holder in due course. Delivery, possession and indorsement are not required to obtain or exercise any of these rights. MERSCORP Holdings, Inc. developed the MERS® eRegistry to manage eNotes, and to meet the requirements of ESIGN and UETA.[103]

HELOCs, on the other hand, are evidence by a line of credit agreement, rather than a promissory note, and are thus, from a UCC perspective, payment intangibles and general intangibles, rather than negotiable instruments. Accordingly, perfection for acquirers of HELOCs—or for warehouse lenders financing HELOCs—has been primarily via the filing of a Form UCC1 financing statement. In order to meet evidentiary requirements, typically paper copies of the relevant documents—and, in some cases, electronic scans—have been stored by a custodian. The residential mortgage industry has leveraged the evidentiary and statutory authority for electronic signatures and electronic contracts, established by ESIGN and UETA, to create electronically originated HELOCs (eHELOCs). While this is a valuable first step, ESIGN and UETA do not provide for a mechanism for perfecting a security interest in an eHELOC, and the MERS® eRegistry does not currently contain the functions necessary to support eHELOCs.[104] Before adoption of the 2022 UCC amendments, perfection in an eHELOC is therefore the same as perfection in a paper HELOC, and stakeholders have been managing eHELOCs in ways that track the management of paper HELOCs. The efficiencies of electronic origination and management, so amply demonstrated with eNotes and the MERS® eRegistry, have yet to be realized for eHELOCs.

Part II: The Promise of the 2022 UCC Amendments

In July 2022, the Uniform Law Commission at its meeting in Philadelphia approved and recommended for enactment in all states a set of amendments to the UCC. For purposes of this Legal Update, the key proposed amendments[105] were those that proposed a new Article 12 and made companion amendments

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[101] UCC 9-313(a).
[102] UCC 9-313(g).
[103] See www.mersinc.org/products-services/mers-esuite/eregistry.
[104] ESIGN's and UETA's requirements for a "transferable record" depend, in part, on the electronic record being a note under the applicable UCC were it in paper form. Since a HELOC does not typically have a promissory note, an eHELOC is not eligible to be a transferable record under ESIGN and UETA.
[105] For convenience, this article describes the 2022 UCC amendments as "proposed" because, at time of writing, they have not been adopted by a majority of states.

to Article 9. The proposed new Article 12 creates a class of digital assets defined as "controllable electronic records" (CERs).

A CER is a "record stored in an electronic medium that is susceptible to 'control.'" For a person to have "control" of a CER, the person must have: (i) the power to enjoy "substantially all the benefit" of the CER, (ii) the exclusive power to prevent others from enjoying "substantially all the benefit of the CER," and (iii) the exclusive power to transfer control of, or to cause another person to obtain control of, the CER.

A person holding a CER perfected by "control" would have lien priority over a security interest in the CER perfected by the filing of a financing statement. In addition, the proposed Article 12 establishes a "take free" rule, giving the person that perfects in a CER by control a UCC status analogous to a holder in due course of a negotiable instrument. "Accounts" or "payment intangibles" (as those terms are defined in UCC Article 9) can be evidenced by a CER, creating a "controllable account" or "controllable payment intangible" if the party obligated on the account or payment intangible has agreed to pay the person in control of the CER. Adopting this statutory structure, an eHELOC could be originated that is eligible to be treated as a controllable payment intangible, and the associated CER susceptible of both perfection and tradability similar to that currently enjoyed by eNotes.[106]

While superficially similar to UETA and ESIGN, the architecture of the 2022 UCC amendments differs in at least one material respect that residential mortgage loan market participants should bear in mind: UETA and ESIGN depend upon the notion of an "authoritative copy" of the eNote, whereas the proposed Article 12 dispenses with this notion and relies on the control concepts summarized above. While the evidentiary aspects of enforcement are beyond the scope of this Legal Update, part of the premise of CERs is that there does not need to be a single, unalterable and unique statement of the controllable payment intangible; so long as the representation of the eHELOC is accurate, each copy is equivalent and there is no inherent collateral in the eHELOC itself.[107]

Part III: The Promise and Potential of Blockchain for UCC Article 12

The Benefits of Blockchain

The MERS® eRegistry does not store eNotes. eNotes are stored in electronic vaults (eVaults), and the eRegistry is the system by which control of the eNote is both established and managed. eHELOCs, like eNotes, depend on a registry system to manage them. And, for purposes of establishing control of a CER under the proposed UCC Article 12, a registry system is the obvious solution, building on the technology of eNotes. Currently, the MERS® eRegistry is the only registry system approved by Fannie Mae, Freddie Mac, Ginnie Mae and the Federal Home Loan Banks for eNotes to be delivered to those investors. However, as noted, the MERS® eRegistry does not currently have the functions to support eHELOCs. The

[106] There is a distinction in proposed Article 12 between a "controllable payment intangible" (in the context of this article, the eHELOC itself) and a CER (in the context of this Legal Update, the eHELOC, the bundle of rights associated with the eHELOC including the right to payment, the right to control the eHELOC, and the right to transfer the eHELOC).

[107] This generally mirrors the status quo: investors and warehouse lenders store a copy of the HELOC with a custodian mainly for evidentiary purposes. The paper HELOC agreement does not need to be held in order to perfect in the HELOC since there is no perfection in a HELOC by possession. Conversely, the paper promissory note, including indorsements and allonges, does need to be possessed in fact in order to perfect by that method.

proposed UCC Article 12 is agnostic as to the specific technology used to meet its requirements, and this is where blockchain may be able to deliver robust results at minimal cost.

By design, blockchain and similar distributed ledger technology depend on multiple nodes that, with appropriate cryptographic proofs (or consensus mechanisms), create immutable records that establish permanent (and often public and auditable) records of transactions. Unlike in centralized recordkeeping models and traditional financial services, there is no single operator upon whom the recordkeeping system depends and no single repository of records. In some respects, blockchain technology may offer significant advantages over single-point-of-authority systems when it comes to secured transactions, including improved security, immutable records, enhanced transparency, streamlined processes, reduced costs and increased trust.

When implemented in a broad, robust network, blockchain technology can significantly enhance security by leveraging its decentralized and transparent nature. Unlike traditional centralized systems, where data is stored in a single location and susceptible to breaches of the central authority's system and records, a blockchain distributes data across a network of computers, or nodes, on the network. As a result, a robust decentralized network comprised of numerous nodes makes it extremely difficult for hackers to compromise the entire network. Each record of a transaction on the blockchain is cryptographically linked to previous transactions, creating an unchangeable chain of information. This immutability and transparency enables participants to verify and validate transactions without a centralized recordkeeping authority to ensure the integrity and authenticity of data.

By utilizing smart contracts—which are self-executing contracts with predefined rules encoded on the blockchain—secured transactions can be automated and streamlined. Smart contracts can automatically enforce terms and conditions, trigger actions upon certain events, and reduce the need for intermediaries.

In addition, blockchain's decentralized nature and consensus mechanisms can help to establish trust among participants. By eliminating reliance on a central authority—such as a bank—and relying on cryptographic verification, blockchain can foster trust in secured transactions. By leveraging blockchain technology and its capabilities, market participants could establish a secure, transparent and efficient transaction environment, allowing them to operate with increased confidence and efficiency.

Blockchain and Proposed UCC Article 12

Proposed UCC Article 12 is agnostic as to the technology used to meet its requirements. As noted above, a CER is a "record stored in an electronic medium that is susceptible to 'control.'" For a person to have "control" of a CER, the person must have: (i) the power to enjoy "substantially all the benefit" of the CER, (ii) the exclusive power to prevent others from enjoying "substantially all the benefit of the CER" and (iii) the exclusive power to transfer control or to cause another person to obtain control of the CER.

Consider a hypothetical eHELOC on a blockchain:

- A CER is a "record stored in an electronic medium that is susceptible to 'control.'"
    - A blockchain creates blocks which are held on a distributed ledger. Each of the blocks would constitute a record stored in an electronic medium.

    - An eHELOC stored in an eVault with a hashed reference on a blockchain would, therefore, meet the first criterion.

- For a person to have "control" of a CER, the person must have: (i) the power to enjoy "substantially all the benefit" of the CER, (ii) the exclusive power to prevent others from enjoying "substantially all the benefit of the CER" and (iii) the exclusive power to transfer control or to cause another person to obtain control of the CER.

    - A blockchain is built on immutable blocks, cryptographically hashed and related to each other.

    - An eHELOC represented on a blockchain would, by definition, be represented by a unique and immutable hashed value. This makes the value exclusively tied to the underlying eHELOC, and—assuming suitable controls for the blockchain—the ability of the holder of that hash value the sole person able to meet the second leg of the test above.

In much the same way that MERS® eRegistry operates as the registry for eNotes, a blockchain, suitably designed or adapted for use with eHELOCs, could easily meet the requirements for establishing CERs for eHELOCs, and simplify the trading of them. Moreover, many blockchains are built with 'smart contract' software in mind. Smart contracts are self-executing software programs that can be designed to do any number of tasks. Again, taking the hypothetical origination—warehouse financing or trading of an eHELOC—smart contracts on a blockchain can automate many tasks:

- A smart contract can be built to validate fields such as verifying existence of the asset on the blockchain, its ownership and its availability (e.g., absence of contrary rightsholders), and the post-transaction transfer of rights to the eHELOC/CER.

- A smart contract can be built to track specific data fields within the eHELOC (e.g., matching mortgagor name and address on the HELOC and the mortgage, verifying maturity, maximum line of credit, and other fields that investors or warehouse lenders value) and generate reports accordingly, simplifying the "stare and compare" work of custodians with paper records.

- A smart contract can be built to execute transactions on an "if/then" basis. For example, in flow purchase arrangements, once an eHELOC meets defined criteria (e.g., "buy box" compliance, return of recorded mortgage, etc.) a sale ticket can be generated for confirmation and transmitted electronically, simplifying the manual tracking of the pipeline.

Challenges Associated with Blockchain

While blockchain holds much promise when it comes to implementing the benefits of proposed UCC Article 12 for eHELOCs, there are some pitfalls and potential challenges. These include recent scrutiny surrounding blockchain, the state of current regulations, and the lack of a clear market leader in the blockchain space for assets of this type.

As acknowledged, blockchain has been under close scrutiny as a result of certain recent scandals and incidents regarding crypto, including fraudulent initial coin offerings, exchange hacks, and Ponzi schemes which have exploited the decentralized and pseudonymous nature of blockchain. Such scandals have raised concerns about investor protection, regulatory oversight, and the overall security of blockchain-based systems. Additionally, the use of blockchain for illicit activities, such as money laundering or illicit transactions, has drawn the attention of law enforcement agencies and regulators. Despite these controversies, proponents of blockchain would argue that many of the recent scandals do not necessarily stand as evidence of inherent flaws of blockchain technology itself, but rather highlight the need for responsible use and a robust governance framework to ensure the integrity and trustworthiness of blockchain-based systems. Nevertheless, some stakeholders may be wary of interacting with blockchain, particularly as its success depends upon a critical mass of stakeholders agreeing to accept and transact using the technology. A number of potential market participants might decide to wait until blockchain technology and blockchain-based systems gain widespread adoption, which will itself impede such adoption.

Regulatory regimes for industry participants vary across jurisdictions (and for the participants). Some banks in the United States may not be able to become participants on a public blockchain as a regulatory matter, or may need to retain a custodian or other vendor (that would need to be onboarded by the bank as a vendor) to perform blockchain-facing functions for it. Similarly, compliance with existing regulations—such as those related to money laundering, terrorism financing, consumer protection and compliance—may not be a simple process depending on the blockchain's design and participation rules and procedures.

No blockchain network has yet emerged as a market leader for a blockchain-based system for perfecting a security interest in an eHELOC. Moreover, once information is referenced on a blockchain network, it is not clear how someone would remove the information from the blockchain network and create it on a new system, or if it would be possible to achieve interoperability between different blockchain networks. Further, ensuring seamless data exchanges and compatibility between different blockchain networks or platforms may require standardized protocols and interfaces. If standardized protocols and interfaces are required, it is unclear at this time if market participants would be able to reach a consensus themselves or if further regulations would be required to address this potential issue.

Conclusion[108]

The proposed UCC Article 12 holds much promise for participants in the market for HELOCs and, specifically, eHELOCs. Much of this promise could be unlocked using blockchain technology, particularly if its value is maximized with appropriate smart contract design and implementation. As with all emerging technology, challenges abound.

There are bright spots, however: with well over a decade of experience with eNotes, the translation to eHELOCs will benefit from the lessons learned. The recent surge in home equity in the US residential market is driving demand for HELOCs, and the meaningful cost savings of eHELOCs over their paper ancestors could help to unlock this value quickly and efficiently. Finally, the use of technology to automate processes suggests the opportunity for more robust origination and life-of-loan management, with less scope for human error, and the ability to scale quickly for new entrants. The coming years are likely to see a change in the way HELOCs are originated and managed in the United States, as the 2022 UCC amendments become more widely adopted.

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