Document hosted at JDSUPRA™
http://www.jdsupra.com/post/documentViewer.aspx?fid=98aa8446-f3c7-4837-a1d9-5a6924e5a1a7

MORRISON | FOERSTER

Legal Updates & News

Legal Updates

Mortgage REITs Are Back (Again)

August 2009
by Thomas A. Humphreys, Armin M. Gharagozlou

The last two months have seen a resurgence in mortgage real estate investment trusts ("REITs") with over $1.2 billion in mortgage REIT initial public offerings. Many other new mortgage REITs have filed registration statements with the Securities and Exchange Commission ("SEC").[1] This explosion of new IPOs is simply another chapter in the evolution of mortgage REITS, which have a long and checkered history. We thought it would helpful to review mortgage REITS, past and present, in considering the current crop of offerings.

Related Practices:

- Federal Tax
- Tax

Background

A REIT is an investment vehicle designed to allow investors to pool capital to invest in real estate assets. It has certain advantages over other investment vehicles; in particular a REIT is entitled to pass-through taxation even if its equity is publicly traded. However, it also has disadvantages, including tax restrictions that limit the REIT to passive investments in qualifying assets (*i.e.*, its assets must primarily consist of real estate related assets) and certain distribution requirements (*i.e.*, it must distribute income to its shareholders currently).

There are three general types of REITs: equity REITs, mortgage REITs, and hybrids. As one might imagine, equity REITs are REITs that invest in equity interests in real property and mortgage REITs are REITs that invest in mortgages and interests in mortgages. Hybrids invest in a combination of the two.

Mortgage REITs generally finance their activities through equity capital and debt offerings. Debt offerings provide leverage, such as through short-term debt (but subject to short-term liquidity risk) which is then used to purchase higher-yielding assets. Leverage generally provides greater yields to equity investors. However, leverage also increases risk, as the recent financial crisis has illustrated.

Tax Advantages

For federal income tax purposes, a REIT is a corporation[2] that receives special tax treatment. The special tax treatment is an exemption from federal income tax at the corporate level to the extent the REIT distributes its income annually. A REIT is subject to normal corporate tax on any income that it retains.

Document hosted at JDSUPRA™
http://www.jdsupra.com/post/documentViewer.aspx?fid=98aa8446-f3c7-4837-a1d9-5a6924e5a1a7

In order to qualify as a REIT for tax purposes, substantially all of the entity's assets must be held in real estate related investments. It also must earn, each year, at least 95% of its gross income from passive sources and at least 75% of its gross income from real estate related sources. Real estate mortgages qualify as good REIT investments under the asset test and produce good income for both the 95% and 75% tests.

A REIT is subject to a 100% penalty tax on income from sales of "dealer property" (generally meaning the sale or disposition of property held by the taxpayer as inventory or primarily for sale to customers in the ordinary course of its trade or business, excluding certain foreclosure property). In general, therefore, a mortgage REIT is limited to passive investments in mortgage loans. However, as discussed below, many REITs have adopted securitization structures in the last 20 years. In these structures, the REIT originates mortgages and then finances them by offering mortgage-backed securities ("MBS") that are treated as borrowings against the mortgages for federal income tax purposes.

A REIT can own a taxable REIT subsidiary ("TRS"). The TRS does not qualify as a REIT itself but instead is subject to a corporate level tax. A REIT's investment in all TRSs cannot exceed 25% of its total gross assets. Accordingly, the use of a TRS can allow a REIT to engage in prohibited activities without losing its preferential tax status.

Regulatory Advantages

In addition to a REIT's special federal income tax treatment, a REIT has certain regulatory advantages. For example, a REIT may qualify for an exemption under section 3(c)(5)(C) of the Investment Company Act of 1940 (the "40 Act"), which is available for entities primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. This exemption generally applies if at least 55% of the REITs assets are comprised of qualifying assets and at least 80% of its assets are comprised of qualifying assets and real estate-related assets. For these purposes, qualifying assets generally include mortgage loans and other assets which are the functional equivalent of mortgage loans. Particularly in light of current regulatory uncertainty, these regulatory advantages may prove useful.

History of Mortgage REITs

The earliest mortgage REITs were construction loan REITs that were formed by several major banks in the 1960s and 1970s. These construction loan REITs, most notably the Chase REIT, went bankrupt in spectacular fashion in the mid-1970s. More than a dozen other REITs went bankrupt during this period.

The next wave of mortgage REITs began with Strategic Mortgage Investment, Inc. ("SMI"), a Genstar Mortgage Corporation-sponsored residential mortgage REIT, in 1982. SMI's strategy was to originate non-conforming mortgage loans and sell a 90% senior interest in the loan to investors while retaining a 10% subordinated interest. SMI obtained a private letter ruling from the Internal Revenue Service ("IRS") that, so long as it sold its senior interest for par, there would be no gain recognized on the sale. SMI was followed by a number of other mortgage REITs, all aimed at the same niche: non-conforming mortgages. Each received its own IRS private letter ruling. These REITs included a REIT sponsored by Countrywide, which later became Indy Mac REIT (and then Indy Mac Bank). They also included Capstead Mortgage Corporation, among others. The rulings these REITs received were later revoked by the IRS in 1985 after the IRS reconsidered the technical basis for the rulings. In response, rather than selling senior participations, mortgage REITs began to adopt a different strategy beginning with the Countrywide REIT. The Countrywide REIT would originate residential mortgage loans and then sell them at cost to a taxable subsidiary. The subsidiary would securitize the loans. In this way, profit from securitizing the loans was not earned at the REIT level and no prohibited transaction tax was triggered. Around the same time, the Countrywide REIT began to issue collateralized mortgage obligations ("CMO"s) directly out of the REIT. These transactions were treated as borrowings rather than sales for federal income tax purposes, resulting in no gain (and, again, no prohibited transactions tax).

In the Tax Reform Act of 1986, Congress enacted the Real Estate Mortgage Investment Conduit ("REMIC") legislation. REMIC is a pass-through vehicle designed to facilitate mortgage loan securitization. Congress wanted REMIC to be the sole vehicle for securitizing multiple-class mortgages. Congress also decided to treat REMIC transactions as sales for federal income tax purposes. This

Document hosted at JDSUPRA™
http://www.jdsupra.com/post/documentViewer.aspx?fid=98aa8446-f3c7-4837-a1d9-5a6924e5a1a7

meant that a REIT securitizing mortgages through REMIC could potentially be subject to a 100% prohibited transactions tax on any gain realized on the sales. However, Congress provided a path for REITs to securitize mortgages. Instead of using REMIC, the REIT issues mortgage backed securities that are treated as debt for federal income tax purposes, an "old style" CMO. The chief consequence, however, is that residual income from the CMO when paid to REIT shareholders is treated as "excess inclusion income", which cannot be offset by the shareholder's net operating losses.

In the 1990s, mortgage REITs boomed. Large REITs, such as American Home Mortgage, Impac, and others, created successful businesses originating and securitizing residential and commercial mortgages. A few REITs suffered in the mid-1990s, including, for example, Mortgage Realty Trust, which filed for bankruptcy in 1995, and Crimi Mae, which filed for bankruptcy in 1998.

Beginning in early 2007, mortgage REITs once again began to feel the heat. The financial crisis wiped out an entire segment of these REITs, which, in general, were in the business of subprime lending. These REITs included, for example, American Home Mortgage Investment Corp., New Century Financial Corporation, and People's Choice Financial Corporation, among others.

The New Crop of Mortgage REITs

The new crop of mortgage REITs generally have one of three investment strategies, with some overlap amongst the three: those modeled primarily after Annaly Capital Management Mortgage (*e.g.*, Cypress Sharpridge and Invesco), those that primarily acquire, originate and manage mortgages (*e.g.*, Colony Financial and Apollo) and those that primarily target distressed debt with the intent to workout (*e.g.*, PennyMac).

In the Annaly model, the REIT acquires government backed mortgage securities and other high-quality mortgage securities with leverage. The mortgage securities are good REIT assets, and the REIT earns an arbitrage spread. The assets are residential mortgage-backed securities ("RMBS"), and in some cases, commercial mortgage-backed securities ("CMBS"). The second type of mortgage REIT both acquires and originates residential or commercial mortgage loans. It uses a TRS for its non-qualifying activities. These REITs may securitize the mortgages to enhance returns. The third type of mortgage REIT is the REIT that invests in distressed mortgages. This can be somewhat tricky for a REIT because of what are called the foreclosure property rules. In general, a REIT can foreclose on a mortgage and, for a temporary period, can earn income on the foreclosed real estate which can pass through to shareholders. The REIT, however, cannot take advantage of the foreclosure property rules if it has acquired the mortgage with an intent to foreclose. Accordingly, these REITs will have to make decisions about which mortgages to purchase. Alternatively, they can acquire the properties in a TRS to avoid foreclosure property issues.

The new REITs are generally externally managed, meaning that the REIT pays a fee to a manager to manage the REIT's portfolio of assets. There has been some debate over which management method is preferential, with recent evidence indicating a demand for internal management in the market for publicly-traded REITs. The controversy has centered on which method of management produces higher returns for investors, with some arguing that conflicts in interest underpinning compensation arrangements for external managers create incentives not necessarily in the best interest of the shareholders.

A number of the new REITs expect to finance their activities through leverage, the Term Asset-Backed Securities Loan Facility ("TALF"), and/or the Public-Private Investment Program ("PPIP"). Under the TALF, the Federal Reserve Bank of New York will provide non-recourse loans to borrowers to fund their purchases of eligible assets, which initially included certain asset-backed securities and then was expanded to include CMBS and non-Agency RMBS.[3] Under the PPIP, certain private investment funds will be established to purchase from financial institutions certain non-Agency RMBS and CMBS (the "Legacy Securities Program"). In addition, certain private investment funds will be established to purchase troubled loans (including residential and commercial mortgage loans) from insured depository institutions (the "Legacy Loans Program").[4] These new REITs believe these programs, coupled with extraordinary market conditions, present significant market opportunities. How these REITs will perform remains to be seen.

For further information contact Anna Pinedo (apinedo@mofo.com), Thomas A. Humphreys

Document hosted at JDSUPRA
http://www.jdsupra.com/post/documentViewer.aspx?fid=98aa8446-f3c7-4837-a1d9-5a6924e5a1a7

(thumphreys@mofo.com) or Armin Gharagozlou (agharagozlou@mofo.com).

TABLE 1: RECENT FILINGS

	Original Filing Date	REIT	Investment Strategy
1	05/21/09	**Sutherland Asset Management**	Agency and non-Agency MBS, residential loans, and other financial assets.
2	05/22/09	**PennyMac Mortgage Investment Trust**	Primarily distressed debt.
3	06/05/09	**Starwood Property Trust**	Primarily commercial mortgage loans and CMBS.
4	06/12/09	**Western Asset Mortgage Capital Corporation**	Primarily non-Agency RMBS.
5	06/26/09	**CreXus Investment Corp.**	CMBS, commercial mortgage loans, other commercial real estate assets, Agency RMBS.
6	06/30/09	**Colony Financial**	Primarily whole loans and CMBS.
7	07/08/09	**Foursquare Capital**	CMBS, RMBS, commercial and residential loans, other financial assets.
8	07/10/09	**Apollo Commercial Real Estate Finance**	Primarily whole loans and CMBS.
9	07/13/09	**AG Financial Investment Trust**	CMBS, non-Agency RMBS, triple net lease assets, Agency RMBS, commercial mortgage loans.
10	07/17/09	**Ladder Capital Realty Finance**	Commercial mortgage loans and CMBS.
11	7/27/09	**Bayview Mortgage Capital, Inc.**	Mortgage loans, MBS, and other financial assets.
12	7/29/09	**Transwestern Realty Finance, Inc.**	Commercial mortgage loans and subordinated notes.

TABLE 2: RECENT PRICINGS

	Pricing Date	REIT	Proceeds
1	06/11/09	**Cypress Sharpridge**	$93,093,000
2	06/25/09	**Invesco Mortgage Capital, Inc.**	$167,450,000
3	7/29/09	**PennyMac Mortgage Investment Trust**	$302,352,408
4	8/11/09	**Starwood Property Trust**	$762,275,000

Footnotes

[1] See Tables 1 and 2.

[2] It must be a corporation for tax purposes but can be a trust or limited liability company, for example, under local law.

[3] For more detail, see our prior client alerts "TARP's Term Asset-Backed Securities Loan Facility: Can Wall Street Help Main Street?" and "TALF Expanded to Include Legacy CMBS: The "Not-so-Troubled" Asset Relief Program?".

Document hosted at JDSUPRA™
http://www.jdsupra.com/post/documentViewer.aspx?fid=98aa8446-f3c7-4837-a1d9-5a6924e5a1a7

[4] For a detailed discussion, see our prior client alert "Worth the Wait? Treasury Announces the Public-Private Investment Program".

© 1996-2008 Morrison & Foerster LLP. All rights reserved.