UNITED STATES OF AMERICA
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
OFFICE OF ADMINISTRATIVE LAW JUDGES

In The Matter of:

PULLER MORTGAGE ASSOCIATES, INC.

Respondent.

HUDALJ 89-112-MR
Decided: October 17, 1990

Emmet N. Roden, Esq.
For the Government

Douglas R. Brown, Esq.
For the Respondent

Before: William C. Cregar
Administrative Law Judge

INITIAL DETERMINATION AND ORDER

Respondent, Puller Mortgage Associates, Inc. ("Puller Mortgage") appeals the April 25, 1989, withdrawal of its HUD-FHA mortgagee approval by the Department of Housing and Urban Development ("the Department" or "HUD"), by the Office of Lender Activities and Land Sales Registration, acting on behalf of the Department's Mortgagee Review Board ("the Board" or "MRB"). Respondent requested a hearing by letter dated May 2, 1989. These proceedings were stayed at Respondent's request until March 6, 1990.[1] On January 3, 1990, HUD filed a Motion for Judgment on the Pleadings. The motion was denied by order dated February 1, 1990. A hearing was held on March 6, 1990, in Indianapolis, Indiana. Posthearing briefs were submitted on May 15, 1990.

[1]Respondent requested stays of these proceedings by written motions dated August 16, and September 15, 1989, and at prehearing telephone conferences held on October 23, and November 13, 1989. The basis for these extensions was its need for time to recapitalize. Recapitalization attempts having failed, the matter was set for hearing by order dated January 3, 1990.

HUD's action resulted from Respondent's failure to file an audit report within 90 days of the close of its fiscal year, as required by 24 C.F.R. Sec. 203.4(b)(4), and HUD Handbook 4060.1. Respondent does not dispute that it failed to file a timely audit report. Rather, it contends that HUD officials informally acquiesced in an extension of the filing deadline, and that HUD's withdrawal of Respondent's mortgagee approval violated Respondent's Constitutional rights[2] and HUD's own procedural regulations.

Findings of Fact

Respondent is an Indiana Corporation. Kenneth A. Puller is the owner, President, and Chairman of the Board. Tr. p. 81. Respondent received HUD approval to participate as a nonsupervised lender on March 14, 1977.[3] J.Ex. 1. HUD regulations require that nonsupervised lenders maintain a net worth of not less than $100,000 in assets acceptable to the FHA Commissioner. 24 C.F.R. Sec. 203.4(b). Nonsupervised lenders are also required to submit audit reports on their financial condition. These audits must be performed by a certified public accountant or by an independent public accountant within 90 days of the close of the lender's fiscal year. 24 C.F.R. Sec. 203.4(b). This report must be "acceptable" to HUD, i.e., it must reflect minimum, sound capital resource, net worth and liquidity levels. Tr. p. 52. Respondent submitted audit reports for each year up to 1988. March 31, 1989, was the last date for submission of the 1988 audit report, since its fiscal year ended on December 31, 1988. Tr. p. 55.

The Mortgagee Review Board is established in the Office of the Secretary of HUD to exercise the Secretary's authority with respect to sanctions against mortgagees. 24 C.F.R. Secs. 25.2, 25.3(a). It is specifically permitted to delegate its authority to impose sanctions, *inter alia*, for failure by nonsupervised mortgagees to submit required audit reports under 24 C.F.R. Sec. 25.9(e) and "for all other nondiscretionary acts". 24 C.F.R. Sec. 25.2.

On September 21, 1983, the Board executed a document entitled "Determinations and Delegation of Authority". This document "determines" that all mortgagees who fail

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[2]Respondent contends that denial of a hearing prior to withdrawal of its mortgagee approval violated its Constitutional right to due process. I have not decided this contention since this administrative proceeding is not an appropriate forum for considering and deciding Respondent's Constitutional arguments. *Califano v. Sanders*, 430 U.S. 99 (1977). I note, however, that the imposition of a sanction prior to affording a *de novo* hearing has been upheld as long as the order is grounded on the coupling of an important governmental interest with a substantial assurance that the suspension is not baseless or unwarranted. *FDIC v. Mallen*, 108 S. Ct. 1780 (1988).

[3]Respondent subsequently obtained HUD approval as a co-insurance lender. Tr. p. 136. A prerequisite for obtaining co-insurance approval is basic FHA mortgagee approval. 24 C.F.R. Secs. 251.101, 252.101, 255.101. In addition, Respondent obtained approval from the Government National Mortgage Association ("GNMA") to act as an issuer of GNMA securities and acquired a GNMA pooled loan portfolio.

to submit audit reports within 75 (now 90)[4] days of the close of their fiscal year shall have HUD-FHA approval withdrawn. The Board made a further "determination" that in all such cases, immediate withdrawal, effective on receipt of the notice, is in the public or best interests of the Department.[5] In that delegation the Board stated that it did not consider "the violation of such fundamental and objective requirements to necessitate individual case consideration by the Board." Identification and notification of such mortgagees is "considered a nondiscretionary act". These nondiscretionary acts are then delegated to the Director, Office of Lender Certification.[6] J.Ex. 3. The "Determinations and Delegation of Authority" has not been published in the Federal Register for notice and comment.[7]

In order to comply with the audit filing requirement, Respondent's audit should have been submitted on or before March 31, 1989. During March 1989, Respondent's auditors, Laventhol and Horwath, identified three problems which prevented an accurate assessment of Respondent's financial well-being. First, the auditors were unable to determine the adequacy of Respondent's loan loss reserve and whether this reserve was sufficient to cover any potential losses on loans. Second, they were unable to determine how much could be collected from advances made by Respondent to GNMA security holders in connection with troubled loans recorded on Respondent's books as receivables. Third, the auditors could not determine the collectibility of $460,000 allegedly owed by a nonperforming investor and which Respondent had filed a law suit to collect. J.Ex. 12, n. 6, 12, 13; Tr. p. 27.

On March 16, 1989, a judgment against Respondent and the Federal National Mortgage Association ("FNMA") was entered by a Denver, Colorado, jury on a claim of negligent misrepresentation. On the same day, Mr. Puller informed Laventhol & Horwath of the entry of the judgment.[8] This judgment and each of the three other

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[4]The regulations which originally established the Mortgagee Review Board and specified its functions became effective on September 12, 1975. 40 Fed. Reg. 43026 (Sept. 18, 1975). These regulations were amended shortly after the Board issued its delegation in September 1983. The amended regulations became effective on October 11, 1983. 48 Fed. Reg. 40707 (Sept. 9, 1983). They provided an additional 15 days to file audit reports.

[5]HUD regulations provide that unless the Board determines that it is in the best interests of the public or the Department, Mortgagees shall be notified and afforded 30 days to reply in writing to the Board prior to imposition of the sanction. 24 C.F.R. Secs.,25.5(d)(4)(i), 25.6.

[6]This title was subsequently changed. The delegation in effect on April 25, 1989, is to the Director of Lender Activities and Land Sales Registration, William M. Heyman.

[7]The Board requires the use of a notice entitled "Exhibit A". This document provides for automatic reinstatement if the audit report is submitted within 90 days of receipt. If the 90 day period is not met, the mortgagee must file a new application.

[8]Respondent's total exposure is $4.8 million. J.Ex. 12, n. 17. This amount exceeds its net worth. The judgment has been appealed and was still pending on March 6, 1990, the date of the hearing in this matter. Tr. pp. 29,83-84, 93, J. Ex. 12, n. 17.

audit problems described above required that any audit contain a "scope limitation."[9] An audit report with a "scope limitation" does not satisfy HUD's requirement that an "acceptable" audit be submitted. J.Exs. 13, 16 para 2-3b.2(a). As a result, Mr. Puller and the auditors jointly agreed to delay the issuance of the audit report which had been prepared and submitted to Mr. Puller for his signature. J.Ex. 12, p. 15; Tr. pp. 31-32.

Mr. Puller informed James Hamernick, former Deputy Assistant Secretary of Housing for Multi-family Development, and Louis Gasper, former Executive Vice President of GNMA of the adverse judgement, and requested them to grant extensions of the audit filing date. Mr. Hamernick's responsibility included the "co-insurance" program. He had no authority over the Mortgagee Review Board. Tr. p. 60. According to Mr. Puller, Mr. Hamernick told him there would be "no problem" extending the FHA deadline for filing a financial report.

However, the record does not establish either the claim that Mr. Hamernick extended the deadline, or, that he had the authority to grant an extension. By letter dated March 24, 1989, Mr. Puller requested Mr. Hamernick to extend the deadline to April 30, 1989. While referring to their previous conversations, this letter makes no mention of any understanding or agreement to extend the filing deadline, nor does the record contain any response to this letter. J.Ex. 5; Tr. pp. 87-88.[10] In addition, Mr. Hamernick's responsibility for the co-insurance program did not extend to the granting of waivers of the audit filing deadlines contained in HUD regulations. Tr. p. 60.

Respondent did not submit the required audit report on March 31, 1989. On April 25, 1989, pursuant to the "Determinations and Delegation of Authority" of the Board, Respondent's mortgagee approval was withdrawn by Mr. Heyman, based on Respondent's failure to submit the required report. This letter also informed Respondent of its right to request a hearing and that submission of an acceptable audit report within 90 days would automatically result in reinstatement of Respondent as a HUD-FHA mortgagee. J.Ex. 8.

Respondent submitted an audit report on May 15, 1989.[11] This document states that the auditors express "no opinion" as to the financial statements of Puller Mortgage because they could not resolve the various uncertainties described above. J.Ex. 12, p. 2. Mr. Heyman's May 19, 1989, response to the audit report states that the report is not acceptable as it is "limited in scope". J.Ex. 13.

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[9]The audit would have contained a "scope limitation" even without the Denver judgment. Tr. pp. 26, 33, 37, 45-46.

[10]A copy of this letter was never received by Mr. William M. Heyman, the Director, Office of Lender Activities and Land Sales Registration, who was the person responsible for granting any extension. Tr. pp. 68-69.

[11]Due to a change in Respondent's fiscal year, the audit report covered a 16 month period. Ans., Para 10.

On the same day that basic FHA mortgagee approval was withdrawn, Respondent was suspended as a co-insurance lender. J.Ex. 9. On May 10, 1989, GNMA issued a notice of issuer default based on Respondent's failure to make construction loan advances. J.Ex. 14, p. 7.

Prior to the withdrawal of Respondent's mortgagee approval, Respondent had assets in excess of $14 million, and employed 128 people. J.Ex. 12, Tr. p. 110. As a result of the withdrawal notice, Respondent's warehouse lenders refused to fund further closings or construction loans. Respondent's GNMA and co-insured loan portfolios were also seized. Tr. pp. 116-118. Respondent is out of business. As Respondent states in its brief, it "has no employees, no income, and no business." Res. Brief, p. 10; Tr. p. 124.

Discussion

I.

The Department violated its own regulations when Mr. Heyman, acting for the MRB, withdrew Respondent's basic FHA approval without providing Respondent with an opportunity to submit matters to the Board prior to the issuance of the withdrawal. This violation directly resulted from the Board's September 1983 partial delegation of authority to the Office of Lender Activities and Land Sales Registration ("the Office"). This partial delegation effectively changed Part 25 of Title 24 of the Code of Federal Regulations ("HUD's regulations") by eliminating the requirement that the MRB exercise its discretion to make three determinations. The MRB was required to exercise its discretion to determine: 1) if there were any matters which explain or mitigate the Respondent's failure to comply with the regulatory requirement; 2) whether withdrawal for an indefinite period was justified by "wilful or egregious" acts committed by Respondent; and 3) whether the issuance of an immediate notice was justified by the public interest or the best interests of the Department.

Section 25.9 of HUD's Regulations identifies a number of grounds for imposing sanctions against mortgagees.[12] Included among these grounds is the failure to meet the requirement to file an audit report within 90 days of the close of its fiscal year. 24 C.F.R. Section 25.9(e). Applicable to all grounds for imposing the sanctions listed in Section 25.9, including the requirement to file an audit report within 90 days of the close of the fiscal year, is a statement that Board *will consider* certain "factors" prior to imposing a sanction. The phrase,"*will consider,*" expresses a mandatory requirement. The factors to be considered include the seriousness and extent of the infractions, the degree of mortgagee responsibility for the occurrence, and any mitigating factors. A second requirement, applicable to indefinite withdrawals of mortgagee approval, is that the Board determine whether the failure to submit the audit report was either "wilful or egregious". 24 C.F.R. Sec. 25.5(d)(2). HUD's Regulations provide a third requirement.

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[12]Included among the sanctions is withdrawal of approval. 24 C.F.R. Sec. 25.5(d).

With one exception, withdrawal of lender approval is to occur only after notification to the lender followed by a 30 day period in which the lender is permitted to respond to the Board. 24 C.F.R. Sec. 25.7. The Board may dispense with this 30 day period if it determines that continuation of mortgagee approval is not ". . . in the public interest or in the best interests of the Department." 24 C.F.R. Secs. 24.5(d)(4)(i), 25.7.

The Board is permitted to redelegate its authority to impose sanctions for failure to submit an audit report within 90 days of the end of a lender's fiscal year. 24 C.F.R. Sec. 25.2. It was pursuant to this authority that the Board delegated its authority to what is now the Office of Lender Activities and Land Sales Registration. J.Ex. 3. This document is only a partial delegation, however. While it delegates the Board's authority to impose the sanction of withdrawal, it does not delegate the Board's authority or responsibility to exercise its quasi-judicial discretion. The unfettered delegation of the nondiscretionary authority to impose sanctions[13] insures that the Board's discretion to impose sanctions can never be exercised.[14]

The practical effect of this partial delegation is that the Board never has before it a case based upon audit reports that have not been submitted. Accordingly, subsequent to September 1983, the Board has effectively prevented itself, or anyone else, from considering matters in explication or mitigation, from determining whether a particular lender's acts were "wilful or egregious", or from determining whether immediate withdrawal is in the public interest or in the best interests of the Department.

The action taken by the Department in this case demonstrates that three regulatory requirements were not satisfied. Prior to the issuance of the withdrawal of lender approval by Mr. Heyman, no consideration was given by the Board to whether Respondent's financial circumstances, including the Colorado judgment against Respondent, were serious enough to warrant withdrawal, or, for that matter, Respondent's failure timely to file its audit was temporary, permanent, wilful, or egregious. No consideration was given as to whether it was in the public or the Department's interests not to provide Respondent 30 days in which to submit matters to the Board for its consideration.

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[13]The delegation states: "Identification of those mortgagees that fail to submit their audit report . . . is hereby considered a nondiscretionary act." *Id.*

[14]The Chairman of HUD's Board of Contract Appeals has recognized that the MRB cannot delegate its adjudicatory responsibilities. He stated: "Even if the MRB wished to delegate its power to make a public interest determination to a subordinate or one exercising ministerial duties on behalf of the MRB, the use of such a delegated power would be of questionable legality since this type of determination is an adjudicatory power and not a ministerial function." *In the Matter of American Investors Diversified*, HUDBCA No. 83-804-M2. It was in response to this decision that the MRB issued the present delegation by which it attempts to comply with *American Investors* by delegating what it considered to be a "ministerial function", i.e., the nondiscretionary authority to withdraw a mortgagee's approval. However, by doing this the MRB has insured that the MRB's delegate never actually exercises its adjudicatory function whenever its delegate exercises his or her nondiscretionary authority.

While HUD Regulations permit the Board to redelegate its authority to impose sanctions, if any redelegation effects a change in a "substantive rule of general applicability", or sets forth a "statement of general policy", the Administrative Procedure Act (APA) requires publication of the redelegation in the Federal Register. 5 U.S.C. Sec. 552. The APA requires: 1) advance publication of rules or their substance; 2) opportunity to comment in writing; and 3) publication of the final rule incorporating a concise statement of its basis and purpose. *Batterton v. Marshall*, 648 F.2d 694, 700 (D.C. Cir. 1980).[15]

Substantive rules of general applicability have been defined as rules "affecting individual rights and obligations", *Chrysler Corp. v. Brown*, 441 U.S. 281, 302 (1979); *citing*, *Morton v. Ruiz*, 415 U.S. 199 (1974), or as rules having "a direct and significant impact upon the substantive rights of the general public or a segment thereof." *Lewis v. Weinberger*, 415 F. Supp. 652, 659 (D.N.M. 1976). The delegation in the instant case affected Respondent's and other similarly situated mortgagees' individual rights and had a "direct and significant impact" upon the substantive rights of Respondent and others because it deprived them of significant regulatorily established rights. The MRB was required to consider whether, given the factual circumstances in each particular case, mortgagee authority should be withdrawn, rather than having that authority withdrawn automatically. The delegation applied to any lender who failed to file an audit report within 90 days of the close its fiscal year. Hence, it was not directed at a specific individual or entitity and, thus, affected the "general public or a segment thereof." Finally, by requiring that all failures to submit audit reports within 90 days of the close of a lender's fiscal year *automatically* result in *immediate* withdrawal of that lender's FHA approval, the delegation set forth a statement of general policy.

By eliminating the requirement to exercise its discretion in its September 1983 delegation, the MRB promulgated substantive rules of general applicability and set forth a statement of general policy. However, it failed to do so in compliance with the notice and comment provisions mandated by the APA. For these reasons, the Department's failure to publish its September 1983 delegation in the Federal Register violated the notification and publication requirements of the APA.[16]

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[15]The Government contends that a hearing officer lacks authority to make determinations regarding the applicability of the APA to actions by the Board and cites cases in support of this proposition. However, the cited cases deal with the question of whether APA jurisdiction extends to hearings conducted under Part 26 of Title 24 of the Code of Federal Regulations, and not with the notice and comment requirements of the APA. Nothing in Part 26 prevents a hearing officer from finding that applicable statutory provisions, *e.g.*, the notice and comment requirements of the APA, have not been complied with by a litigant.

[16]The Government contends that the Part 25 regulations relate to a "condition report" of a financial institution and, as such, are excepted from the requirements of the Administrative Procedure Act. See. 5 U.S.C. Sec. 552 (b)(8). That contention is misplaced. The exception relied upon by the Government relates to *disclosure* of those reports under the Freedom of Information Act, not to the requirement that the MRB exercise its discretion when it proposes to take action against those who are required to *file* such reports of condition.

II.

The failure of the MRB to exercise its discretion in this case, however, results in no harm to Respondent since review before a hearing officer is *de novo*. In this review, the hearing officer is required to consider the same regulatory requirements which the Board was bound to consider in the first instance.

The record in this case establishes that, even before the adverse judgement in Colorado, the auditors could not determine the amount of Respondent's loan loss reserve, or whether certain items could be claimed as receivables. The resulting "scope limitation" on any audit submitted at that time would not have satisfied HUD's requirements. The facts do not establish that the Colorado judgment was only a temporary setback; it was still pending as of the hearing date in the instant case. Even were the judgment to be upset, the preexisting audit flaws precluded the auditors from issuing an audit acceptable to HUD. Therefore, there is sufficient cause to uphold the withdrawal of Puller's mortgagee approval.

Indefinite debarments are to be issued only where there has been a determination that Respondent's acts are "wilful or egregious". Respondent failed to submit any evidence that the required report was the result of mistake or simple negligence. Respondent deliberately chose not to file the required report in the face of its substantive deficiencies. Accordingly, its failure to file the required report was "wilful".

The Department has demonstrated by a preponderance of evidence that an immediate withdrawal of approval was in the public interest or in the best interests of the Department. The submission of a periodic audit report is required in order to permit HUD to ascertain whether the fiscal condition of its approved lenders is sufficient to minimize any risk to the public fisc. At the time lender approval was withdrawn, neither the auditors, nor HUD could determine whether Respondent was a fiscally sound institution. Respondent's own auditors could not determine the adequacy of its loan loss reserve or the extent of its assets. The Colorado judgment exceeded Respondent's net worth. It is not in the public or the Department's interest for a lending institution to obligate the funds of the United States in the absence of a determination that lender is solvent. Respondent has not demonstrated that it was in the public interest to allow Respondent to remain in business in the face of mere speculation that its financial condition was sufficient to meet its financial obligations.

CONCLUSION AND ORDER

A preponderance of evidence supports the decision of the Mortgagee Review Board to withdraw Respondent's HUD-FHA mortgagee approval. Accordingly, it is

ORDERED that the action is affirmed.

William C. Cregar
Administrative Law Judge

Dated: October 17, 1990