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

In the Matter of:

FLAGSHIP MORTGAGE SERVICES, INC.

Respondent

HUDALJ 90-154-MR
Decided: January 16, 1991

Ed Rader, *pro se*

Michael D. Noonan, Esquire
For the Government

Before: THOMAS C. HEINZ
Administrative Law Judge

INITIAL DETERMINATION

Statement of the Case

This proceeding arose pursuant to 24 C.F.R. Sec. 25.1 *et seq.* as a result of action taken by the Mortgagee Review Board of the Department of Housing and Urban Development ("the Board") by letter dated August 10, 1990, excluding the Respondent from participation in HUD/FHA programs for a period of one year.

Respondent appealed the action and requested a hearing, which was held in Ft. Worth, Texas, on September 13 and 14, 1990. Thereafter the parties filed briefs.

Discussion

Respondent, Flagship Mortgage Services, Inc., is a Bedford, Texas, corporation engaged in the business of originating, but not servicing, single family residential mortgage loans, many of which have been insured by HUD/FHA. Mr. Ed Rader is the President of Respondent. (Tr. 6-7)[1] On March 13, 1987, Mr. Rader signed an Application for Approval as Mortgagee in which he agreed on behalf of the Respondent to "comply with the provisions of the HUD regulations and other requirements of the Secretary of HUD." (Tr.7) Respondent became an approved "nonsupervised" mortgagee on April 14, 1987. (Tr.7; 24 C.F.R. Sec.203.4)

[1]The following reference abbreviations are used in this decision: "Tr." for "Transcript"; "Gx." for "Government's Exhibit"; and "Rx." for "Respondent's Exhibit."

As a result of a high default rate on HUD/FHA insured loans originated by Respondent, the Mortgage Monitoring Division of HUD conducted two investigatory reviews of Respondent's single family mortgage insurance operations. The first occurred in June of 1989 and the second in late January and early February of 1990. (Tr.7, 50) Those two reviews gave rise to the complaint wherein the Government alleges Respondent violated HUD regulations, handbook requirements, and statutory requirements by failing to implement and maintain a written quality control plan, failing to establish and maintain separate mortgagor escrow accounts, failing to ensure that mortgagors made the minimum required investments in their mortgaged properties, and knowingly submitting false information to HUD.

Written Quality Control Plan

Section 203.2(j) of 24 C.F.R. requires approved mortgagees to "implement a written Quality Control Plan that assures compliance with the regulations and other issuances of the Commissioner regarding loan origination and servicing." The same requirement is set out in HUD Handbook 4060.1, which also provides that one of the objectives of a quality control plan is to "assure that prompt and effective corrective measures are taken when deficiencies in loan origination or servicing are identified." (Gx.1) The Department found during both of its reviews that Respondent had not implemented a written quality control plan. (Tr.53-55) In response to the Department's June 1989 complaints, Respondent hired Jan Wakeland in July of 1989 specifically for the purpose of developing and implementing a quality control plan. Nevertheless, six months later Respondent had not corrected the deficiencies that had been identified by Ms. Wakeland. Respondent admitted in a memorandum dated January 29, 1990, that its quality control plan "has not been adequately developed or implemented." (Rx.3,p.l) That failure violates 24 C.F.R. Sec. 203(j) and Handbook 4060.1. The fact that prior to December 26, 1989, the Department had not precisely specified the minimum requirements for an acceptable plan does not save Respondent. (*See*, Mortgagee Letter 89-32; Rx.1) The burden was on Respondent to devise an acceptable plan in writing. It did not do so. Violating the provisions of HUD regulations and handbook requirements provides grounds for the Department to take administrative action under 24 C.F.R. Secs. 25.9(g) and (j).

Escrow Accounts

Section 203.4(b)(3) of 24 C.F.R. requires mortgagees to "segregate escrow commitment deposits, work completion deposits, and all periodic payments received under insured mortgages...in a special account...." This requirement is mirrored in HUD handbook 4060.1, para. 2-3d. Respondent admits that it did not establish any escrow accounts, while conceding it received escrow-type funds. "Only occasionally did Flagship receive such funds and then against it's [*sic*] specific written closing instructions, in which case Flagship would forward such to the servicing investor." (Respondent's Brief, p.1) Respondent makes a similar admission in Government's Exhibit 33 (p.6):

> Some times [*sic*] the title company will send a lump sum amount, including all fees and the escrow deposits back to me after the loan has funded. I then send the lump check to accounting to be deposited and at the same time request a check for the exact dollar amount of escrows and interest deposit, so that I can forward this to the servicing investor. The escrows and interest amount are taken from the Hud l statement.

That Respondent was not in the business of servicing loans does not excuse it from the obligation to establish escrow or trust accounts for deposit of certain types of funds that mortgagees may receive. Respondent's citation of HUD Handbook 4330.1, para. 3, p.7, to support its case is unavailing. That section merely provides that under certain circumstances a mortgagee may establish a trust account rather than separate escrow accounts. In fact, the cited section emphasizes that "escrow funds collected on insured loans may not be commingled, even temporarily, with funds used for operating purposes, collections, etc." Yet this is precisely what Respondent did. This violation of the regulations and handbook requirements created grounds for administrative action under 24 C.F.R. Secs. 25.9(b), (g), and (j).

Minimum Required Investment

Section 203(b)(9) of the National Housing Act (12 U.S.C. Sec. 1709(b)(9)) and 24 C.F.R. Sec. 203.19(a)(1) require mortgagors to make a minimum investment of at least three percent of the cost of the property in order for a mortgage to be eligible for FHA insurance. In some instances, instead of cash, the minimum investment may be made in the form of repairs and improvements to the property by the mortgagor, sometimes called "sweat equity." At the time mortgagors apply for mortgage insurance, mortgagees are required to determine and certify that the mortgagors have sufficient assets to make the minimum cash investment or that they have the skills necessary to perform the required sweat equity repairs and improvements. (*See*, Gx.2, HUD Handbook 4000.2 REV-1, para. 5-2; Gx.2A, Mortgagee Letter 86-10; Mortgagee Letter 87-27; Gx.2B, Housing Division Circular Letter 85-7(Forth Worth); HUD form 92900.)

The Government argues that Respondent did not satisfy these requirements on three occasions. The loan application form for [redacted] Gardea and [redacted] Perez (FHA Case No. [redacted]) does not indicate the source of down payment or liquid assets sufficient to make the required minimum investment in the property. (Gx.3) Another document prepared in connection with the Perez loan shows that the borrowers paid an earnest money deposit of $100. (Gx.4) The HUD form 92900 that Respondent prepared indicates the borrowers had $1,600 in cash (including deposit on purchase) and were to pay $1,440 cash on a property with a base price of $34,000. (Gx.5) These representations were contradicted by Mrs. Perez in a telephone conversation with a Government investigator. In that conversation, Ms. Perez is reported to have said that she and her husband did not make an earnest money deposit, that they did not pay any money at closing, that Respondent asked no questions regarding a down payment, that Respondent in fact asked no questions about any money they had, and that they did no sweat

equity work. She said they had no bank account at the time of the transaction. (Gx.6) Excepting evidence regarding sweat equity, Respondent introduced no probative evidence to counter the investigator's report.

Respondent submitted documents showing Mrs. Perez and her husband in fact made $950 worth of repairs and improvements to the property they purchased. (Rx.7) However, the HUD form 92900 Respondent prepared in connection with the Perez loan indicates that the minimum investment requirements were to be satisfied with cash, not sweat equity. (Gx.5) Respondent certified on HUD form 92900 that the information contained in Section II of the form "was obtained directly from the borrower by a full-time employee of the lender and is true to the best of the lender's knowledge and belief." Accordingly, whether or not Mr. and Mrs. Perez satisfied minimum investment requirements with sweat equity, the preponderance of the evidence proves that, contrary to its certification, Respondent submitted false information to HUD, which is cause for administrative action under 24 C.F.R. Secs. 25(g), (j), and (k).

The evidence regarding an FHA-insured loan taken out by [redacted] Ellis demonstrates that Respondent failed to make sure the borrowers could satisfy minimum investment requirements. Sweat equity is not an issue in this case. Section II of HUD form 92900, the loan application prepared by Respondent, indicates that the buyers had made an earnest money deposit of $500, but that no down payment was contemplated on a property with a base price of $50,000. Mrs. Ellis told Government investigator Brown that Respondent's representative knew she and her husband were not going to be making a down payment. She also reported that they did not provide any earnest money for the transaction, but the record is unclear whether Respondent's representative was made aware of this fact. (Gx.12) If Respondent had fulfilled its obligations to investigate the financial condition of the borrowers and to determine the source of funds used for a deposit, it would have become aware that Mr. and Mrs. Ellis paid no earnest money. In any event, the information Respondent supplied HUD on the form 92900 was false. Moreover, as the required minimum investment in the property was in excess of $1,500 (3% x $50,000 = $1,500), and the borrowers supposedly were to invest only $500 and no sweat equity, the loan application on its face reveals that Mr. and Mrs. Ellis were not qualified borrowers. Respondent's treatment of the Ellis loan provided grounds for administrative action under 24 C.F.R. Secs. 25.9(g), (j), and (k).

In FHA Case No. [redacted] regarding mortgagor [redacted] Story, documents prepared by Respondent represent that Mr. Story was to supply the necessary minimum investment in the property with sweat equity, but according to Government investigator Brown, Mr. Story told him that he did no work on the house, that he did not perform any sweat equity, and that he "didn't know anything about any sweat equity." (Gx.10) In contrast, Respondent submitted a letter from Mr. Story (Rx.8), which states:

> We painted the inside and outside. We also had to replace some damaged siding and other various items listed on the appraisers [*sic*] repair list for our down payment.

Mr. Story told Respondent a different story than he told the Government investigator. Although Mr. Story did not specify all the work he performed on the property in the document submitted by Respondent, and although the record does not reveal that he personally has the requisite skills to perform all the required repairs that had been identified by HUD before the sale, nevertheless, the evidence is too ambiguous and contradictory to sustain a finding that Mr. Story did not in fact perform sufficient sweat equity to satisfy the minimum investment requirement. Accordingly, the Government has not satisfied its burden under 24 C.F.R. Sec. 26.23(g) to show that Respondent violated certification requirements in connection with the Story loan.

Certification of Personal and Financial Status

At the time [redacted] Evans took out a loan with Respondent, they had a $1,000 liability to Tarrant Bank to be paid within nine months, and Mr. Oliver was making child support payments of $108.33 per month. (Rx.14) Respondent knowingly failed to report these liabilities to HUD/FHA but argues with regard to the bank debt that FHA guidelines allow mortgagees to ignore debts payable within 10 months. As for the child support payments, Respondent argues:

> In reference to not counting $108.33/month child care/support for the two children mentioned on the 1003 application was to be $300.00/month. [*sic*] HUD's requirement has always been that the amount shown in a divorce decree is the amount counted. In this case, the coborrower received child support in the amount $429/month. The processor offset these and considered them a wash. [Rx.14]

Respondent cites no authority to support these arguments and none has been found. By failing to report the applicants' financial obligations, Respondent gave HUD false information, which is grounds for an administrative action under 24 C.F.R. Secs. 25.9(g), (j), and (k).

Verifications of Employment

Originating mortgagees are required to verify employment information supplied by loan applicants. Verification is accomplished by sending a form designed for that purpose to the borrower's employer, who is directed to return it directly to the mortgagee. The verification of employment form ("VOE") "must not pass through the hands of the applicant, real estate agent, or any other third party." (HUD Handbook 4000.2 REV-1, para. 5-5(b); Gx.2) Mortgagees are also required to certify on the HUD form 92900 that the VOE forms did not pass "through the hands of any third persons and are true to the best of the lender's knowledge and belief." The record shows four cases in which Respondent either permitted VOE forms to "pass through the hands of third persons" or submitted forms to the Government containing information that Respondent knew was false.

Defaulting mortgagor [redacted] Slack told a Government investigator that he had hand-carried the VOE form to his brother, who employed him to do janitorial work. (Gx.16) Likewise, [redacted]. Collins, who also defaulted on his loan, told the investigator he hand-carried his VOE form to his employer. (Gx.25) Similarly, [redacted] Nunez told the investigator that one of Respondent's loan officers handed him the VOE forms and asked that he have them executed. (Gx.29) Respondent did not refute any of this evidence. Hence, Respondent has violated paragraph 5-5(b) of HUD handbook 4000.2 REV-1 and given cause for administrative action under 24 C.F.R. Secs. 25.9(g) and (j).

The Government argues that in these three cases Respondent falsely certified that the borrowers were employed on a regular, full-time basis, whereas in fact Mr. Collins and Mr. Nunez were merely contract laborers, and Mr. Slack was self-employed and had only worked for his brother for two months without pay. Section II of form 92900 does not require the employment of the applicant to be "regular" or "full-time," nor does the lender's certification regarding employment in Section III of the form use these terms. Therefore, there is nothing on the face of the form to preclude a lender from truthfully signing the certification regarding the employment of an applicant who is a part-time or contract employee without divulging the precise nature of that applicant's employment status. In other words, if the lender has a duty to report that an applicant has part-time or contract employment rather than "full-time" or "regular" employment, that duty cannot be found in form 92900. As the Government cites no other source for such a duty, for the purposes of this case I must conclude that no such duty exists and that Respondent did not falsely certify the employment status of Messrs. Collins and Nunez.

As for Mr. Slack's pay status and period of employment, the record is inconclusive. Respondent submitted a letter purportedly written by Mr. Slack that corroborates the statement in the loan application that he had worked for his brother at D & R Janitorial Services for two years. The record also contains an IRS form 1099 showing payment of $9,600 by D & R Janitorial Services to Mr. Slack in 1987. This evidence supports the statement in the loan application that he was paid $800 per month. (Rx.10) On the other hand, the Government investigator's interview notes indicate that Mr. Slack told him he had only worked two months for his brother and had received no pay. (Gx.16) No finding adverse to Respondent can be made based on this contradictory evidence.

In the case of [redacted] Gonzales, Respondent certified that Mrs. Gonzales earned $[redacted] per month babysitting in her home. Two letters ostensibly written by Mrs. Gonzales' sisters and submitted by Respondent during the loan application process seemed to confirm this certification. (Gx.19-20) However, during an interview by Government investigators after default on the mortgage, Mrs. Gonzales declared in writing that the "statements from my sisters regarding babysitting income are false...I did not tell Mr. Day [Respondent's representative] that I earned $[redacted] per month income or worked as a babysitter as shown on the loan application signed by Mr. Day." (Gx.21) She said she told Respondent's representatives that she had no income or anticipated income. (Gx.22) This evidence was not refuted by Respondent. I therefore conclude

that Respondent knowingly submitted false information to HUD, a cause for administrative action under 24 C.F.R. Secs. 25.9(g), (j), and (k).

Sanction

The Government clearly has established grounds for administrative action under 24 C.F.R. Sec. 25.9. Where cause appears for administrative action, 24 C.F.R. Sec. 25.5 states that the Mortgagee Review Board of the Department may withdraw HUD/FHA approval of a mortgagee "for a reasonable, specified period of time commensurate with the seriousness of the grounds(s) for withdrawal, generally not to exceed six years." The evidence in this case establishes multiple grounds for administrative action, several of them serious. When, for example, as here, a mortgagee knowingly submits false information to HUD/FHA, it unquestionably commits a serious breach of its fiduciary duty to the Government. The Federal Housing Administration cannot operate properly if it cannot trust and rely upon mortgagees to supply true, accurate, and complete information. *See, Mechanics National Bank v. HUD*, 522 F. Supp. 25,26 (D.D.C. 1981); *In the matter of Ramsey Agan*, HUDBCA 83-773-D17, p.14; *In re Samuel T. Isaac and Associates*, HUDBCA 80-485-D29, p.6).

Citing 24 C.F.R. Sec. 25.5(d)(4)(i), the Mortgagee Review Board on August 10, 1990, withdrew Respondent's HUD/FHA approval for one year effective upon receipt of notice by Respondent.[2] Respondent contends withdrawal was unmerited and attempts

---

[2] On December 15, 1989, Public Law 101-235, the "Department of Housing and Urban Development Reform Act of 1989," was approved. Among other things, the Reform Act for the first time made the Mortgagee Review Board a creature of statute rather than of HUD regulation. The statute authorizes the Secretary to promulgate regulations concerning the Board (as yet unpublished), and empowers the Board to take a variety of administrative actions, including withdrawing a mortgagee's HUD/FHA approval for "not less than 1 year." 103 Stat. 2033. However, unlike the old regulatory language in 24 C.F.R. Sec. 225(d)(4)(i), the statute does not authorize the Board to withdraw HUD/FHA approval effective upon receipt of notice by the mortgagee. Under the terms of the 1989 Reform Act, when the Board wants a mortgagee to stop doing business with the FHA immediately, pending completion of legal proceedings, it must issue a "suspension," not a "withdrawal."

> SUSPENSION. The Board may issue an order suspending a mortgagee's approval for doing business with the Federal Housing Administration if there exists adequate evidence of a violation or violations and continuation of the mortgagee's approval, pending or at the completion of any audit, investigation, or other review, or such administrative or other legal proceedings as may ensue, would not be in the public interest or in the best interests of the Department. A suspension shall last for not less than 6 months....[103 Stat. 2033]

Despite the fact that in the instant case the Board issued an immediately effective withdrawal rather than a suspension and a proposed withdrawal, several reasons compel me to affirm the Board's action. During the period required to complete administrative or legal proceedings, there is no practical difference between a suspension and a withdrawal because the effect of these two administrative actions on the mortgagee is the same; that is, the mortgagee is precluded from conducting business with HUD/FHA. Because the Board could have issued a suspension pending completion of legal proceedings, and because there are sufficient grounds to suspend/withdraw Respondent's HUD/FHA approval for one year, Respondent has not been prejudiced by the Board's issuance of an immediately effective withdrawal rather than a suspension and a proposed withdrawal. In other words, the Board's error was harmless.

to excuse its violations by pleading ignorance of HUD/FHA requirements and pointing to its untrained and relatively inexperienced staff. That contention has no merit, as ignorance of the law is never an excuse. Similarly, Respondent's attempts to improve its operations and the long and unblemished personal record of its president, though laudable, do not excuse or significantly mitigate Respondent's violations.

Respondent also argues that the Government's case improperly rests on unreliable and untrustworthy evidence supplied by various mortgagors. The probative value of the evidence submitted by the Government has already been discussed, *supra.* Finally, Respondent contends its problems with HUD/FHA are the result of bias and incompetence on the part of the Government's investigators and regulators. No credible evidence in the record supports that contention. In sum, nothing in the record shows that withdrawal of Respondent's HUD/FHA approval for one year is not commensurate with the seriousness of Respondent's violations of HUD/FHA requirements.[3]

Conclusions and Order

The Government has demonstrated by a preponderance of the evidence that the Mortgagee Review Board had adequate grounds under 24 C.F.R. Sec. 25.9 to take administrative action on August 10, 1990, against Respondent under color of the authority conferred by 24 C.F.R. Sec. 25.5. Respondent has committed serious infractions of HUD/FHA rules, regulations, and requirements. Withdrawal of Respondent's HUD/FHA approval for a period of one year effective on the date Respondent received notice of the Board's action is commensurate with the seriousness of the grounds for administrative action. The record reveals no mitigating factors sufficient to merit altering or amending the Board's action. Accordingly, the action of the Mortgagee Review Board on August 10, 1990, against Respondent Flagship Mortgage Services, Inc., is hereby **ORDERED** affirmed.

Thomas C. Heinz

THOMAS C. HEINZ
Administrative Law Judge

Dated: January 16, 1991

[3]Note that one year is the minimum withdrawal period under the HUD Reform Act of 1989. 103 Stat. 2033