UNITED STATES OF AMERICA

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

BOARD OF CONTRACT APPEALS

WASHINGTON, D.C.

In the Matters of:	:	
VICTOR ZARRILLI and	:	HUDBCA No. 89-4509-D47
MARK TWAIN BANK,	:	HUDBCA No. 90-5242-M5
Respondents.	:	

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DETERMINATION BY ADMINISTRATIVE JUDGE TIMOTHY J. GRESZKO

November 28, 1990

Statement of the Case

By letter dated July 24, 1989, James E. Schoenberger, General Deputy Assistant Secretary, U.S. Department of Housing and Urban Development ("Department," "Government," or "HUD") notified Victor Zarrilli ("Zarrilli" or "Respondent"), that, pursuant to 24 C.F.R. §24.305(b), (d) and (f), the Department was proposing to debar him from further participation in primary covered transactions and lower tier covered transactions as either a participant or principal at HUD and throughout the Executive Branch of the Federal Government, and from participation in procurement contracts with HUD, for a period of three years. The proposed debarment was based on an allegedly false certification by Zarrilli that Mark Twain Bank ("MTB,"

"mortgagee," or "Respondent") had received the mortgagor's required equity investment on the Drake Plaza Apartment project. By letter dated October 27, 1989, HUD Assistant Secretary C. Austin Fitts amended the July 24, 1989 letter of James Schoenberger, by adding two additional charges. The amending letter charged that Zarrilli had improperly directed MTB's escrow agent to disburse funds on two occasions. Zarrilli was not temporarily suspended pending a final determination of the debarment action.

By letter dated December 6, 1989, Assistant Secretary Fitts informed Mark Twain Bank that the Department had withdrawn MTB's HUD/FHA mortgagee approval for an indefinite period of time. The withdrawal of MTB's mortgagee approval was issued pursuant to 24 C.F.R. §25.5(d)(4)(i), and was based upon allegations of violations of HUD-FHA requirements by MTB in connection with the Drake Plaza Project. The letter stated that MTB falsely certified that it had received the required equity investment from the mortgagor of the Drake Plaza Project, and that MTB had failed to maintain adequate controls over a project escrow account, which resulted in the improper disbursement of project escrow funds totalling $624,000.

Respondents Zarrilli and MTB made timely requests for hearings on the propriety of the sanctions. These cases were consolidated for hearing by order dated January 26, 1990, and a hearing was conducted in St. Louis, Missouri. Both parties filed post-hearing briefs. This determination is based upon the consideration of the entire record in this case.

Findings of Fact

1. At all pertinent times, MTB was a HUD/FHA approved lender doing business in St. Louis, Missouri. (Stipulation of Fact ("SF") 2).

2. In late 1986, MTB became involved in the development of the Drake Plaza Project ("Drake" or "project"), a low to moderate income rental housing project located in St. Louis, Missouri, which was financed in part with an FHA-insured loan. MTB was the trustee of a bond issued by the City of St. Louis, and became the mortgagee of record for the project. Victor Zarrilli acted on behalf of MTB. (Govt. Exh. 1; SF 3 and 14).

3. William A. Thomas ("Thomas," or "developer") acted on behalf of the partnership which was the mortgagor of the Drake. The project was financed in part by a Community Development Agency ("CDA") loan of $1,150,000, an Urban Development Action Grant ("UDAG") of $1,254,328, and an FHA-insured loan of $3,442,000. The mortgagor was also required to make an initial equity investment in the project and to have clear title to the

land prior to initial endorsement ("closing"). The closing took place on December 30-31, 1986 in the HUD St. Louis offices. SF 4, 5, and 7).

4. Prior to closing, another lender, Gershman Investment Corporation ("Gershman"), which had originated and processed the mortgage, assigned the loan to MTB as the closing began. Thereafter, MTB became the mortgagee of record and Gershman Investment became MTB's servicing mortgagee. Gershman was a highly experienced and reputable company in the St. Louis, Missouri area. Gershman was utilized by MTB as MTB's servicing mortgagee for this project under a very detailed servicing agreement between Gershman and MTB. (SF 12, 13; Resp. Exh. A).

5. Prior to closing, the mortgagor retained Stewart Kenney of Community Title Company ("Community Title") to issue title policies for the property and to act as escrow agent for the disbursal of project funds. Community Title utilized the South Side National Bank, St. Louis, Missouri, as its escrow depository. Vatterot Construction Company was the general contractor on the project. Community Title was also a highly experienced and reputable company in the St. Louis, Missouri area. (Tr. p. 634; SF 15).

6. Among the attendees at the closing were William Thomas, Victor Zarrilli, Jack Sheredano, representing Gershman, and Stewart Kenney, representing Community Title. Wilbur R. Mackin, Jr. attended the closing on behalf of HUD in his capacity as the HUD St. Louis Office Director of Housing. Joyce Haile-Sellassie attended the closing as HUD's legal representative. The atmosphere at the closing was unusually chaotic because of severe pressure to conclude approximately six other closings, including the closing at issue, prior to January 1, 1987, in order to avoid certain negative tax consequences that might have caused some of these projects to be cancelled or postponed. (Tr. pp. 134, 391, 416, 424-25, 761).

7. On December 30, 1986, Thomas executed a Mortgagor's Certificate, FHA Form No. 2433, on behalf of Drake Plaza Associates, which stated, among other things, that "the land included in the mortgage has been paid for in full." (Resp. Exh. D).

8. On December 31, 1986, Community Title issued Title Insurance Policy No. M 3802-15155 on the project's land. The policy stated, in relevant part, that, "The estate or interest referred to herein is at Date of Policy vested in: Drake Plaza Associates, a Missouri limited partnership." (Resp. Exh. E)

9. At the closing, Community Title issued a check from the escrow account in the amount of $124,852 to Solon Gershman, Inc., an affiliate of Gershman. Zarrilli did not see this check at

closing. The check was given to Sheredano, who then caused Gershman to write its company check for the identical amount to MTB to cover project bond related expenses. Although Sheredano realized that the Community Title check should not have been made payable to Gershman, both Sheredano and Gershman failed to inform MTB that the $124,852 check was drawn on funds from the escrow account, rather than separate bond transaction funds. (Resp. Exhs. L, M; Tr. pp. 497-498, 541-42, 778-780).

10. On December 31, 1986, Zarrilli executed on behalf of MTB a Mortgagee's Certificate, which states, in relevant part:

> (13) The Mortgagor has deposited with us or subject to our order *in a depository satisfactory to us*, the . . . [c]ash required, if any, over the proceeds of the mortgage, to complete the project, which will be used before any mortgage proceeds are advanced in the amount of ~~$490,846~~ (sic) $555,715 V.Z.[1]
>
> (14) We understand that nothing herein contained . . . is to be deemed to be a waiver of any of the provisions of the aforesaid FHA Regulations, but all of said instruments are intended to be subject thereto. (Govt. Exh. 1)(emphasis supplied).

Zarrilli testified at the hearing that he lined-out the $490,846 figure on the certificate, changed the figure to $555,715, and initialed the change. The $555,715 figure was a rework of the amounts required to effectuate the closing, and was calculated by Dennis Worth, Chief of the HUD St. Louis Mortgage Credit Branch, on the day of the closing. This figure was one of three owner equity figures ($493,000; $490,846; and $555,715), that were at one time or another, considered at closing. No explanation was given by the Department for the changes in the owner equity requirements, except that the changes reflected last minute corrections of errors.

Zarrilli testified that he made the certification with respect to the $555,715, on the basis of his receipt of an uncertified $500,000 check presented by Thomas, and because he believed that Thomas was entitled to a $376,481.50 credit against owner's equity, for expenses which Thomas paid at closing on project draw ("draw," or "draw request") number 1 (HUD Form No. 82403, Application for Advance of Mortgage Proceeds). Zarrilli also testified that he credited the mortgagor with the proceeds of two additional checks received from the mortgagor at closing, in the amounts of $48,541 and $46,302.50. These funds were to be

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[1] The letters and punctuation "V.Z." are Zarrilli's initials.

held for the bond trust indenture and for the advance payment of a mortgage insurance premium under project draw number 1.

Zarrilli testified that he was not informed by Thomas that the $500,000 check was to be used for the purchase of land. Zarrilli stated that he believed that the land had already been paid for because of the signed mortgagor's certification that the land had been purchased and because of the statement in the title policy that the owner had fee simple title. Zarrilli stated that he was informed at closing by Sheredano that the $500,000 check had been made payable by Thomas to Community Title, because the title company was going to hold the owner's equity. Zarrilli further stated that he gave the check to Sheredano, as his agent, to give to Stewart Kenney, President of Community Title. (Zarrilli, Tr. pp. 766-779; Worth, Tr. pp. 134, 145, 164; Haile-Sellassie, Tr. p 421).

11. The $500,000 check, which was drawn on a Drake Plaza Associates checking account, listed Community Title as payee, and was ultimately turned over at closing to Stewart Kenney, Community Title's president. In early January, 1987, Kenney deposited the check in the escrow account, but the check was returned for insufficient funds. In January, 1987, Kenney disbursed CDA funds from the escrow account to pay for the land, but did not inform either HUD or MTB of this action until October, 1987. This disbursement was not made pursuant to a HUD-approved draw request. (Kenney, Tr. pp. 601-604, 610; Resp. Exh. I).

12. A letter dated June 13, 1988, from Kenneth Lange, Manager, HUD St. Louis Office, to John Dubinsky, MTB's Board Chairman, states in relevant part:

> 1. At the initial closing, which occurred on December 31, 1986, FHA Form No. 2434, Mortgagee's Certificate, was signed by Mr. Zarrilli for Mark Twain Bank, N.A., certifying to the receipt of $555,715.02 in cash from Drake Plaza Associates. At the closing neither cash, nor the equivalent of cash, was received. *Rather, a simple check . . . was accepted by Mr. Zarrilli at the closing table, and immediately, within seconds, passed on to Mr. Sheredano, who represented Gershman Investment Corporation, the servicing mortgagee* . . . . (Govt. Exh. 31) (emphasis supplied).

13. Sometime in late 1987, Susan Stegmoeller, a Multi-Family Loan Specialist in the HUD St. Louis Office, became aware that Vatterot Construction had not received the amount of funds from the escrow account that HUD expected it to have received by that point in the construction process. At that time she also learned that Thomas' $500,000 check had not cleared. Numerous meetings

were held at the HUD St. Louis Office from September to December, 1987, regarding this project. The HUD St. Louis Office determined that the escrow account was underfunded by $412,889.07 and that the UDAG funds anticipated for this project had not yet been approved for release by HUD in Washington. The HUD St. Louis Office refused to approve any more of Vatterot's draw requests until the shortfall in the escrow account was remedied. In November, 1987, a meeting was held at the HUD St. Louis Office, in which it was agreed that the shortfall would be remedied by the application of funds from a $125,437 letter of credit, which had been posted by Thomas, and by proceeds from a $287,457 loan from Vatterot Construction to Drake Plaza Associates. (Tr. pp. 226-257; SF 25, 26).

14. After the November 1987 meeting, Zarrilli directed Community Title to make a number of disbursements from the escrow account. Pursuant to UDAG Agreement number B-85-AA-29-5037 dated September 12, 1985 ("UDAG Agreement"), executed by HUD and the City of St. Louis, funds were disbursable from the escrow account, after the Developer had expended its equity funds, at a ratio of 76 per cent FHA-insured funds to 24 per cent UDAG funds. (Govt. Exh. 20).

15. Thomas submitted draw request number 13 to HUD, on or about December 4, 1987. As a result of that draw request, Thomas requested, and HUD approved payment, on the following line-items:

Description	(A) Amount Claimed	(B) HUD Approved Amt.
Construction cost	$ 466,477.00	$ 251,574.70
Interest	9,857.50	9,857.50
Architect's fees	8,194.00	4,536.26
Mtg. insur. prem.	17,211.50	17,211.50
RE taxes	4,000.00	0.00
TOTAL	$ 488,528.50[2]	$ 283,179.96

Of the $283,179.96 approved for payment, the draw request indicated that $209,553.17 (74%) was payable from FHA-insured funds, and that $73,626.79 (26%) was payable from UDAG funds, which had not yet been received. There is no explicit instruction on the draw request that payments on individual line-items were to be pro-rated. (Govt. Exh. 4).

16. By letter dated December 10, 1987, addressed to Community Title, Zarrilli authorized Community Title to make fund

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[2] This sum is reflected on draw request number 13 as the total amount claimed under column A.

advances from FHA-insured funds against draw request number 13, as follows:

1)	Interest	$ 9,857.50
2)	Mortgage Ins. Premium	$ 17,211.50
3)	Architect's Fees	$ 3,356.83
4)	Construction	$ 179,127.34
	TOTAL	$ 209,553.17

The total amount of FHA-insured funds which MTB approved for payment equalled the aggregate amount of FHA-insured funds which HUD approved for payment. However, MTB's approval permitted Community Title to pay the full amount of interest and the full amount of the mortgage insurance then due from FHA-insured funds. These payments also resulted in an underpayment of the construction and architect's fee line-items, because the UDAG funds had not been received and were unavailable to MTB. A copy of Zarrilli's December 10, 1987 letter to Community Title was provided to Kenneth G. Lange, Manager, HUD St. Louis Office. HUD did not state any objection to the distribution of proceeds on draw request number 13 as authorized by MTB prior to Thomas' submission of draw request number 16 to HUD. (Govt. Exh. 5; Tr. pp. 807-812).

17. Thomas submitted draw request number 16 to HUD, on or about December 28, 1987. Thomas requested, and HUD approved payment, as follows:

Description	(A) Amount Claimed	(B) HUD Approved Amt.
Interest	$ 14,107.55	$ 13,914.30
RE taxes	7,663.03	6,835.73
TOTAL	$ 21,770.58	$ 20,750.03

Of the $20,750.03 approved for payment, $15,355.02 (74%) was payable from FHA-insured funds, and $5,395.01 (26%) was payable from UDAG funds which had not yet been received. (Govt. Exh. 6).

18. During a telephone conversation in early January, 1988, Stegmoeller informed Zarrilli that he was not to permit the utilization of more than 74 per cent FHA funds for the payment of any line item on a draw request She also instructed him to draw down on the mortgagor's $125,000 letter of credit to fund the shortfall created by the lack of UDAG funds, which had not yet been released for distribution. Zarrilli became quite upset. He informed Stegmoeller that her instructions to him had to be incorrect, because the $125,000 letter of credit was insufficient to meet the UDAG fund shortfall and because a failure to pay the

full amount of any interest payment when due would put the mortgage into default. Zarrilli requested that Stegmoeller discuss her position with her superiors, and that they inform him of their position in writing. (Tr. pp. 276-284; 813-818).

19. By letter dated January 19, 1988, addressed to Community Title, Zarrilli authorized Community Title to make payments from FHA-insured funds against draw request number 16 on the following line-items as indicated below:

1)	Interest	$ 14,107.55
4)	RE tax[3]	$ 1,247.47
	TOTAL	$ 15,355.02

The total amount which MTB directed Community Title to disburse equalled the aggregate amount of FHA-insured funds authorized by HUD for payment. However, MTB's approval permitted Community Title to pay the full amount of interest from FHA-insured funds, and a portion of the tax line-item.

Zarrilli authorized the utilization of FHA-insured funds to pay the full amount of interest and the full mortgage insurance premium on draw request number 13, because there were insufficient funds to pay all of the HUD-approved amounts due to a lack of UDAG funds, and because he did not want the note to be in default for failure to pay interest, or the mortgage insurance to lapse for failure to pay the premium. He also authorized payment from FHA-insured funds of the full amount of interest due on draw request number 16, for the same reasons. (Tr. pp. 807-812).

20. By letter dated February 25, 1988, Dennis R. Worth, Acting Director, Housing Development Division, HUD St. Louis Office, directed Zarrilli to change the disbursement instructions in his January 19, 1988 letter to Community Title, and to specifically instruct Community Title to make payments of $10,296.58 interest (.74 x $13,914.30) and $5,058.44 real estate taxes (.74 x $6835.73). Zarrilli made the requested adjustments by letter to Community Title dated March 8, 1988. He informed HUD by copy of that letter that the developer had defaulted on the FHA-insured mortgage note, and instructed HUD to request immediate payment from the developer of the shortfall. (Resp. Exhs. FF, GG).

21. The UDAG funds became available for disbursement in April, 1988, and a possible default was averted. (SF 28)

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[3] This amount was not to pay taxes, but to reimburse Gershman for the payment of taxes. (Tr. p. 821).

22. The project was completed in June, 1988, and final closing was held in November, 1989. As of the date of the hearing, the project was current in meeting its mortgage payments. (SF 29, 30).

Discussion

A. Debarment of Zarrilli

Applicable Regulations

Under pertinent HUD regulations, program "participants" may be debarred for a variety of causes. 24 C.F.R. §24.305. Zarrilli admits that he is a "principal" and hence he is a participant in programs of this Department as defined by 24 C.F.R. §24.105(P). (SF 1).

A debarment may be imposed to protect the public interest, as it is the policy of the Federal Government only to do business with "responsible persons." 24 C.F.R. §24.115. Responsibility is a term of art in Government contract law, defined to include not only the ability to perform a contract, but the honesty and integrity of the participant as well. *Roemer v. Hoffman*, 419 F. Supp. 130 (D.C. D.C. 1976). Although the judicially imposed test for debarment is present responsibility, it is well established that a finding of lack of present responsibility may be based on past acts. *Schlesinger v. Gates*, 249 F.2d 111 (D.C. Cir. 1957), *cert. denied* 355 U.S. 939 (1958). A debarment may not be imposed for punitive purposes.

In order to debar a person, the cause for debarment must be established by a preponderance of the evidence, and the Government has the burden of proving that cause for debarment exists. 24 C.F.R. §§24.313(b)(3), (4). The existence of a cause for debarment does not necessarily require that the contractor be debarred; the seriousness of the contractor's acts or omissions and any mitigating factors should be considered in making any debarment decision. 24 C.F.R. §24.115(d).

The Government alleges that cause for debarment of Zarrilli exists pursuant to 24 C.F.R. §§24.305(b), (d), and (f). 24 C.F.R. §24.305(b) provides that a debarment may be imposed for:

> Violations of the terms of a public agreement or transaction so serious as to affect the integrity of an agency program, such as:
>
> (1) A willful failure to perform in accordance with the terms of one or more public agreements or transactions;

> (2) A history of failure to perform or of unsatisfactory performance of one or more public agreements or transactions; or
>
> (3) A willful violation of a statutory or regulatory provision or requirement applicable to a public agreement.

24 C.F.R. §24.305(d) provides that a debarment may be imposed for:

> Any other cause of so serious or compelling nature that it affects the present responsibility of a person.[4]

24 C.F.R. §24.305(f) provides that:

> In addition to the causes set forth above, HUD may debar a person from participating in any programs or activities of the Department for material violation of a statutory or regulatory or program requirement applicable to a public agreement or transaction including applications for . . . insurance or guarantees or . . . conditional or final commitment to insure or guarantee.

I. False Certification

The Government charges in Count I of its complaint that Zarrilli made false certifications on the Mortgagee's Certificate with respect to the $555,715 owner's equity figure set forth on the face of that certificate. The Government contends in its brief that this certification was false on the grounds that: (1) Zarrilli never received Thomas' $500,000 check; (2) even assuming that Zarrilli received the check, it was not "cash," because the check was not "certified" and bore no guarantees of payment; (3) MTB never had a HUD-approved agreement with Community Title for the retention and disbursement of the owner equity funds; and (4) MTB was not entitled to give the mortgagor a credit against owner's equity for the $376,481 in prepaid items on draw number

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[4] The United States District Court for the Western District of Missouri has held that these causes are limited to discriminatory acts or violations regarding conflicts of interest. *Sellers v. Kemp*, No. 89-1142-CV-W-1, October 23, 1990, available on LEXIS, GENFED library, DIST file. Causes of this nature have not been pleaded in this case by the Government.

1. The Government asserts that these actions constitute grounds for debarment under 24 C.F.R. §§24.305(b), (d), and (f).

Zarrilli contests these contentions on the grounds that: (1) he was justified in certifying that he had received $555,715 from the mortgagor because he had received substantially more than that amount at closing; (2) it was the custom and practice in the St. Louis area to treat uncertified checks as "cash" at HUD closings of FHA-insured projects; (3) it was the custom and practice in the St. Louis area for mortgagees, at closing, to give mortgagors a credit against owner's equity of certain prepaid amounts; (4) he had properly complied with the provisions of the Mortgagee's Certificate, which only required him to certify that MTB had deposited the money in a depository satisfactory to MTB; and (5) his certification was reasonable under the circumstances of this closing.

I am unable to find on the record before me that Zarrilli's certification constitutes grounds for his debarment for several reasons.

First, I find Zarrilli's explanation of the facts surrounding both the transfer of the $500,000 check and his endorsing of the Mortgagee's Certificate to be reasonable and credible. To his knowledge, he received not less but more than the amount which he certified. His testimony is corroborated by the HUD Office Manager's letter of June 13, 1988. Moreover, there is no evidence in the record that Zarrilli had any motive to make the certification at issue without the receipt of Thomas' $500,000 check. In addition, the testimony of Thomas, Sheredano, and Kenney, all of whom were called as witnesses in the Government's case-in-chief, was neither useful nor probative of the Government's position on this issue, as their testimony contained numerous conflicts on crucial points.

Second, several of the witnesses called by the Government testified that it was indeed a common practice, if not standard operating procedure at HUD closings in St. Louis, for mortgagees to accept uncertified checks from mortgagors as owner's equity, to treat such checks as cash, and for mortgagees to give mortgagors a credit against owner's equity for certain expenses paid at or before closing. (*See, e.g.*, testimony of Thomas, Tr. p. 646; Sheredano, Tr. p. 493). The testimony of HUD's own closing attorney, who had more than fourteen years of experience in conducting closings of HUD projects, corroborates the acceptance of these practices. When asked on cross-examination whether it would have been reasonable for Zarrilli to have certified that he had received $555,715 if he had documents evincing $376,000 in paid receipts on draw number 1, and a $500,000 check from the mortgagor, HUD's attorney responded: "I can't say it would be unreasonable." (Haile-Sellassie, Tr. p. 440). Her primary criticism of Zarrilli's certification was that

it could have contained more explicit information about the $376,000 credit. (Tr. p. 445). Even if this attorney's view is accepted as true, this fact would not, *per se*, prove that Zarrilli's certification was false.

The Government did not offer expert testimony to prove that an uncertified check could not be accepted as "cash," nor did the Government cite any relevant HUD regulations, published guidelines, or other legal authority that might support its definition of cash. The term "cash" does not necessarily mean legal tender nor is it always defined to require some form of guaranteed payment. *See Long v. Manning*, 455 S.W.2d 496, 502 (1971), wherein the Supreme Court of Missouri held that the acceptance of a check at a real estate foreclosure sale met a requirement for a "cash" sale, because the sale was not made upon "credit." *See also Stewart v. Selden*, 473 S.W.2d 3, 8-9 (Tex. 1971), holding that the term "cash" is used to mean not only money, but also checks and demand deposits in banks. I accordingly do not find, under the circumstances of this case, that Zarrilli falsely characterized the funds in question as cash.

Third, I do not find that Zarrilli falsely certified that the owner's equity had been deposited. Zarrilli certified, in accordance with the preprinted language on the Mortgagee's Certificate (a HUD Form), that the owner's equity had been placed in a depository "satisfactory to us." (FF 10). The evidence demonstrates that it was a common practice in St. Louis, which was condoned by HUD, to allow mortgagors in the St. Louis area to tender required owner's equity at closings. This evidence was provided, in large part, by the Government's witnesses, and the Government did not call other witnesses with sufficient expertise in St. Louis area commercial practices to rebut it. (*See e.g.*, Sheredano, Tr. p. 514; Kenney; Tr. p. 601; Thomas; Tr. pp. 695-697. *See also*, Bullock, Tr. pp. 906-907). Since this was an acceptable commercial practice in St. Louis, then it was appropriate for Zarrilli to make the certification at closing, upon receipt of the funds. Since the check was transferred at closing to Kenney and deposited (FF 11), I find no evidence that Zarrilli falsely certified that the funds had been deposited. I further find that Kenney's custody of the check was the substantial equivalent of deposit.

The evidence before me raises an issue, unresolved in this record, as to whether Zarrilli should have exercised a higher degree of care in making the certification in issue. Zarrilli, however, was not charged with lack of due care, but rather was charged with the making of a false certification. In this context, the Government has not met its burden of proof. Zarrilli's certification, although inaccurate to the extent that it does not set out the total amount of funds that he perceived were tendered, was not made with any intent to deceive HUD, and

the circumstances at closing, with the pressure to close and the constant changing of numbers by HUD, were indeed difficult, at best. I, accordingly, conclude that Zarrilli's certification does not constitute grounds for debarment under 24 C.F.R. §§24.305(b), (d), and (f), nor am I persuaded by these facts that Zarrilli lacks present responsibility.

II. The Draw Requests

The Government charges in Counts II and III of its complaint that, with respect to draws 13 and 16, Zarrilli misdirected the disbursement of mortgage proceeds in violation of the Building Loan Agreement and the explicit terms of the draw requests. The Government contends that the alleged misdirection occurred when Zarrilli directed the escrow agent to pay certain line items on these draw requests in amounts that did not correspond to the ratio of 74 per cent FHA funds to 26 per cent UDAG funds. The Government argues that these actions are cause for debarment under 24 C.F.R. §§24.305(b), (d), and (f).

Zarrilli contends that neither the approvals by HUD of draws number 13 or 16, nor any HUD regulation, required that each line item be paid 74 per cent from FHA-insured funds, and 26 per cent from UDAG funds, and that the total payment authorized from FHA-insured funds did not exceed 74 per cent on either draw. Zarrilli further contends that he directed payments on these draws to avert a default on the bond and the lapsing of the mortgage insurance, and that FHA-insured funds had to be used because UDAG funds had not then been made available for disbursement.

There is no language in the Building Loan Agreement executed by Thomas and MTB on December 30, 1990 (Govt. Exh. 2), that required Zarrilli to prorate payments on draw requests by line item. Likewise there is no specific instruction on the draw request forms, in HUD's hand-written notations thereon, or in any other document in this record that explicitly mandates proration by line item. (*See, e.g.*, Govt. Exhs. 4, 6).

Zarrilli's position on this issue is corroborated by the testimony of witnesses for both sides. Richard Fitzgerald, a Realty Loan Specialist in the HUD St. Louis Office, was called as a witness on this subject by the Government. Fitzgerald testified that there is no HUD regulation nor language on the HUD draw request form that requires proration by line item, and he characterized the proration problem as one involving record keeping. Fitzgerald also stated that mortgagees would not know about HUD's preference as to proration unless informed of such by HUD. (Fitzgerald, Tr. pp. 114, 119, 125, 127).

Zarrilli's position is also corroborated by the testimony of Wilbur R. Mackin, former Chief of the Mortgage Credit Branch in the St. Louis HUD Office (Mackin Depo., Resp. Exh. QQ, pp. 58-59); Johnny Bullock, a former Manager of the HUD St. Louis Office (Tr. p. 911); and William Thomas, who testified that on three other HUD projects with FHA/UDAG funding, like the Drake, which were closed at about the same time as the Drake, the St. Louis HUD Office simply allowed Thomas to pay the HUD-approved expenses on each draw request 100 per cent from FHA-insured mortgage proceeds until the UDAG monies flowed and no one from HUD said that there was "some reg or rule or contract or bookkeeping requirement" which required a 74%/26% line item proration. (Thomas, Tr. pp. 689, 691).

Although Susan Stegmoeller testified that Zarrilli should have resolved the funding shortfall by calling in the mortgagor's $125,000 letter of credit (Tr. p. 277), there was also credible testimony that Zarrilli's actions were reasonable and prudent, under the circumstances. (Lange, Tr. p. 47; Thomas, Tr. p. 704; Bullock; Tr. pp. 912-914). In light of the language in the bond indenture, which appears to require the mortgagee to start the default process in the event of nonpayment of interest (Resp. Exh. Q, *Indenture of Trust* dated December 1, 1986, §§801-804), it appears that Zarrilli's actions were taken to protect what he reasonably believed to be the project's best interests. I do not find that Zarrilli's actions on draws 13 and 16 establish a lack of present responsibility. On the contrary, his actions were quite responsible given the serious financial calamity which could have resulted if a default had occurred.

In the absence of evidence that a strict line item proration was required by statute, regulation, or other guideline chargeable to mortgagees by actual or constructive notice, and for the reasons stated above, I find that the Government has not carried its burden of proof on Counts II and III.

B. Respondent Mark Twain Bank

Applicable Regulations

The Mortgagee Review Board may impose sanctions, including withdrawal of a mortgagee's HUD/FHA approval, when any report, audit, investigation or other information before the Board discloses that a basis for an administrative action against a mortgagee exists under 24 C.F.R. §25.9. *See* 24 C.F.R. §25.5. A withdrawal sanction must be for a reasonable, specified period of time commensurate with the seriousness of the ground(s) for withdrawal, generally not to exceed six years. A withdrawal may be for an indefinite time period for egregious or willful

violations by the mortgagee. 24 C.F.R. §§25.5(d)(1), (2), and (3). The Government has the burden of establishing that cause for withdrawal of approval exists. 24 C.F.R. §26.23(g).

24 C.F.R. §25.9, provides in relevant part, that one or more of the following violations may result in an administrative action by the Board under §25.5:

> (j) Violation of the requirement of any contract with the Department, or violation of the requirements set forth in any statute, regulation, handbook, mortgagee letter, or other written rule or instruction;
>
> (k) Submission of false information to HUD in connection with any HUD/FHA insured mortgage transaction;
>
> * * * * *
>
> (p) Business practices which do not conform to generally accepted practices of prudent lenders or which demonstrate irresponsibility;
>
> * * * * *
>
> (w) Any other reasons the Board, Secretary, or Hearing Officer, as appropriate, determine to be so serious as to justify an administrative action.

The Government asserts that the alleged acts constitute cause for withdrawal of MTB's HUD/FHA mortgagee approval pursuant to 24 C.F.R. §§25.9(j), (k), (p), and (w).

I. False Certification; Lack of Knowledge by MTB of HUD/FHA Regulations

The Government charges in Count I of its complaint that MTB made false certifications on the Mortgagee's Certificate and caused such false certifications to be submitted to HUD. Count I further charges that Mark Twain Bank authorized an agent (Zarrilli), who had little, if any, knowledge of HUD/FHA requirements, to act on its behalf at the closing.

For the reasons stated above (Discussion, False Certification), I do not find the facts attendant to the execution of the Mortgagee's Certificate to be sufficient cause for the withdrawal of MTB's HUD/FHA mortgagee approval under §§25.9 (j), (k), (p), and (w).

As to Zarrilli's alleged lack of knowledge of FHA/HUD requirements, the Government contends that as a condition of

being a HUD-approved lender, MTB agreed and certified that it would comply with all provisions of the Department's regulations and other requirements of the Secretary of HUD. (*See, e.g.*, Govt. Exhs. 8, 9, and 10). The Government points out that in order to be a HUD-approved mortgagee, a mortgagee must "employ trained personnel competent in all aspects of mortgage lending to perform their assigned duties," 24 C.F.R. §203.2(a)(2). The Government contends that Zarrilli lacked the degree of competence mandated by this regulation to act on MTB's behalf on this project.

MTB asserts the defense that it and Zarrilli relied upon Gershman, as the originating mortgagee and as the servicing mortgagee, to ensure full compliance with all mortgagee activities before the initial closing, at the initial closing, and thereafter. (Zarrilli, Tr. pp. 755-756, 762-765, 777).

MTB's position that it relied upon Gershman's expertise at closing is corroborated in part by the terms of the loan servicing agreement, which was executed by MTB and Gershman on December 1, 1986, thirty days before the closing. (*See Agreement for Servicing Loan*, Resp. Exh. A). Under the terms of this agreement, Gershman was an independent contractor of MTB who was required to "comply with all applicable provisions of the United States Housing Act of 1937, as amended, and all rules and regulations issued thereunder in the performance of this agreement." Gershman was also required to use "at least the same degree of care in servicing the [loan] as it employs in servicing mortgage loans on behalf of FNMA" and to "[p]roceed diligently to collect all payments due under the Mortgage Loan and note . . . as they become due . . . ." *Id.*, paragraphs 1, 4, 11, and 16. This agreement can reasonably be interpreted, by virtue of both its date of execution and the various duties set forth therein, to have required Gershman to have performed on behalf of MTB, many of the mortgagee's duties at closing.

The testimony of several witnesses indicates that Gershman performed the functions of mortgagee, not only before the closing, but also at the closing. (Kenney, Tr. pp. 594-95; Thomas, Tr. p. 693); (Worth, Tr. p. 166). While Sheredano's testimony with respect to his duties at closing was essentially that he had no duties except to collect monies due Gershman, Sheredano stated that his role at the closing was "to see that everything keeps going." He admits that Zarrilli asked him questions at closing and that he responded to these questions. (Sheredano, Tr. pp. 476, 480, 518).

Zarrilli's testimony on this issue is corroborated by the terms of its loan servicing agreement with Gershman and is consistent with the credible testimony of other witnesses. I thus find that MTB and Zarrilli reasonably believed that they were entitled to rely on Gershman's expertise at closing, to

assist MTB in the performance of the mortgagee's duties at closing.

There was substantial agreement at trial by witnesses for both sides that Gershman was a reputable and experienced HUD-approved mortgagee and that Zarrilli's reliance on Gershman was reasonable. (Lange, Tr. p. 21; Worth, Tr. p. 165; Haile-Sellassie, Tr. p. 417; Kenney, Tr. p. 595; Mackin Depo., Resp. Exh. QQ, p. 20).

I do not find, under the facts and circumstances of this case, that Zarrilli's participation in the either the closing or the post-closing administration of the mortgage on behalf of MTB necessarily violated the employment provisions of 24 C.F.R. §203.2(a)(2). There is no language in the applicable HUD regulation, including the definitions section, that precludes mortgagees from employing independent contractors of sufficient competence, such as Gershman, to assist them in the performance of their duties as mortgagee.

Although Zarrilli admits that he is only "generally" familiar with HUD/FHA regulations and requirements (Zarrilli, Tr. p. 832), his reliance on Gershman's widely recognized expertise was reasonable and within the scope of the applicable regulation. I conclude on this basis that Zarrilli's activities on the project on behalf of MTB do not establish grounds for the sanction imposed by the Mortgagee Review Board under 24 C.F.R. §§25.9 (j), (k), (p), and (w).

II. Inadequate Cash Control

The Government charges in Count II of its complaint that MTB failed to maintain adequate controls over the disbursement of project funds, asserting that the mortgagor's cash was never deposited with MTB and never in a depository under an agreement approved by HUD; that the project escrow agent acted at the direction of the mortgagor and made disbursements totalling more than $624,000 using HUD grant funds impermissibly; and that MTB authorized an agent who had little, if any, knowledge of HUD/FHA requirements to act on its behalf with regard to the project mortgage. The Government asserts that the alleged acts constitute cause for withdrawal of MTB's HUD/FHA mortgagee approval pursuant to 24 C.F.R. §§25.9(j), (k), (p), and (w).

MTB admits that the mortgagor's cash was never deposited with MTB or in a depository under an agreement approved by HUD, but contends that under local custom and practice, mortgagees in the St. Louis area were not in fact required by HUD to enter into HUD-approved depository agreements. MTB also admits that Community Title acted at the direction of the mortgagor and made improper disbursements of $624,000 using HUD grant funds. MTB

contends, however, that the improper disbursements were not caused by inadequate cash controls on the part of MTB, but rather were caused by the improper disbursement of escrow funds by Community Title, and the failure of Gershman to either properly monitor Community Title's activities or to assure that project disbursements were made pursuant to the HUD-approved draw requests.

Although HUD regulations do require an agreement between a project escrow agent and mortgagee to be approved by the FHA Commissioner (24 C.F.R. §207.19(c)(2)), the testimony at trial clearly establishes that many key officials of the HUD St. Louis Office, both present and former, were unaware of this requirement, and did little, if anything, over an extended period of time, to enforce it. (Bullock, Tr. pp. 898, 900-901, 908-909; Mackin, Depo., Resp. Exh. QQ, pp. 31-32; Worth, Tr. p. 179-180). Stewart Kenney, who has served as the escrow agent for forty or more HUD multi-family transactions in the St. Louis area, testified that he never had a written escrow agreement with the mortgagee on any of these transactions, and testified that the HUD St. Louis Office did not require a written escrow agreement. (Kenney, Tr. p. 592).

HUD's Mortgagee's Certificate requires the mortgagee to certify that the "[m]ortgagor has deposited with us *or subject to our order in a depository satisfactory to us, the . . . [c]ash required* . . . ." (FF 10) (emphasis supplied). While the Government argues correctly that HUD area offices do not possess the authority to waive the requirements of this provision, it is hardly surprising, under the facts in this case, that mortgagees in St. Louis were not complying with it. In any event, it would not appear that an administrative sanction is now warranted in this case, absent a warning that the HUD St. Louis Office will no longer condone or be a participant in such entrenched practices.

Zarrilli and MTB relied on Community Title and Kenney to perform their responsibilities as escrow agent in a proper, ethical, and lawful manner. (Zarrilli, Tr. p. 759-760). There was no dispute that Community Title and Kenney were reputable and experienced project escrow agents and that Zarrilli's and MTB's reliance on Community Title and Kenney was reasonable. (Haile-Sellassie, Tr. p. 418; Sheredano, Tr. pp. 516-517); Thomas, Tr. pp. 693-694; Mackin Depo., Resp. Exh QQ, p. 31). In addition, the record establishes that Community Title and Kenney understood their fiduciary duties to HUD and MTB, as project escrow agent. (Kenney, Tr. pp. 591-604).

The record reveals, at best, a violation of a regulation that was apparently not being enforced by the HUD St. Louis Office. While the failure to enforce the regulation does not amount to a waiver of the regulation, this failure is a mitigating factor. Moreover, there is no evidence that MTB's

utilization of Community Title as project escrow agent was imprudent or otherwise unreasonable. Federal courts have long considered whether the alleged violations were "isolated errors or "part of a pervasive pattern of imprudent practices." *Mechanics National Bank v. U.S. Department of Housing and Urban Development*, 522 F.Supp. 25, 28-30 (D.D.C. 1981) (affirming *Mechanics National Bank*, HUDBCA No. 77-5-MR (March 6, 1979, as amended July 27, 1989) (available on LEXIS, PUBCON library, HUD file)). I do not find MTB's violation of the Department's regulation, on one occasion in 1986, to be willful, egregious, or of a degree of seriousness to warrant the withdrawal of MTB's HUD/FHA mortgagee approval, for an indefinite time period. I, accordingly, conclude that the Government has not offered sufficient evidence to support a finding that MTB failed to maintain adequate cash controls by virtue of its utilization of Community Title, as project escrow agent.

With respect to the remaining cash control allegations, the evidence establishes that Community Title misapplied $500,000 in project escrow funds to pay for the land underlying the project, without informing Zarrilli, MTB or HUD, on whose behalf Community Title was admittedly acting as agent. (FF 11; Will, Tr. pp. 569, 572). The evidence also establishes that Community Title misapplied an additional $124,852 by writing a check for this amount, at closing, to Solon Gershman, Inc.; that Sheredano then caused Gershman to write its company check for the identical amount to MTB to cover project bond related expenses; and that Sheredano and Gershman failed to notify or otherwise inform Zarrilli or MTB that the $124,852 had originated from a Community Title check paid from project escrow funds, rather than from separate bond transaction funds. (FF 9). The Government asserts that these misapplications of funds establish that MTB's cash controls were inadequate.

MTB's loan servicing agreement with Gershman was a key component in MTB's cash control mechanism. This agreement, which was quite detailed and elaborate, imposed duties upon Gershman to both collect and account for funds due under the terms of the mortgage loan, on a monthly basis. (*See generally*, Resp. Exh. A).

The evidence establishes, and Gershman admitted at hearing, that it did virtually nothing to assure that it in any way complied with its obligations to MTB under the loan servicing agreement. (Will, Tr. p. 547; Sheredano, Tr. 507, 587). The evidence also establishes that some of Community Title's disbursements were not approved in a draw request, and that Community Title knew it could not disburse escrow funds without such an approved draw request. (Kenney, Tr. pp. 603-604). There is no evidence that MTB could have anticipated that the funds in question would be improperly disbursed, or that such improper disbursements resulted from any inadequacy in MTB's cash controls. The mere fact that improper disbursements were made

does not establish, *ipso facto*, that the controls were inadequate.

I find on this evidence, as did the Department's Mortgagee Review Board, that "problems with the project fund disbursal (*sic*) system may have been averted if [Gershman] had maintained adequate quality control procedures for multifamily loan servicing . . . ." (July 10, 1989 letter addressed to Mr. Solon Gershman, signed James E. Schoenberger, Chairman, Mortgagee Review Board, Resp. Exh. II). These improper disbursements would not have been made if Gershman and Community Title had performed their respective obligations to MTB and the Department. In view of the foregoing reasons and since the Government has submitted no evidence that addresses the adequacy of MTB's cash controls, I find that the Government has not met its burden of proving that MTB failed to maintain adequate controls over the disbursement of project funds.

Respondents assert, as an affirmative defense, that the sanctions in question are punitive. As grounds for this defense, Respondents assert that HUD has taken no action against Community Title, and has lifted a sanction against Gershman, upon Gershman's submission to HUD of a new quality control plan.

In order to prove that HUD's action is punitive, Respondents must demonstrate that: (1) others similarly situated have not been subjected to as severe a sanction; and (2) that the allegedly discriminatory action was based on an impermissible motive. *Karen Kay Lujan*, HUDALJ No. 90-1413-DB (Jun. 22, 1990), citing *Oyler v. Boles*, 368 U.S. 448, 456 (1962); *United States v. Ness*, 652 F.2d 890, 892 (9th Cir. 1980), *cert. denied*, 454 U.S. 1126 (1981). Although there is some evidence in this record that supports Respondents' disparate treatment claim, I do not find this evidence, standing alone, sufficient to satisfy the second prong of the test. I find for this reason that Respondents have not satisfied their burden of proof on this issue.

Conclusion and Order

The record in this case does not establish that either Zarrilli or MTB engaged in intentional wrongdoing. The errors of Zarrilli and MTB appear to be one time, isolated acts which occurred under unique and somewhat trying circumstances. There is no evidence that Zarrilli or MTB intended to deceive the Department; no evidence that Respondents made or intended any wrongful gains; and no evidence of financial injury to the Department as a result of the problems at issue. In addition, the underlying transactions took place almost four years ago, and there is no evidence of any irresponsible conduct by either Respondent since that time. I consider this passage of time to

be a mitigating circumstance. *Norma Coleman*, 88-3432-D42 (Feb. 15, 1990)(available on LEXIS, PUBCON library, HUD file), and I so hold here. Respondents have also indicated that corrective action has been taken, by requiring the presence of their own counsel at closings. (Zarrilli, Tr. p. 895). I find such corrective action to be mitigating.

Under the circumstances of this case, I do not find that either Respondent lacks present responsibility. For the above reasons, it is my conclusion that: (1) The debarment of Zarrilli is not warranted under the circumstances of this case; (2) the indefinite withdrawal of MTB's HUD/FHA mortgagee approval is not warranted under the circumstances of this case; and (3) while MTB's violation of 24 C.F.R. §207.19(c)(2) constituted grounds for the imposition of an administrative sanction, a sufficient period of time to protect the public interest has elapsed during which MTB did not participate as a HUD/FHA approved mortgagee. Consequently, it is my determination that the withdrawal of MTB's HUD/FHA mortgagee approval shall be terminated, and that MTB's HUD/FHA mortgagee approval shall be restored immediately.

ORDERED this 28th day of November, 1990.

Timothy J. Greszko
Administrative Judge