P R O C E E D I N G S

11:53 a.m.

In the Matter of)
)
STEPHEN J. FERRY,)
BETH AN FERRY,)
) HUDBCA No. 90-5228-D17
and) Docket No. 90-1424-DB
)
FERRY FINANCIAL, INC.,)
)
Respondents.)

BENCH DECISION AND ORDER

Statement of the Case

By letters dated November 21, 1989, Stephen J. Ferry and Beth An Ferry, Respondents in this case, were notified that the U.S. Department of Housing and Urban Development intended to debar them and their affiliate, Ferry Financial Inc., from participation in all Departmental programs for an indefinite period of at least five years on the grounds that they allowed funds from custodial accounts to be used to pay corporate expenses and for continuing to originate, fund, acquire, and sell FHA mortgage loans at American Mortgage Securities Exchange, Inc. (American) after American's mortgagee approval had been withdrawn.

Respondents were temporarily suspended pending determination of debarment. They made a timely request for a hearing on their proposed debarment. It was agreed that a bench decision would be issued pursuant to 24 C.F.R. Section 26.24(d) at the end of the hearing. This is the bench decision in this case.

FINDINGS OF FACT

1. Stephen J. Ferry is the owner-operator of Ferry Financial, Inc. He has been in the mortgage lending business since 1967 and, until 1989, the vast majority of his experience was with government insured loans. He started Cal Home Capital in 1978 with his wife, Beth An Ferry, as co-owner. In 1984, the name of Cal Home Capital was changed to American Mortgage Securities Exchange, Inc. (American). Stephen Ferry was the President and Chief Executive Officer of American until August, 1987, when he turned over the title and role of President to Robert Joyce. Ferry thereafter held the title of Vice President but took no active role in Corporate affairs from August, 1987 until about January, 1989, when he returned as an active officer. He had become ill in early 1986 and was unable to do more than part-time work as a loan officer, when he was not hospitalized, until January, 1989. When Ferry returned full time in January, 1989, Joyce continued as President and CEO of American.

3. In September, 1979, American applied to HUD-FHA for approval as a non-supervised mortgagee allowed to participate in HUD-FHA mortgage programs. In its application, American agreed to comply with the provisions of FHA regulations and other requirements of the FHA Commissioner. It also agreed to use escrow funds only for the purpose for which they were received and to submit an annual audited financial statement prepared by an independent CPA within a reasonable time following the end of its fiscal year. American was required to maintain a net worth of $100,000 or more with assets acceptable to FHA to continue as a non-supervised approved mortgagee. American was approved as a non-supervised mortgagee by HUD-FHA.

4. American failed to submit an annual audit report for the fiscal year ending July 31, 1988 in a timely manner as required by HUD.

5. Timothy Lafranchi, the independent CPA who had been preparing annual audit reports for American since 1980, and who also had been preparing monthly and quarterly financial statements of American, had discovered, in preparing the audit for the fiscal year ending July 31, 1988, that custodial funds held by American through its loan servicing operations in

escrow for those purposes had been transferred to the corporate account through an "in transit" transfer and had been used to pay corporate expenses. The custodial funds so transferred appeared to be funds from mortgagors due to be paid to Freddie Mac by American on behalf of the mortgagors. Although the funds due to be paid each month to Freddie Mac were, in fact, paid on time, the custodial account had been depleted. As of July 31, 1988, the custodial account was missing $124,488. This was revealed on the face of the audit report prepared by Lafranchi. The audit report also showed, on its face, that American's net worth was less than $100,000. (Exh. G-2.)

6. Stephen Ferry found out, for the first time, as did Beth An Ferry, that the custodial funds had been misused on or after January 31, 1989, when a a copy of the audit report was provided to Mr. Ferry and he told Beth An Ferry about it. Stephen Ferry became enraged that such an impropriety could have occurred and planned immediately to take steps to cure the problem with the custodial fund account and to get an infusion of capital into American to increase its net worth.

7. American was also a participant in HUD's FHA program through which approved personnel of American

underwrote HUD-FHA loans. To be a participant in the Direct Endorsement Program, a mortgagee must be approved by HUD-FHA and is to have a net worth of $250,000. The $250,000 net worth requirement had been waived for American by HUD for the previous fiscal year and Stephen Ferry believed that HUD could and would waive both that net worth requirement and the $100,000 net worth requirement upon request to HUD.

8. HUD's Office of Lender Activities and Land Sales Registration sent an authorized letter to American dated February 27, 1989, stating that American's HUD-FHA approval was immediately withdrawn due to American's failure to submit an annual audit report and to pay annual fees. The letter also stated that American's approval would be "reinstated automatically upon submission of an acceptable audit report and remittance of the annual fee within 90 days" from the date of receipt of the letter. The letter further stated that American was to continue its responsibilities "in connection with outstanding HUD-FHA insured mortgage loans." It stated that the withdrawal of approval would not affect outstanding firm commitments, including construction loans under the multi-family program. It stated that conditional

commitments, however, should be assigned to a HUD-FHA approved mortgagee. For a Direct Endorsement lender, which American was, it was given the option of assigning such loan to an approved mortgagee or to submit direct endorsement applications "now in process for commitment processing" to the HUD field office within five days. The letter finally stated that HUD would accept no new applications for commitments, other than those specifically described in the letter, and would return pending applications. The letter was signed by William M. Heyman, Director of the Office of Lender Activities. (Exh.G-1.)

9. American received the letter withdrawing its mortgagee approval on or about March 3, 1989. Both Stephen Ferry and Robert Joyce immediately tried to reach William Heyman to work out a plan by which American could be reinstated. Their telephone calls were not returned by Heyman until April 17, 1989, but Heyman's staff was communicating with American during this time period.

10. American immediately sent the audit report prepared by Lafranchi and the required fee to HUD. Stephen Ferry assumed that, as soon as he sent the report, American would be "automatically reinstated" based upon his understanding of the February 27, 1989

letter.

11. By letter dated March 10, 1989, HUD notified American that it was unable to reinstate its approved status because the audit report filed was not acceptable to HUD. The deficiencies in the audit report that were noted in the March 10, 1989 letter were that American's net worth was only $49,714, the diversion of the custodial funds for company use, and the listing of Ferry's home as an asset in exchange for stock was a non-acceptable asset. The letter also required further explanations of these matters and remedial action. It was signed by Sandra Allison, Director of the Lender Approval and Recertification Division of HUD-FHA. (Exh. G-5.)

12. Between March 27, 1989 and May 1, 1989, Robert Joyce wrote Sandra Allison and other HUD officials to try to explain the matters questioned in Allison's March 10, 1989 letter. The underfunding of the custodial fund account had been reduced to $60,697 from the sale of the servicing department, and those proceeds were paid directly to Freddie Mac. Stephen Ferry was trying to find an investor for American to bring capital into the company to increase its net worth. Ferry finally found an investor that he believed would be acceptable to HUD and set up a meeting with

Heyman, Allison, HUD attorney Bruce Albright, Mr. Ferry, the investor, and the investor's accountant. Stephen Ferry believed the purpose of the meeting, when held, would be to approve the investor and reinstate American.

13. In response to Sandra Allison's March 10, 1989 letter, American submitted a revised audit report which was not accepted by HUD because the net worth requirement had not been satisfied. American then submitted a re-revised audit report dated May 1, 1989, and a letter dated May 18, 1989 from its CPA explaining answers to the questions raised by HUD. HUD continued to determine that American could not be reinstated because of the net worth problem and notified American of its decisions in writing.

14. The letters written by Joyce to HUD, and the audit in each revision, stated the trust, otherwise referred by the parties in this case as custodial funds, were used to pay corporate expenses. No explanations were offered for why or how that occurred.

15. By letter dated May 5, 1989, the Mortgagee Review Board notified American that the February 27, 1989 withdrawal letter was being amended based on the diversion and improper use of mortgagor trust (custodial) funds. American's approval was withdrawn

by that letter for a period of three years. The letter was unequivocal and clear that American's approval had been completely withdrawn. It made no allowance for the continuance of any activities for which mortgagee approval was required. (Exh. G-12.)

16. American was notified of its right to request a hearing on the withdrawal of approval for three years. It did so, but later withdrew its request.

17. The withdrawal of mortgagee approval remained in effect at all times from March 3, 1989, when American received the February 27, 1989 letter, until the present.

18. During the time that American has had its mortgagee approval withdrawn, from March 3, 1989 to about October 1, 1989, it continued to underwrite, hold, close, and transfer loans that were to be insured by HUD-FHA. Both Stephen Ferry and Beth An Ferry were aware of this and actively participated in it. The only functions that Stephen and Beth An Ferry believed American could not perform after its withdrawal of approval were that, it could not solicit new loans, it could not obtain an FHA case number through the CHUM system, it could not request an appraisal for a loan to be insured by HUD, and it could not submit a file to HUD-FHA. Both Ferrys

testified that they continued to do business at American exactly as before the withdrawal of approval with the few exceptions described by Beth An Ferry.

19. American underwote loans that were to be insured by HUD-FHA through Jennie Gunderson, an approved underwriter with American. American's other approved underwriter refused to underwrite any more loans to be insured by HUD-FHA after the withdrawal and notified Stephen Ferry that she would be risking her approval as an underwriter to do so. Nonetheless, American continued to have loans underwritten and Stephen Ferry never even checked with HUD or another approved lender to determine whether underwriting was a permissible function for a lender lacking mortgagee approval.

20. Between March 3, 1989 and September 30, 1989, Golden Pacific Mortgage Company (Golden), a HUD-approved loan correspondent, originated a series of FHA mortgages in its own name but the loans were underwritten by American through the Direct Endorsement Program. Golden assigned the loans to American which, in turn, assigned the loans to Empire American Realty Company, which became the assignee of 128 loans to be insured by HUD-FHA. Beth An Ferry signed the documents assigning the loans to Empire.

On some of the loans, she also signed for American on HUD Form 92900. Ferry Financial, Inc. was listed on the Deed of Trust notes of at least some of the loans as the trustee. Sometimes Golden closed the loans before assigning them to American and sometimes the loans were assigned before closing and American closed them.

21. Beth An and Stephen Ferry had read or were aware of the contents of the February 27, 1989 letter from HUD, as well as the March 10 and May 5 letters.

22. After American's HUD-FHA approval was withdrawn, Beth An and Stephen Ferry participated as officers and employees of American in the funding, acquisition, and sale of between 128 and 160 loans including the sale of 128 FHA loans to Empire.

23. Stephen and Beth An Ferry stipulated that they knew and understood that FHA approval was a statutory and regulatory requirement for a mortgagee lender to participate in the origination, funding, acquisition, and/or sale of FHA loans. However, in their testimony, they negated this stipulation by testifying under oath that they believed at all times that American could underwrite, fund, hold, assign, and sell loans that were to be insured by HUD-FHA. They testified that they believed that they were not

violating HUD requirements by continuing to perform these acts after American's mortgagee approval had been withdrawn. Stephen Ferry stated that he would do essentially the same things today, under the same circumstances.

24. HUD Handbook 4060.1, given to American when it became a HUD-FHA approved mortgagee, makes clear that approval is needed to submit applications for insurance, purchase, hold, service, and sell HUD-insured mortgages. It also makes clear that the mortgages covered by the approval requirement are those originated with an intent that FHA mortgage insurance will be applied for, even if the mortgage insurance certificate is not issued until a later date. (Ext. G-31.)

25. Beth An Ferry never told anyone at Empire or Golden that American was no longer a HUD-approved mortgagee. Stephen Ferry did not tell anyone at either Empire or Golden until Cheryl Jaster confronted him about that fact in about May, 1989, according to him, although Jaster denied having been told anything about the withdrawal by anyone at American. I find Stephen Ferry's testimony in this regard to be more reliable. He assured Jaster that American was negotiating with HUD and that he expected reinstatement within four to

six weeks. When Jaster checked back with him on American's status in September, 1989, he admitted that American was still not reinstated. Empire refused to do any more business with American from that point.

26. Both Ferrys believed that it was in the best interests of their employees, and of HUD, to continue to do HUD-FHA business while they were negotiating with HUD to have American be re-approved. They did not think that it was "hurting" anyone to do so.

27. Sometime subsequent to the reduction of the imbalance in the custodial account, it was again used for improper purposes and its imbalance increased to over $120,000. Stephen Ferry did nothing to correct this matter other than to be very upset that it had occurred again.

DISCUSSION

Debarment is a sanction to be imposed in the public interest and the best interest of HUD. Establishment of a cause for debarment does not, *per se*, mandate imposition of the sanction and all relevant mitigating factors are to be considered. The test for the need for debarment is the present responsibility of participants. However, a finding of lack of present responsibility may be based on past acts.

Beth An and Stephen J. Ferry are principals as defined in the regulations applicable to debarment and Ferry Financial is their affiliate. These matters have been stipulated by the parties. HUD may debar principals and affiliates. I find that cause for debarment has been established because both Ferrys, in their roles as employees and officers of American, committed violations of the terms of a public agreement in one or more transactions so serious as to affect the integrity of HUD-FHA's Direct Endorsement Program and its Unsupervised Mortgagee Approval Program. These are grounds for debarment under 24 C.F.R. Section 24.305(b). While I do not find that either Stephen or Beth An Ferry knew or should have known of the initial misuse of the custodial funds, which are a category of escrow funds that may not be used to pay corporate expenses, I find that they knew about it when it recurred. Their accountant only discovered it initially when doing an in-depth year-end audit. The funds transfer was done in such a way as to be difficult to detect. However, the problem recurred after Stephen Ferry returned to work and he was made aware of it. He asked Anita Domondon about it and she responded by fleeing from his office. Domondon quit two days later. Ferry always assumed she was the cause of the problem but did not fire her because he dreaded the cost, financially and psychically, of an employee lawsuit. He therefore did nothing except express his distress to Robert Joyce when the problem recurred and apparently did not give clear directives that such fund transfers could not be done when he found out about them initially. This was a failure of responsible conduct that is to be expected from an officer and owner of a HUD participant. It is appalling in its helpless resignation from accepting responsibility. It also calls into question Stephen Ferry's sincerity that he understood how unacceptable this handling of funds was by his response when it occurred again.

The more troubling aspect of this case is the extraordinary continuation of business pretty much as usual after the withdrawal of mortgagee approval. Both Ferrys made a decision to conduct their business in this matter because "no one was hurt" as they saw it, and they were sure that HUD would reinstate them retroactively, thereby making the 128 loans they sold to Empire insurable by HUD-FHA. I find it absolutely incredible that they did not realize that they were performing functions not permitted of lenders without mortgagee approval. They had the HUD Handbook and are bound to know and comply with HUD rules and regulations. It was all there in black and white. Even if the February 27, 1989 letter was somewhat confusing and perhaps contradictory, it was still clear that approval was withdrawn and what that meant. Any questions in this regard certainly should have been put to rest by the Mortgagee Review Board's letter of May 5. But business continued as usual until Empire refused to buy any more loans from American and it became clear that HUD was not going to reinstate American or give pre-approval to its investor. This was the height of irresponsibility by the Ferrys. It was stupid. It was irrational. It had no foundation in reality. It ultimately put Empire in the position of having to resubmit the loans for underwriting so that they could be issued insurance certificates by HUD-FHA.

The impact on the direct endorsement program and the mortgagee approval program was serious and appalling. Government programs exist for a purpose. Net worth requirements serve a purpose. Requirements that funds be handled properly have a purpose. The Ferrys never considered those purposes as important, from a standpoint of the public or HUD, only their own need to keep their business going. So they told no one about the withdrawal, even those such as Empire and Golden that needed to know about it, and continued to live in a dream world where the government would forgive them their trespasses retroactively. They also were never open with HUD that they were continuing to do HUD-FHA business or, they can be sure, they would have been facing both a longer withdrawal and debarment much sooner.

Their attitudes at this hearing have been at sharp variance with the stipulations entered on their behalf. They profess ignorance of HUD rules and regulations, quibble with them, and were generally defiant. They have no more understanding today of why HUD is so distressed with their conduct than they did the day they received the withdrawal of approval letter. This is a tragedy because the Ferrys had exemplary careers for so many years. Nonetheless, I find that they are a poor risk as participants in HUD programs based on their conduct since March 3, 1989, which has been absolutely appalling in its passive-aggressive wholesale violations of almost every basic requirement for participation in the Direct Endorsement and Unsupervised Mortgagee Approval programs. Nothing in the record mitigates this conclusion. Their beliefs in retroactive forgiveness as an excuse for their total disregard of program requirements was absurd. In fact, it's shocking. It was in no way responsible.

Stephen Ferry had the opportunity, knowledge, and corporate position from which to prevent these irresponsible acts. He did not do so and, in fact, ratified them and participated in them. I find that a four-year period of debarment of Stephen Ferry, at the very least, is mandated in the public interest because of the seriousness of the violations that he could have prevented. What he did was actively subvert the purposes of the mortgagee approval program and the direct endorsement program, even after a warning from his own employee responsible for underwriting in the direct endorsement program. His professed concerns about his business are disingenuous in this context. Inasmuch as Stephen Ferry has been restricted from participation in HUD programs since November 21, 1989, almost a year, I will give him credit for that time, although it is clear to me that he has learned little and made no progress towards responsibility during this time. He shall be debarred until November 20, 1993.

Beth An Ferry took a less active role in the fateful corporate decisions after March 3, 1989, but she knew of them and participated in clearly unallowable activities after that date. A corporate officer may not simply be like the three monkeys, covering their eyes, ears, and mouth. To have remained silent about the withdrawal to those she dealt with regularly at Empire and Golden was not responsible. She, too, still is without any real understanding of why what she did was a serious violation that affected the integrity of departmental programs. Therefore, debarment of Beth An Ferry is warranted and necessary. However, because she went along, rather than led, and was not one of the decision-makers in fact, I find that a two-year debarment is warranted in the case of Beth An Ferry. She has been suspended since November 21, 1989 and will be given credit for that time. She shall be debarred until November 20, 1991.

SO ORDERED October 31, 1990.

JEAN S. COOPER
Administrative Judge and
Vice Chairman
HUD Board of Contract Appeals

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JUDGE COOPER: Both parties have got a right to request Secretarial reviews of this decision. You have 30 days from today to request such Secretarial review pursuant to 24 C.F.R. Section 24.713.

We will be in adjournment.

(Whereupon, at 12:20 p.m., the hearing in the above-entitled matter was closed.)