



Board of Contract Appeals
U. S. Department of Housing and Urban Development
Washington, D.C. 20410-0001

In the Matter of:

HERITAGE MORTGAGE COMPANY,

Respondent

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:
: HUDBCA No. 92-C-7603-MR11
: Docket No. 92-284-MR
:
:

Mr. Donald L. MacNeil
President and Chief Executive Officer
Heritage Mortgage Co.
1000 East 111th Street
Chicago, IL 60628

For the Respondent

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Office of General Counsel
Department of Housing and
Urban Development
Washington, D.C. 20410

For the Government

DETERMINATION BY ADMINISTRATIVE JUDGE DAVID T. ANDERSON

September 2, 1993

Statement of the Case

By letter dated June 23, 1992, Arthur J. Hill, Assistant Secretary for Housing of the U.S. Department of Housing and Urban Development ("HUD" or "Government") and Chairman of the Mortgage Review Board ("Board" or "MRB"), advised Donald MacNeil, President of Heritage Mortgage Company ("Heritage" or "Respondent"), that the MRB was, effective upon MacNeil's receipt of the letter, withdrawing the HUD-FHA mortgagee approval of Heritage for a period of two years. The letter also stated that the MRB had determined that "continuation of Heritage's approval during the period within which Heritage may request a hearing would not be in the public interest or [in the] best interests of the Department".

The letter further stated:

The withdrawal of Heritage's HUD-FHA mortgagee approval is based upon the failure of Heritage to fulfill its obligations pursuant to the March 29, 1991 Settlement Agreement between Heritage and the Department. Specifically,

Heritage: 1) failed to timely remit the first installment payment of \$12,923.33 due the Department pursuant to the Agreement; 2) failed to pay the Department the second installment payment of \$11,971.14 due pursuant to the Agreement; and 3) failed to remit to the Department the amount of \$13,914.79 presently due pursuant to the Agreement for the Department's claim loss with respect to FHA Case No. 131-553406. The failure by Heritage to comply with the terms and conditions of the Settlement Agreement is a violation of the Agreement and is grounds for withdrawal of Heritage's HUD-FHA mortgagee approval pursuant to 24 C.F.R. Sections 25.9(j), 25.9(p), and 25.9(w).

The withdrawal of Heritage's HUD-FHA approval is also based upon violations of HUD-FHA requirements by Heritage that were disclosed during a review of Heritage's HUD-FHA insured mortgage activities by the Department's Monitoring Division. The violations by Heritage include: 1) submitting loans in default to HUD-FHA for mortgage insurance endorsement; 2) failure to document the source of mortgagors' funds used for earnest money and/or closing costs; and 3) failure to verify the income used to qualify a mortgagor. These are violations of the Department's requirements as set forth in HUD Handbooks 4000.4 REV-1 AND 4155.1 REV-2, and are grounds for withdrawal of Heritage's HUD-FHA mortgagee approval pursuant to 24 C.F.R. Sections 25.9(g), 25.9(j), 25.9(k), 25.9(p) and 25.9(w).

By letter dated June 29, 1992, MacNeil, on behalf of Heritage, appealed the withdrawal of Heritage's Mortgagee Approval and requested a hearing within 30 days after the Department received the Mortgagee's request in accordance with 24 C.F.R. §25.8 (b). MacNeil's letter of appeal was received by the Department on June 30, 1992. A hearing in this matter was held on July 29-30, 1992, in Chicago, Illinois. This determination is based upon the testimony and exhibits admitted in that proceeding and upon consideration of pre- and post-trial submissions by the parties. Respondent's motion for a new hearing was denied by order dated October 8, 1992.

Findings of Fact

1. During all pertinent times, Heritage was a mortgage lender and an approved participant in a HUD program authorized by Section 203 of the National Housing Act, 12 U.S.C. §1709, where HUD-FHA insured loans are made by approved private lenders to qualified purchasers of single family homes. In 1985, Heritage was approved for participation in HUD's Direct Endorsement Program which allows mortgagees to underwrite and close mortgage loans without prior HUD review or approval. Under HUD's Direct Endorsement Program, Heritage was responsible for originating and underwriting loans which were insured by HUD, obtaining verifications of deposits and verifications of employment, obtaining credit reports, and ultimately approving the loan as an underwriter. Approved mortgagees, such as Heritage, are also required to meet certain financial eligibility criteria and to demonstrate competence in underwriting loans. (Tr. 26-27).

2. On March 29, 1991, HUD and Heritage entered into a Settlement Agreement, the pertinent parts of which are:

WHEREAS, HUD's Office of Inspector General conducted an audit of Heritage for the period August 1, 1987 through July 31, 1989, and issued an Audit Report dated June 13, 1990 (Audit Case No. 90-TS-221-1015); and

WHEREAS, the Audit Report alleged violations of HUD policies and prudent lending practices in the origination of HUD-FHA insured mortgages by Heritage, including Heritage's failure to have in place an adequate Quality Control Plan; and

* * * * *

WHEREAS, the Board considered the Audit Report and Heritage's written responses and unanimously voted to place Heritage on probation for a period of six months and to offer Heritage an opportunity to enter into a Settlement Agreement in lieu of further administrative proceedings in connection with this matter;

* * * * *

NOW, THEREFORE, HUD and Heritage agree as follows:

1. Heritage shall be placed on probation pursuant to 24 C.F.R. Section 25.5(b) for a period of six months commencing on October 18, 1990 and terminating on April 18, 1991. As conditions of probation, Heritage agrees to: (i) fully comply with all rules, regulations and other requirements of HUD pertaining to the origination and servicing of HUD-FHA insured mortgages; and (ii) maintain

a Quality Control Plan which conforms to the requirements set forth in Mortgagee Letter 89-32.

2. Heritage agrees to indemnify HUD for its losses on certain loans as described below....

(a) With respect to those loans identified by FHA Case Numbers 131-5209664 and 131-5122682, Heritage shall indemnify HUD for its losses thereon by paying to HUD, on or before the effective date of this Settlement Agreement, the amount of \$10,982.70 and by paying three additional installments, (including principal and interest at 9% per annum) to HUD on the following dates in the following amounts:

September 30, 1991 amount due: \$12,465.36
(including interest of \$1,482.66)

March 30, 1992 amount due: \$11,971.14
(including interest of \$988.44)

September 30, 1993 amount due: \$11,476.92
(including interest of \$499.22)...

3. Any material breach of the terms and conditions of this Settlement Agreement shall constitute independent grounds for imposition of administrative sanctions by the Board against Heritage pursuant to 24 C.F.R. Part 25.

4. Immediately after the effective date of this Settlement Agreement, the Board shall recommend to the HUD Chicago Regional Office that Heritage's Direct Endorsement privilege be unconditionally reinstated, provided that Heritage otherwise meets all requirements as a Direct Endorsement lender.... (Govt. Exh. 3).

3. Heritage was subjected to an 18-month probation while participating in the Direct Endorsement Program. This probationary period initially commenced on or about October, 1989, and terminated on or about April, 1991, and was imposed by the HUD Chicago Regional Office. A second, concurrent probation of Heritage was imposed by the Mortgagee Review Board on October 31, 1990; that administrative sanction was terminated in March of 1991 with the execution of the Settlement Agreement. Letters of complaint from Heritage to the MRB in the fall of 1990 seem to confirm that the relationship between Heritage and the HUD Chicago Regional Office was strained and troublesome. One of these letters even states:

In hindsight we now fear that HUD Chicago's objective was to force Heritage out of business in order to reduce the availability of credit

to the riskier markets within Chicago and also to claim credit for effective enforcement action.

On at least one occasion, Heritage claims that the Chicago Regional Administrator refused to meet with representatives of Heritage to discuss problems that Heritage was having with HUD. (Resp. Exhs. 8 and 9; Tr. 484-485; 544-547).

4. The lengthy probationary period had an adverse impact upon Heritage's loan processing activity. Heritage was operating in a very competitive market, and Heritage lost ground to other competitors because it was placed on probation by HUD. Many real estate agents turned away from Heritage and to other mortgage lenders because they were aware of Heritage's problems with HUD and believed that these difficulties would delay endorsement of loans. (Tr. 468-469, 475, 478-480).

5. The volume of loans originated and processed by Heritage dropped precipitously from approximately 720 in fiscal year 1989 to about 20 loans per month in the last nine months of 1990. In fiscal year 1991 Heritage processed about 25 loans a month. (Tr. 497-500).

6. In 1990 and 1991, Heritage suffered severe liquidity and cash flow problems which required infusions of capital from outside sources to cover general operating expenses. Income for Heritage during this period was insufficient due to a drop in loan closings. (Tr. 447-454).

7. The first payment from Heritage required by paragraph 2(a) of the Settlement Agreement, which was due on September 30, 1991, was transmitted to the Department by letter dated February 25, 1992 in the amount of \$12,923.33, an amount which reflected "the \$12,465.36 payment owed the Department ... and interest on the principal portion for the five months since September 30." (Govt's Exhibit 7).

8. By letter dated March 17, 1992, Hill advised Heritage that:

The Mortgage Review Board (Board) of the Department of Housing and Urban Development has considered the failure of Heritage Mortgage Company (Heritage) to timely fulfill its obligations pursuant to the March 29, 1991 Settlement Agreement between Heritage and the Department. The Board also considered your proposal to amend the terms of the Agreement.

You are hereby advised that the Board has deferred taking any action against Heritage

pending further review of Heritage's performance in remitting the March 30, 1992 indemnification payment due to the Department under the terms of the Agreement, and, a review of more recent (October 1991) Monitoring Division findings concerning the HUD-FHA insured mortgage activities of Heritage. (Govt. Exh. 8).

9. By letter dated March 26, 1992, Hill wrote Heritage:

This is to advise you that the Mortgagee Review Board (Board) of the Department of Housing and Urban Development is considering an administrative action against Heritage Mortgage Company (HMC) pursuant to 24 CFR Part 25 (copy enclosed). This letter also constitutes a 30-day notice as required by 12 U.S.C. 1708.

You are notified pursuant to 24 CFR Section 25.6 that any action by the Board would be based on violations of HUD/FHA requirements by HMC disclosed during a review of HMC's HUD/FHA insured mortgage activities by HUD's Monitoring Division from July 8-19, 1991.

The violations of HUD/FHA requirements by HMC include: 1) submission of defaulted loans for endorsement; 2) failure to document the source of funds used for earnest money and/or closing costs; and 3) failure to verify income used to qualify a mortgagor.

The foregoing are violations of HUD/FHA requirements as set forth in HUD Handbooks 4000.4 REV-1 and 4155.1 REV-2. You have 30 days from receipt of this letter to provide the Board with a written response to the monitoring review findings as set forth in Attachment "A" to this letter. Failure to respond within the 30 day period will result in a determination by the Board without the benefit of any comments or response that you may wish to provide.

Attachment "A" listed, as a basis for possible administrative action, the nine loans which "were in default when submitted for endorsement" despite Heritage's letter[s] that the "loans were current when endorsement was requested." Allegations of irregularities involving three other loans submitted by Heritage which were listed in Attachment "A" were withdrawn by

the Government. (Govt. Exh. 9).

10. By letter dated March 27, 1992, Heritage forwarded to HUD a check in the amount of \$11,971.14, representing the second payment due under the terms of the Settlement Agreement. The letter reiterated Heritage's request for a modification of the Settlement Agreement in order to defer the third payment due, and stated that Heritage had undergone "considerable pains" to make this second payment. At the time that this check from Heritage to HUD was issued, sufficient funds were available in Heritage's account to cover the check. (Resp. Exh. R-5; Tr. 459).

11. By letter dated March 30, 1992 to William Heyman, Director, Office of Lender Activities, at HUD Headquarters in Washington, D.C., MacNeil stated that, as a result of the administrative action being contemplated by the MRB against Heritage's "alleged violations pertaining to the same loan origination covered by the OIG audit which resulted in a settlement agreement between Heritage and the Department in March 1991": (1) Heritage viewed the Department's action as constituting a breach of agreement; (2) a check "in the amount of approximately of \$12,000 ... submitted to you on March 30, 1992 representing a payment as of that date" should be returned to Heritage; and (3) Heritage had placed a stop payment on that check. Heritage decided to take this action because it believed that the notice that the MRB was considering further sanctions against Heritage was in violation of the Settlement Agreement although the notice referred to irregularities on nine loans none of which were identified in paragraph 2(a) of the Settlement Agreement. The check was returned uncashed to Heritage. (Govt. Exhs. 10 and 11; Tr. 60-61; 539-544; 547-549).

12. As a participant in the Direct Endorsement program, Heritage's loans which were monitored by the HUD Chicago Regional Office had an unusually high default rate in 1991. (Tr. 151-152). In addition, some of the loans in Heritage's loan portfolio "were loans that were endorsed or sent in for endorsement that were showing to be having at least more than two payments in default at the time they were endorsed." (Tr. 158). In addition, several of Heritage's loans were submitted late to the HUD Chicago Regional Office for endorsement, i.e., submitted in excess of 30 days after closing for HUD/FHA insurance. (Tr. 160-163).

13. When a loan, accompanied by requisite documents, is submitted to the HUD Chicago Regional Office for endorsement, the documents are placed in a "binder" and date-stamped by the HUD office's mail clerk to show the date of receipt of those documents. On the front of each binder is another stamp, usually in the lower right corner, which indicates the date that the particular loan was endorsed for insurance by HUD's Chicago Area Office. (Tr. 246-248).

14. The Government submitted copies of documents relating to nine separate loans closed by Heritage and subsequently conveyed to HUD. These documents show basically that there was an unusual delay between the time these loans were closed by Heritage and the time they were submitted to HUD for endorsement. Each of the loan packages contains essentially a HUD-1 Settlement Statement, a cover letter and underwriter/mortgagee certification, and a letter from the mortgagee setting forth an explanation as to why the loan was submitted to HUD late. (Tr. 162-169; Govt. Exhs. 14-22).

15. A loan identified at hearing as the "Thompson" loan was closed on December 5, 1989; the underwriter/mortgagee certification is dated January 29, 1990; a "late letter" included with these loan documents indicated that the file was submitted to HUD late because the seller failed to sign a document at the closing, because of a severe backlog, and because the file was temporarily lost. (Govt. Exh. 14). The HUD case binder for the Thompson loan indicates that the loan documents were received from Heritage on July 19, 1990; the loan was endorsed for insurance on August 15, 1990. (Govt. Exh. 23).

16. The "Duncan" loan was closed on July 25, 1989; the underwriter/mortgagee certification is dated August 14, 1989; a "late letter" included with these loan documents indicated that the file was submitted late because "the city inspection which was done ... was inadvertently placed in the wrong file." This "late letter" is dated January 23, 1990. (Govt. Exh. 15). There was no HUD case binder offered into evidence with respect to the Duncan loan.

17. The "King-Gibson" loan was closed on November 9, 1989; the Settlement Agreement is dated November 9, 1989; the file contains no underwriter/mortgagee certification; a cover letter dated June 30, 1990, states that the file was being submitted late because the "MIP" statement was received late, and because of a severe backlog in Heritage's (mortgage loan processing) department. (Govt. Exh. 16). The HUD case binder for the King-Gibson loan indicates that it was received at HUD on July 26, 1990; the loan was endorsed for insurance on August 14, 1990. (Govt. Exh. 24).

18. The "Calbert" loan was closed September 22, 1989; the underwriter/mortgagee certification is dated October 23, 1989; a "late letter" included with these loan documents indicated that the file was submitted to HUD on "January 2, 1989" (sic) and that the reason the loan was submitted late was due to the failure of the sellers to sign the F09 Closing Statement. (Govt. Exh. 17). HUD case binder for the Calbert loan was received on January 26, 1990. No endorsement date is indicated on this HUD case binder. (Govt. Exh. 25).

19. The "Harris" loan was closed September 7, 1989; the underwriter/mortgagee certification is dated February 16, 1990; a "late letter" attached to a cover letter is dated July 20, 1990, and indicated that the file was submitted to HUD late because the "certification for this file was misplaced." (Govt. Exh. 18). The HUD case binder for this file has two dates stamped on it for the dates when the loan documents were received by HUD, i.e., July 27, 1990, and August 21, 1990. The date for the endorsement of the insurance is September 21, 1990. (Govt. Exh. 26).

20. The "Bernicky" loan was closed November 16, 1989; the underwriter/mortgagee certification is dated March 19, 1990; a "late letter," which is attached to a cover letter, is dated March 19, 1990, and states that the file was submitted to HUD late because "the termite [sic] had to be sent to the borrowers for signatures." (Govt. Exh. 19); there was no HUD case binder offered into evidence with respect to the Bernicky loan.

21. The "Roland" loan was closed October 17, 1989; the underwriter/mortgagee certification is dated November 15, 1989; a "late letter," attached to a cover letter dated November 15, 1989, indicates that the reason for this late submission was due to the illness of an underwriter. (Govt. Exh. 20). The HUD case binder for the Roland loan indicates that the loan documents were received July 26, 1990; the loan was endorsed for insurance on September 6, 1990. (Govt. Exh. 27).

22. The "Lige" loan was closed October 4, 1989; the underwriter/mortgagee certification is dated July 30, 1990; a "late letter" attached to cover letter dated November 13, 1989, indicates that the file was submitted to HUD late because of the illness of an underwriter and because of a backlog. (Govt. Exh. 21). The HUD case binder for the Lige loan indicates that the loan documents were received August 8, 1990; the loan was endorsed for insurance on August 30, 1990. (Govt. Exh. 28).

23. The "Robinson" loan was closed September 1, 1989; the underwriter/mortgagee certification is dated November 1, 1989; a "late letter," dated February 20, 1990 and included with these loan documents, indicates that the file was submitted late because of a "late charge on the MIP and we had to wait for a corrected MIP." (Govt. Exh. 22). The case binder for the Robinson loan indicates that the loan documents were received July 24, 1990; the loan was endorsed for insurance on August 6, 1990. (Govt. Exh. 29).

24. Charles Martinez, a loan specialist with the HUD's Monitoring Division in Chicago, a division of HUD's Office of Lender Activity and Land Sales Registration, conducted a review of Heritage's lender files in July of 1991; this was initiated because Heritage's default rate on FHA-insured loans was over ten percent. With respect to the nine loans at issue, Martinez

claimed that they had all been submitted to HUD for endorsement while in a state of default, i.e., with two or more payments due. This aspect of his testimony was uncontroverted. (Tr. 150-154, 158, 161-162).

25. Linda Nessi, Branch Chief for the Northern Branch Monitoring Division of the HUD Office of Lender Activities in Washington, D.C., testified that in June 1991, Heritage was selected for a review by her division because in April 1991, her office received a report which listed Heritage as having the second highest number of defaults for fiscal year 1989 endorsements in the Chicago area, and the highest number of defaults for fiscal year 1990 endorsements in the Chicago area. Nessi defined a default as being a situation where two payments are past due on a mortgage. Nessi testified that, based on their "payment histories," the nine loans in question had been improperly submitted to HUD for endorsement while in a default status. Nessi stated that "it was highly unusual to find that many loans with that kind of violation." (Tr. 322-330).

26. A loan submitted for endorsement when that loan is in default exposes the Department to serious financial risks because if the loan is in a default state at the time of endorsement, HUD is obligated to pay a claim on that loan and must then seek indemnification from the mortgagee. (Tr. 330-1, 343; HUD Handbook 4000.4 REV-1).

27. Heritage's default rate for fiscal year 1989 was ten percent; for fiscal year 1990, Heritage's default rate was eight percent. (Tr. 337).

28. The default rate of mortgages originated by Heritage and endorsed by HUD was significantly reduced over a two-year period from mid-1990 to mid-1992. Heritage's mortgage default rate as of June 30, 1992 was approximately 4.5 percent. The average mortgage default rate the HUD Chicago Regional Office was slightly under two percent as of mid-1992. In this two-year time period, it was generally recognized and accepted by the HUD Regional Office in Chicago that the "reputation" of Heritage as an underwriter had markedly improved, and that Heritage "had definitely turned a corner in terms of what the proper underwriting procedures were." It was the opinion of Judith Heaney, Chief, Single Family Housing Development Branch in the Chicago Regional Office, of her supervisor, and of the staff, that Heritage's underwriting had, during this period, "improved significantly." Heritage's current underwriter was characterized as being "certainly as good as any underwriter that we have with any other company." Heaney testified that Heritage's default rate "peaked about three years ago and has been reducing [sic] in the last two years." (Tr. 312-315).

29. Organizational changes at Heritage resulted in the

departure from Heritage of Betty Christianson, Heritage's underwriter, and Deborah Tanke, Vice President. These individuals as well as Michelle Allen, a shipping clerk at Heritage who made improper certifications on behalf of Heritage on certain loan documents, were apparently responsible for various irregularities in the processing of mortgage loan applications. Other signatories to mortgage loan documents in 1990 on behalf of Heritage were Kat McCarthy, Leta Martinez, Adele White-McCoy, an underwriter, Kimberly Marx Jensen, another shipping department employee of Heritage, all of whom are no longer with Heritage. Some or all of these individuals were involved in processing the nine loans identified above which were in a state of default when submitted to HUD for endorsement. Often there were instances where entire files were lost, and frequently some of the documents within these files were lost. Some of the files that were lost or misplaced were alleged by Heritage to have been lost or misplaced by HUD personnel. However, there was insufficient evidence to substantiate this allegation.

During this period of admitted mismanagement prior to 1990, John Standish was president of Heritage, and it was a widespread practice of certain employees, who were not officers of Heritage or who were otherwise unauthorized, to sign and make certifications on behalf of Heritage on various loan documents. Although Heritage avers, basically, that HUD ratified Heritage's procedures by endorsing loans notwithstanding these signatures, this practice was ended with Heritage's reorganization after MacNeil became president of Heritage in December of 1989. The fact that these organizational changes at Heritage occurred is not in dispute. All of the nine loans at issue were closed in 1989, the lastest on December 5, 1989, essentially prior to MacNeil's takeover of Heritage. (Tr. 485-495; 533-538; Resp. Brief, at 2).

30. In order to reverse its high default rate, Heritage, in 1991, initiated a homeowner's counseling program whereby buyers, prior to applying for a mortgage, would be given general information regarding their expected mortgage payments, backup resources, homeowner repairs, and homeowner awareness. (Tr. 472, 474).

31. Heritage also instituted a new management "program that was patterned after the Motorola Fortune 500 company to eliminate defects" in the way it processed its files (a "quest for excellence program"), counseled prospective clients more intensively, provided potential clients with a publication encouraging new homeowners to become more fiscally responsible and with a questionnaire to help identify spending patterns,

replaced departing employees with more responsible persons, and directed members of Heritage's staff to attend courses in special training hosted by Motorola. (Tr. 513-519, 580; Resp. Exhs. 15-17).

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. 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:

(g) Failure to comply with any agreement, certification, undertaking, or condition of approval listed on either a mortgagee's application for approval or on an approved mortgagee's Branch Office notification;

* * *

(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.

Discussion

There are three issues which can be summarily dealt with here. First, the Government did not offer proof to substantiate two of the four alleged violations of HUD-FHA regulations by Heritage which are set forth in the June 23, 1992 letter from the MRB Chairman to Heritage, i.e., "failure to document the source of mortgagors' funds used for earnest money and/or closing costs," and "failure to verify the income used to qualify a mortgagor." The gravamen of the Government's case against Heritage was Heritage's alleged failure to make payments to HUD in accordance with the terms of the Settlement Agreement, and Heritage's alleged improper submission of nine loans to HUD for endorsement while the loans were in a state of default.

Second, Heritage argues in its Reply Brief that it was subjected to "continuous tortious interference" in its business affairs by personnel at HUD's Chicago Regional Office despite Heritage's repeated complaints to the Assistant Secretary for Housing-FHA Commissioner, the HUD Chicago Regional Administrator, and the Mortgagee Review Board. Letters from Heritage to HUD also document disharmony, friction, and suspicion between Heritage and the HUD Chicago Regional Office. Nevertheless, these arguments, as well as allegations by Heritage of bad faith on the part of HUD and/or certain HUD employees, were never substantiated by adequate evidence, and thus fail for lack of proof.

Third, Heritage has argued in its Reply Brief that the Department's investigation into its loan files in 1991, which uncovered certain irregularities beyond those identified by the OIG in its 1987-1989 audit, was, in essence, retaliatory, arbitrary, unjustifiably selective, and punitive. However, Heritage has not proven its allegations that the Department, or any of its employees, committed acts which were arbitrary, retaliatory, or selective against Heritage. Furthermore, in order to prove that HUD's actions were punitive, Heritage 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 (June 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). There is simply no evidence in this record that supports Respondent's disparate treatment claim. I find that Respondent has not satisfied its burden of proof on this issue.

Administrative Judge Jean Cooper of the HUD Board of Contract Appeals aptly stated in Horizon Savings Association, HUDBCA No. 91-5946-M12 (September 1, 1992), that:

The purpose of withdrawing HUD-FHA approval from a mortgagee is to protect both the public and HUD from doing business with a mortgagee that fails to adhere to the regulations and program requirements of the mortgage insurance program, and more generally, fails to adhere to prudent lending practices. 24 C.F.R. Section 25.9. A [direct endorsement mortgagee] must originate HUD-insured loans with at least as much care and prudence as it would with conventional loans because HUD has placed its reliance on the mortgagee to only approve quality loan applications for publicly funded mortgage insurance. The [direct endorsement mortgagee] is the eyes and ears of HUD when originating such loans.

Failure to adhere to HUD program requirements and prudent lending practices jeopardize the HUD-FHA mortgage insurance program and the public fisc that funds it. It is immaterial whether a mortgagee deliberately avoids and subverts the regulations and requirements imposed on it, or if it fails to follow them through misunderstanding, carelessness, or lack of knowledge. In either case, the public interest in a sound mortgage insurance program needs protection. However, mortgagees that intentionally subvert and defraud clearly pose a greater long-term risk than those that are honest but imprudent. Thus, all mitigating factors are to be considered, including the seriousness and extent of the lending irregularities, and the degree of mortgagee responsibility for the irregularities, in deciding how long the withdrawal sanction should be, if applied at all, in a given case. 24 C.F.R. Section 25.9.

The Government contends essentially that the MRB's withdrawal of Heritage's mortgagee approval is based on two separate and distinct grounds: (1) Respondent's breach of a Settlement Agreement which had essentially resolved outstanding problems between HUD and Respondent in Respondent's participation in HUD's mortgage insurance endorsement program; and (2) Respondent's violation of HUD regulations in submitting loans in default for HUD/FHA mortgage insurance endorsement. The Government asserts that the alleged acts constitute cause for withdrawal of Heritage's mortgagee approval pursuant to 24 C.F.R. §§25.9(g), (j), (k), (p), and (w).

Heritage's defense against the MRB sanction is predicated upon: (1) Heritage's contention that HUD had breached the terms

of the Settlement Agreement, and, thus, Heritage was acting properly when it demanded the return of the check in the amount of \$11,971.14 which was due and payable on March 30, 1992, pursuant to the terms of the settlement agreement; and (2) that any violation, if any, of HUD regulations relating to Heritage's submission of loans for HUD/FHA endorsement were justifiable, fully explained by the appropriate accompanying late letters, and waived by the HUD Chicago Regional Office's acceptance without objection of the nine loans for endorsement. Further, Heritage contends that the MRB sanction is not warranted because the problems in submitting loans for HUD/FHA insurance endorsement, if any, have been corrected, and that Heritage's current loan processing performance in the Direct Endorsement Program is competent, responsible, and acceptable to HUD personnel in the HUD Chicago Regional Office.

The record in this case simply does not support Heritage's contention that the Government initially breached the terms of the Settlement Agreement. Clearly, Heritage's decision to demand return of the check representing the second payment due HUD under the Agreement was ill-considered. Nowhere in the record of this case do I find any act or omission by HUD personnel which could reasonably be construed as a breach, or an anticipatory breach, of the provisions of the Settlement Agreement which could, as a consequence, justify Heritage's failure to pay as agreed. The irregularities discovered in the files of the nine loans at issue, which were a basis for the MRB's withdrawal of Respondent's mortgagee approval, were not subject to the terms of the Settlement Agreement as Heritage contends. In fact, the review of Heritage's files which resulted in the discovery of these irregularities occurred in July of 1991, while the Settlement Agreement was signed in March of 1991. Nothing in the language of the Settlement Agreement provides Heritage with any shelter from administrative actions by the MRB for future discoveries of HUD regulatory violations by Heritage which were not revealed in the 1987-1989 OIG audit.

With respect to the late submissions of the nine loans at issue which were accompanied by various letters of explanation as to why they were submitted late, I find that the reliance by Heritage on the explanations and excuses set forth in these letters, no matter how well-meaning, is not exculpatory. In the operation of HUD's Direct Endorsement program, the Department's initial defense against program errors and abuse lies with the credibility, responsibility, integrity, and prudence of its program participants. Without the conscientious and responsible conduct of its program participants, particularly of those involved in the preparation of financial documents in the operation of the Department's Direct Endorsement Program, HUD is exposed to serious financial risk.

The evidence is conclusive and un rebutted that these nine loans were submitted by Heritage for HUD/FHA mortgage insurance endorsement while in varying degrees of default. Notwithstanding Heritage's explanations for the delays, which vary from lost documents to its inability to obtain certain signatures by the purchasers, the record is clear that Heritage's actions in submitting these loans, which were clearly in a state of default to HUD for HUD/FHA mortgage insurance endorsement, were clear violations of HUD rules, and subjected HUD to a substantial financial risk. Clearly, such activity by a mortgagee cannot be viewed as the activity of a responsible participant in a HUD program.

Nevertheless, the record seems to support Heritage's contention that, since the commission of these violations, the company has been reorganized, the employees who were responsible for these violations are no longer with the company, quality controls have been implemented, necessary training has been provided to the staff, enhanced financial awareness techniques have been provided to loan applicants, and the company's loan processing procedures have been significantly improved. In fact, by the admission of the Government's own witness, not only has Heritage's default rate decreased markedly, but its underwriting capability is now as good as any other in the Chicago area. While it should be easier to maintain quality control when there are only 25 loan closings a month instead of closing loans at the rate of 720 per year, the significant reduction in Heritage's loan default rate augurs well for Heritage's future and suggests that the changes implemented by Heritage are having the desired positive effect.

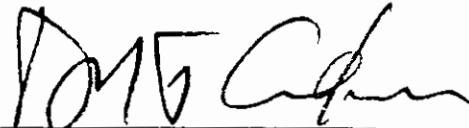
Without attempting to minimize the seriousness of Heritage's past loan processing practices, it should be noted, if one can reasonably make the comparison, that nine loans improperly submitted to HUD for endorsement out of 720 loans in 1989 represents a statistically insignificant 1.25 percent. In addition, the procedures at the HUD Chicago Regional Office can hardly be commended in terms of their quality control, since these loans were apparently accepted for endorsement even though a cursory glance could readily reveal a significant time lapse between a loan closing date and the loan's receipt by HUD, as well as the date of the last payment on the loan. Furthermore, there is nothing in the record of this case which demonstrates that Heritage falsified any documents, altered documents, failed to disclose information contained in its files, or intended to defraud HUD. In view of these facts, equity seems to be on the side of Heritage.

In any event, the record of this case demonstrates that cause for the withdrawal of Heritage's mortgagee approval exists under 24 C.F.R. §25.9(g), (j), and (p). While the law is well-established that the present responsibility of a person or entity

doing business with HUD can be inferred from past acts, HUD sanctions under 24 C.F.R. Part 25 are prospective sanctions designed to protect the Department and the public from potential misconduct; they are neither "penalties" nor to be used for punitive purposes. Mechanics National Bank and Mechanics National Mortgage Co., HUDBCA No. 77-5-MR (March 6, 1979); PFG Mortgage Inc. and Robert Otto Potter, HUDBCA Nos. 92-G-7577-MR6 and 92-G-7598-D58 (October 9, 1992). I find that the withdrawal of Heritage's mortgagee approval from June 23, 1992, to this date has afforded the Department sufficient protection from potential harm, and has likewise afforded Heritage sufficient time to maximize the effect of its reorganization and quality controls. Consequently, a further period of ineligibility would, under these circumstances, no longer be necessary. However, since Heritage has failed to make its payments under the terms of the Settlement Agreement, the withdrawal of Heritage's mortgagee approval should continue for its two-year duration unless Heritage honors its financial obligations to HUD as set forth in that Agreement. Should Heritage pay the amounts due prior to June 23, 1994, this period of ineligibility will no longer be necessary, and should thereupon be terminated.

Conclusion and Order

For the foregoing reasons, it is my determination that the withdrawal of Heritage's mortgagee approval by the MRB was warranted and should continue until June 23, 1994, except that Heritage's mortgagee approval should be reinstated prior to June 23, 1994, upon the fulfillment of Respondent's obligation to pay HUD the sums due with appropriate interest pursuant to the terms of the Settlement Agreement entered into on March 29, 1991.



David T. Anderson
Administrative Judge