UNITED STATES OF AMERICA
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
BOARD OF CONTRACT APPEALS
WASHINGTON, D.C.

In the Matter of: **STRATFORD MORTGAGE CORP.** Respondent.	HUDBCA No. 92-G-7615-MR18 Docket No. 91-267-MR

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DETERMINATION BY ADMINISTRATIVE JUDGE TIMOTHY J. GRESZKO

June 1, 1994

Statement of the Case

Stratford Mortgage Corporation ("Stratford" or "Respondent") at all times pertinent was a lender approved by the U.S. Department of Housing and Urban Development ("HUD" or "Department") / Federal Housing Administration ("FHA") as a Direct Endorsement ("DE") mortgagee. In September, 1990, HUD's Mortgagee Monitoring Division ("MMD") reviewed Stratford's loan origination activities and discovered that Stratford's quality control plan did not comply with certain HUD requirements. The MMD also concluded that

Stratford originated a number of HUD-FHA insured loans in violation of various HUD program requirements including, in relevant part: (1) failures to conduct required face-to-face interviews with mortgagors while representing that such face-to-face interviews were conducted; (2) causing or permitting misrepresentations of the sources of mortgagors' funds for down payments and closing costs, or failing to determine the sources of these funds, thus allowing the mortgagors to avoid making the minimum required investment in the properties; (3) allowing the wrongful provision of funds by developers and realtors to the mortgagors for use in the purchases; (4) causing or permitting submission of certain false information and false certifications to HUD; and (5) causing a mortgage loan to be overinsured.

By letter dated June 25, 1992, HUD's Mortgagee Review Board ("MRB") notified Stratford that it was proposing the withdrawal of Stratford's HUD-FHA approval for a period of three years. The letter stated that Stratford's actions constituted violations of the Department's loan processing requirements as set forth in HUD Handbooks 4000.2 REV-1, 4000.4 REV-1, 4060.1, 4155.1 REV-1, 4155.1 REV-2, 4155.3 REV-3, and the Department's regulations at 24 C.F.R. Part 203, and are grounds for the withdrawal of Stratford's HUD-FHA mortgagee approval, pursuant to 24 C.F.R. §§ 25.9(g), (j), (k), (p), and (w). By letter dated July 20, 1992, addressed to the HUD Docket Clerk, Stratford requested a hearing of this matter. In April, 1993, the parties jointly requested that this matter be determined upon a written record, and this request was granted.

The Government's complaint in this case charges that, with respect to the transactions at issue: (1) Stratford participated in a scheme with realtors, salespersons, and borrowers to circumvent HUD regulations; (2) because of Stratford's actions, the requirements for buyer downpayments as set forth in 24 C.F.R. § 203.19 were not met by the purchasers; (3) because of Stratford's actions, each of the sales contracts and each of the transactions constituted a false statement; (4) Stratford caused the false statements to be submitted for the purpose of influencing HUD to insure the mortgages; (5) Stratford knowingly or recklessly permitted realtors, or others not permitted to do so under HUD's regulations, to provide funds to the mortgagors, and in doing so, aided and enabled the mortgagors to avoid making the minimum investments required under HUD regulations; and (6) Stratford caused or permitted false statements regarding credit, source of funds, and other matters on behalf of mortgagors, to be submitted to HUD.

On April 5, 1993, Stratford filed a motion for summary judgement, and moved in the alternative for an order specifying which issues were without controversy and established as a matter of law. As grounds for its motion, Stratford asserted that a prior judgement was rendered on the merits of this case in the case ***In the Matter of F.D. "Red " Rutledge***, HUDBCA No. 92-C-7561-D41 (Jan. 15, 1993). Both ***Rutledge*** and the present case arise from the same MMD review. A substantial part of the evidence in this case is transcript from the ***Rutledge*** hearing. All of HUD's most serious charges against Stratford are derived from Rutledge's practices in these transactions. In ***Rutledge***, it was found that Stratford's loan officer, Rutledge, did not participate in, nor have actual knowledge of, schemes to defraud HUD in 16 of the 20 transactions which are the subject of this case. On April 27,

1993, the Board ruled that collateral estoppel precludes the re-trial in this case of Rutledge's actual knowledge of, or his participation in, fraudulent schemes related to the 16 transactions involved in both the ***Rutledge*** case and this case.

This determination is based upon the written record, documents, briefs, and reply briefs as submitted by the parties, including transcripts and documents which were introduced into evidence in the ***Rutledge*** case. Stratford and the Government have submitted a number of affidavits and statements into evidence which were also considered in rendering this determination. This determination adopts the findings of fact in the ***Rutledge*** case to the extent that such facts are relevant to this case.

Relevant Handbook Requirements for Loans Insured by HUD

HUD Handbook 4000.2 REV-1 (Mortgagee's Handbook-Application Through Insurance - Single Family) (Govt. Exh. 133) describes the HUD policies and procedures required of approved mortgagees in preparing and submitting applications to HUD for mortgage insurance. Chapter 5 of Handbook 4000.2 REV-1 describes the loan origination responsibility of the mortgagee. Paragraph 5-1 of the Handbook requires that mortgagees develop loans:

> in accordance with accepted practices of prudent lending institutions and HUD requirements. They must obtain and verify information with at least the same care that would be exercised in originating a loan in which the mortgagee would be entirely dependent on the property as security to protect its investment.

Paragraph 5-2 of Handbook 4000.2 REV-1 describes the procedures for obtaining borrower approval from HUD for mortgage insurance by use of HUD Form 92900, Application for Insured Mortgage. It states that the Form 92900 provides the information necessary to determine the borrower's probable ability to make the payments on the mortgage and to maintain the property. Paragraph 5-2(a) of the Handbook provides, in pertinent part:

> In accordance with prudent lending practices, a face-to-face interview with the loan applicant must be conducted by a company employee, at which time the fully completed loan application should be reviewed with the loan applicant. HUD requires that the Form HUD 92900 be completed prior to the applicant(s) signing the form. The applicant(s), in signing, are certifying that the information on the form is true and correct to the best of their knowledge and belief.

HUD Handbook 4060.1, entitled Mortgagee Approval Handbook (Govt. Exh. 130) also contains instructions in Appendix 1 applicable to the gathering of information necessary to complete the Form 92900. Appendix 1 of Handbook 4060.1 states, in pertinent part:

Preparation of Form HUD-92900 Application

(1) In accordance with prudent lending practices, at least one time prior to the submission of the final application to HUD, a face-to-face interview with the loan applicant must be conducted by a company employee. The most preferable time for such face-to-face interviews is immediately prior to the signing of the final loan application (Form HUD-92900), at which time the fully completed loan application should be reviewed by the loan applicant. The interview of the loan applicant should include a review of the occupancy certification to minimize the likelihood of a false certification regarding intention to occupy.

(2) The preliminary credit application form used by the mortgagee should require, in accordance with accepted prudent loan origination practices, that the applicant mortgagor list each outstanding liability, including mortgage liabilities, and each asset, including real property. The mortgagee should obtain complete responses to all questions. All conflicts in information should be resolved and the loan file documented.

(3) As required by HUD regulations, 24 C.F.R. Sections 203.2(a)(2) and 203.10, all loans submitted to HUD must be fully processed by employees of the mortgagee.

(4) In accordance with prudent lending practices, the mortgagee must not permit the applicant mortgagor, or its own employees to sign any credit document or other form in blank.

(5) HUD Handbook 4000.2 paragraph 3-7 requires the mortgagee to obtain and verify the correctness of information with at least the same care that would have been exercised had it been entirely dependent on the property as security to protect its investment. Accordingly, the final application Form HUD-92900 must list all assets and liabilities known to the mortgagee. Consideration should be given by the mortgagee to requiring some level of review by management or supervisory officials of all cases submitted to HUD for mortgage insurance.

HUD Handbook 4000.2 REV-1 (Govt. Exh. 132) sets out the applicable minimum investment requirements for borrowers. Section 2-7 of Handbook 4000.2 REV-1 states in pertinent part:

> 2.7 MINIMUM INVESTMENT BY BORROWER. The borrower's investment in the property must be equal to the difference between the total cost of acquisition and the amount of the mortgage to be insured, but at least 3 percent of the cost of acquisition. In no instance, may his/her investment be less than the difference between the cost of acquisition (the total cost including repairs, alterations or additions, plus closing costs, but exclusive of non-realty items or prepaid expenses) and the amount calculated by applying the appropriate formula from paragraph 2-6b to the acquisition cost.

Findings of Fact

1. Stratford, at all times pertinent, was a HUD-FHA approved lender with DE authority, located in Richardson, Texas. As a DE lender, Stratford underwrote loans for HUD, and submitted them to HUD after closing for issuance of a mortgage insurance certificate. HUD relies on its DE lenders to originate and underwrite loans using prudent lending practices, and following HUD requirements and procedures outlined in relevant HUD Handbooks. (Finding of Fact ("FF") 2, ***Rutledge***, *supra* at 4.)

2. The 20 transactions at issue in this case occurred during a period from December, 1987, through April, 1990. (Govt. Exhs.).

3. During the week of September 24-28, 1990, and the week of December 3-7, 1990, the MMD conducted an audit of certain loans originated by Stratford. The MMD audited specifically targeted loan files in which known wrongdoers were involved in well-planned schemes with borrowers to defraud HUD into insuring and overinsuring mortgages. After determining that Stratford had originated a number of mortgages in which these wrongdoers were involved, HUD decided to review these loan files. (Govt. Exh. 129A).

4. The MMD referred this matter to the MRB for appropriate action. The MRB, by letter dated April 4, 1991, notified Stratford that, pursuant to 24 C.F.R. § 25.6, it was considering initiating an administrative action against Stratford. HUD also notified Rutledge that it was proposing to debar him for five years for his role as a Stratford loan officer in 16 of the 20 transactions at issue, based on his alleged conduct of committing willful, serious violations of HUD requirements. (Govt. Exh. 133).

5. In July, 1992, the HUD Board of Contract Appeals held a formal hearing to determine whether Rutledge should be debarred. The Board determined that HUD failed to prove its major charge against Rutledge, that Rutledge either participated in or had actual knowledge of fraudulent schemes perpetrated by the wrongdoers and borrowers. HUD was successful in proving that Rutledge had improperly allowed interested third parties to handle verification forms and that he had not conducted adequate face-to-face interviews with several borrowers when he took the initial loan application, despite his certification on that form indicating that he had done so. In the absence of evidence that Rutledge had knowledge of the fraudulent schemes at issue, the Board held that a three-year debarment of Rutledge was appropriate and necessary to protect the public interest. *See **Rutledge**, supra at 10.*

Face-to-Face Interviews

6. Facts related to this issue are averred with respect to 18 mortgage transactions involving [redacted] Baker, [redacted] Chatman, [redacted] DeLeon, [redacted] Dominguez, [redacted] Lara, [redacted] Malone, [redacted] Mathis, [redacted] Mitchell, [redacted] Payne, [redacted] Perales, [redacted] Pratt, [redacted] Raabe, [redacted] Requena, [redacted] Rodgers, [redacted] Russell, [redacted] Sosa, [redacted] Tripp, and [redacted] Wilson. Rutledge was the loan officer for these transactions. In each transaction, Rutledge marked on the Form 1003 (the preliminary credit application) for these transactions, that he had personally gathered the information directly from the borrowers by means of face-to-face interviews. (Complaint and answer, paragraphs 39-40; Govt. Exhs. 1, 6A, 9, 13-15, 17, 21, 33, 40, 48, 53, 61, 64, 68, 71, 82, 97, 110).

7. Of the 18 transactions cited above, all but the Mitchell and Rodgers transactions were considered in ***Rutledge***. Adequate face-to-face interviews were conducted by Rutledge in the Dominguez and Raabe transactions. Although Rutledge submitted an affidavit in which he states that he interviewed all of the borrowers face-to-face, the preponderance of the evidence is that he did not personally and completely interview the other borrowers to obtain the information for the FNMA Form 1003, and there is no evidence that any other Stratford employee conducted face-to-face interviews of the other borrowers. Rutledge did not conduct adequate face-to-face interviews in the Baker, Chatman, DeLeon, Lara, Malone, Mathis, Mitchell, Payne, Pratt, Requena, Russell, Sosa, and Wilson transactions. Jeff Bosse, a developer and realtor, or Bosse's wife, Donna, conducted the preliminary loan application interviews, without Rutledge's participation, with respect to Chatman, DeLeon, Lara, Perales, Pratt, Requena, and Sosa. Corina Ewing, a salesperson for Custom Builders, interviewed Mathis, Payne, Russell, and Wilson, without Rutledge's participation. Rutledge copied the information gathered by the Bosses or Ewing onto the Form 1003, together with information from credit checks, and then had the Bosses or Ewing obtain the signatures of the borrowers on the completed Form 1003 in most cases. If Rutledge reviewed the information on the Form 1003 with the borrowers, his review was very brief and he did not inquire about their source of funds to close the loan or other information critical to

development of reliable financial data on which to make a loan. The critical evidence submitted on this issue by the Government with respect to the Rodgers and Tripp transactions was in the form of telephone conversation memoranda which allegedly record conversations between HUD employees and the borrowers. According to these memoranda, the borrowers informed HUD that Rutledge did not interview them. This evidence is entitled to little weight, because it was not subject to either verification or cross-examination, and is not sufficient to prove a failure to conduct face-to-face interviews in these two transactions. (FF 5, ***Rutledge***, *supra* at 5-6; ***Rutledge*** Tr. pp. 215-58, 346-86; Affidavit of F.D. "Red" Rutledge dated June 1, 1993; Govt. Exhs. 1, 48, 68A, 96A, 97, 107A).

8. In all but the Burford transaction, which was not originated by Rutledge, the Forms 1003 were completed in Rutledge's hand and were initialed by Rutledge to indicate that he had obtained the information recorded on the form in a face-to-face interview of the prospective borrowers. Stratford has submitted affidavits in support of the proposition that it reasonably relied on Rutledge's representations that he had personally conducted the face-to-face interviews. There is no opposing evidence that Stratford's reliance on Rutledge's representations was unreasonable, or that Stratford had independent knowledge that Rutledge did not conduct these interviews. In the absence of such evidence, I find that Stratford did not have independent knowledge that Rutledge was not conducting the face-to-face interviews, and I further find that Stratford reasonably relied on Rutledge's representations that he had conducted the requisite face-to-face interviews. (Govt. Exhs. 1, 6A, 9, 13, 17, 21, 33, 40, 48, 53, 56, 61, 64, 68, 71, 82, 85A, 97, 110; Affidavit of Peter C. Tabisz dated June 1, 1993; Affidavit of Rick E. Smith dated June 1, 1993; Affidavit of Greta Phillips dated June 18, 1993).

False Statements - Failures to Meet Minimum Investment Requirements

9. Jeff Bosse, Sherna Stone, Mickey Foster, Charles Soden, and Corina Ewing, all developers or their representatives, and Charles Blaylock, a realtor, implemented schemes to present false information about borrowers to Stratford to influence Stratford to approve loan applications that would not otherwise be approved or would be approvable for a lesser amount than requested. Both Ewing and Bosse provided much of this false information to Rutledge for the Form 1003, and in many, if not most instances, this false information carried over onto the HUD Forms 92900 (the final loan application) and the HUD-1 Settlement Statements for the transactions. This false information included information about employment status and earnings of borrowers, cash and other assets that they had available for closing, and the source of funds for the closing costs and downpayment required by HUD. Such false information was provided in the Baker, Burford, Chatman, DeLeon, Dominguez, Lara, Malone, Mathis, Mitchell, Payne, Perales, Pratt, Raabe, Requena, Rodgers, Russell, Sosa, and Wilson transactions. It was subsequently "verified" on the required verification forms. False gift letters and explanatory letters documenting sources of funds were created at the suggestion of, and with the assistance of, Bosse, Stone, Foster, or

Ewing, in the Burford, Chatman, DeLeon, Mathis, Mitchell, Perales, Raabe, and Requena transactions.

There is little evidence that Rutledge knew or suspected that any of this information was false, except in the Mitchell transaction, in which there is probative evidence in the nature of a sworn statement from Mitchell that a false gift letter was discussed by Charles Mitchell and Soden in the presence of Rutledge, and that Rutledge participated in the conversation and helped draft the false gift letter. Rutledge denied under oath having any such knowledge, and there is insufficient evidence to establish that Rutledge knew or suspected that any of this information was false. Although certain borrowers, including [redacted] Baker, [redacted] Raabe, and [redacted] Wilson assumed that Rutledge must have known about the schemes to provide undisclosed cash and false information, [redacted] Pratt, [redacted] Payne, [redacted] Mathis, [redacted] Dominguez had the opposite impression. There is no evidence of actual statements or acknowledgements by Rutledge to any borrower to support their suspicions. There was some testimony about newspaper advertisements stating "no down payment," but none of these advertisements were submitted as evidence, and Rutledge denies having any knowledge of these advertisements. In addition, borrowers were told by the developer's representatives that if Rutledge or others inquired about a source of funds, that they were to state that the funds were a "gift" or, alternatively, to say nothing. In many, if not most of the loans at issue, the borrowers did not meet the HUD/FHA minimum investment requirements for their loans, because the funds for downpayments and other cash required from the buyers to close could not be provided by developers and sellers. However, the evidence in this record is insufficient to support a finding that Rutledge, or any other Stratford employee or officer, knew that developers and sellers were routinely providing cash to the borrowers, or of the false gift letters and the making of temporary bank deposits designed to cover up the sources of these payments. (***Rutledge, supra,*** FF 5-8; Affidavit of F.D. "Red" Rutledge dated June 18, 1993; ***Rutledge*** Tr. 69-70, 116, 140-141, 184-185, 188, 193, 222, 224, 231, 240-241, 246, 264, 268, 269, 272, 313-315, 356-357, 376-378, 393-395, 427-429, 444-47, 485-486, 569, 574-577, 602-605).

10. There is little evidence in this record going to the willful participation or knowledge of Stratford employees other than Rutledge of the schemes to circumvent HUD's investment requirements. The statement of Leonard Burford, which alleges that during a meeting with an unidentified Stratford employee, Blaylock informed the Burfords that he would provide them with $2,500 cash for the downpayment and instructed the Burfords on how to write a false gift letter. The Stratford employee who took the Burford application was Peter Tabisz, Stratford's Chief Executive Officer. Tabisz took the Burford loan application because the loan officer was unavailable and because the Burfords agreed to come to his office. During the conversation between the Burfords and Blaylock, Tabisz was sitting at his desk doing some loan-related calculations, allegedly within earshot of Blaylock and the Burford's. Burford states that "The loan officer was fully able to be aware of the arrangement," but not that he was aware of it. Tabisz recalls that he was informed at the time by Burford that Burford was funding the down payment through a gift from his mother and/or substantial overtime pay that he expected to earn in the near future. This evidence is

insufficient to establish that Tabisz either knew that Blaylock was going to supply funds to the Burfords or of the false gift letter scheme concocted by Blaylock in the Burford transaction. (Burford statements - Govt. Exhs. 85A, 92A; Affidavits of Peter C. Tabisz date June 1 and June 18, 1993).

11. Stratford's loan processors, Jan Walker and Greta Phillips, who closed eighteen of the transactions at issue, also deny under oath that they participated in or had knowledge of these fraudulent schemes, or that they were aware of the fact that Red Rutledge had not conducted the face-to-face interviews at issue. (Affidavits of Jan Walker dated June 1 and June 18, 1993; Affidavit of Greta Phillips dated June 18, 1993). In the absence of evidence to the contrary, I find that Stratford did not willfully participate in the fraudulent scheme to avoid HUD requirements. I also find that Stratford did not know that Rutledge was committing acts that violated HUD/FHA program requirements.

The Over-insured Loan

12. The Hutcherson transaction, which was an investor refinance loan, closed on September 24, 1987, with a $43,200 mortgage as shown on the HUD-1 Settlement Statement. The mortgagor acquired the property for $13,000 on September 6, 1987, and performed $26,155.82 of repairs and rehabilitation on the property. The appraised value of the property at the time of closing was $49,000. The FNMA Form 1003 dated April 6, 1987, shows a $13,000 original cost for the property and an improvement cost of $22,000. The maximum available mortgage, under applicable HUD mortgagee letters, was $35,560, because as an investor loan, the mortgage was limited to the lesser of 85% of the acquisition cost or appraised value, since the mortgagor had acquired the property less than twelve months prior to the refinance transaction. Stratford admits that the loan was overinsured, but attributes the problem to a "mistake." (Govt. Exhs. 93-95; Resp. Reply Brief at 43).

The Strawbuyer Transaction

13. In the Pratt transaction, [redacted] Pratt originally intended to purchase a home, but her daughter, [redacted] Pratt, was substituted as the buyer by Jeff Bosse when he ran a credit check on [redacted] that was "no good." [redacted] Pratt appears as the buyer on all of the loan related documentation in this transaction. Stratford obtained an affidavit of occupancy from [redacted] Pratt that is included in the loan file. There is no evidence in this case with respect to whether [redacted] Pratt actually lived in the home at issue. (***Rutledge***, Tr. 63; Govt. Exhs. 82, 83, 84; Resp. Exh. 3).

Loan Processing Procedures

14. It was not Rutledge's duty as a loan originator to evaluate the information and documentation received to support a loan application. He did not prepare either the HUD Form 92900 or the HUD-1 Settlement Statement. These functions were the duties of the loan processor, the underwriter, and the loan closer at Stratford. (***Rutledge, supra*** FF 9).

15. Jan Walker was the Stratford loan processor on the Baker, Burford, Dominguez, Mathis, Mitchell, Payne, Raabe, Russell, Sosa, Wilson, and Tripp, transactions. Greta Phillips was the Stratford loan processor on the Chatman, DeLeon, Lara, Malone, Perales, Pratt, and Requena transactions. The Hutcherson and Rodgers transactions were processed by Vicki McKessack and Kathy Smith, respectively. Rick E. Smith was Stratford's DE underwriter on all of the transactions at issue. (Govt. Exhs. 2, 7, 10, 15, 18, 22, 34, 41, 49, 54, 57, 62, 65, 69, 72, 83, 90, 93, 102, 114; Affidavit of Rick E. Smith dated June 1, 1993).

16. The flow of a loan file at Stratford, which is tracked by an automated computer system, is as follows: (1) the application is taken by the loan officer; (2) all information is then given to the processor; (3) the processor sends out all verifications, orders the appraisal, credit report, and the title work; (4) as verifications are returned, the processor compares them to the application; (5) after all verifications and the appraisal are returned, the Form 92900 is completed for the applicant's signature; (6) the file is then forwarded to the underwriter; (7) after the loan is underwritten and all conditions are met, the survey is ordered; (8) when the survey is complete, the loan goes to closing; (9) loan closing documents are prepared and sent to the title company; and (10) after funding of the closed loan, all documents pertaining to insuring the loan are sent to HUD. (Affidavit of Jan Walker dated June 1, 1993).

17. Smith, Stratford's DE underwriter and President, was, at all pertinent times, responsible for the supervision of the production and servicing departments. Smith continues to perform in those capacities. The production department consists of the loan originators, processors, closers, and underwriting. As the company's D.E. underwriter, Smith is responsible for conventional, FHA, and VA loans. All loans are underwritten under the Government guidelines that apply to the particular file. Stratford has a policy that closing documents will not be released until the loan has been approved and preclosing contingencies cleared. Stratford believes that it has always been conscientious in observing HUD regulations and guidelines. (Affidavit of Peter E. Smith dated June 1, 1993).

18. At all times pertinent, Stratford utilized the following relevant loan processing procedures and policies:

(A) Stratford would attempt to find alternative ways to determine credit standing when normal channels were not available. Examples of these are letters from landlords, verifications from utility companies and letters from individuals granting personal credit.

Although these types of certifications may not be viewed as the best, they are better than no reference at all when the credit bureaus have nothing on file to report and the borrowers have been traditionally cash buyers and not credit users.

(B) When gifts are involved, Stratford obtains signed and notarized gift letters to verify the funds in either the donor's account or the recipient's account or both when possible.

(C) Verifications may not be passed through the hands of an applicant. All verifications are either mailed or couriered by an employee of Stratford or a independent courier service with no financial interest in the transaction.

(D) HUD 92900s are signed prior to underwriting. Loans will not be approved without a signed Form 92900.

(E) An applicant's income and credit report will be reviewed early in the process to inform applicants if they qualify for a mortgage.

(F) Stratford attempts to remove all discrepancies from its loan files through careful loan processing procedures. Prior to the existence of an automated system, Stratford performed this task manually, and human errors occurred. Stratford now utilizes a sophisticated computer program which produces higher efficiency and contains numerous check points and reports for management which greatly limits file inconsistencies. The system generates variance reports to list the differences between what the borrowers stated in their initial application versus what is verified in writing through the verification process. (Affidavit of Peter C. Tabisz dated June 1, 1993; Affidavit of Rick E. Smith dated June 1, 1993).

19. The parties have submitted copies of loan documents for each of the loans at issue. The documents show that one loan was closed in 1987, four loans in 1988, nine in 1989, and six in 1990. Jan Walker acted as Stratford's loan processor on ten loans between October 27, 1988 and September 5, 1989. Greta Phillips processed eight loans between January 5, 1989 and April 10, 1990. One loan was processed by Vicki McKessack in 1987, and one loan was processed by Kathy Smith in 1988. An analysis of these transactions reveals that in many instances, loan applicants had recently opened bank accounts into which large sums of cash had been deposited. In several of these instances, Stratford obtained source of funds letters which indicated that the cash infusions were from job-related income, bonuses, gifts from parents or relatives, proceeds from a life insurance policy, and an income tax refund. In several transactions, there is no evidence of verifications of deposit or employment, nor any explanation, argument, or comment from the Government with respect to the absence of such evidence from this record. Under the circumstances, I decline to draw any negative inferences based on the absence of such evidence in this record. Upon review of the documentation in this record, I do not find anything so unusual or so deficient as to have necessarily put Stratford on notice that these transactions were part of a fraudulent

scheme. The Government has not submitted any evidence, such as expert testimony, going to the adequacy of this documentation for loan processing and underwriting purposes. Likewise, there is no evidence going to the issue of whether a pattern was established during these transactions which would have put Stratford on notice of the fraud at issue. Respondent has submitted two affidavits which state that it has reviewed this documentation and found nothing unusual in the documents which would have required it to further inquire before proceeding with underwriting any of the loans. In the absence of any evidence to the contrary, I decline to draw any negative inferences with respect to the adequacy of this documentation for underwriting purposes, and I find that the Government has not established that Stratford's loan processing and underwriting were not adequate in these transactions. (Govt. Exhs. 2, 7, 10, 15, 18, 22, 34, 41, 49, 54, 57, 62, 65, 69, 72, 83, 90, 93, 102, 114; Affidavits of Rick E. Smith dated June 1, 1993; Affidavit of Peter C. Tabisz dated June 1, 1993).

20. The HUD Forms 92900 utilized in each of the transactions at issue contained a lender's certification which provided, in pertinent part, as follows:

> The undersigned lender makes the following certifications . . .
>
> > 26A. The information furnished in Section I is true, accurate, and complete.
> >
> > 26B. The information contained in Section II was obtained directly from the borrower by a full-time employee of the undersigned lender or its duly authorized agent and is true to the best of the lender's knowledge and belief.
> >
> > 26C. The credit report submitted on the subject borrower (and spouse, if any) was ordered by the undersigned lender or its duly authorized agent directly from the credit bureau which prepared the report and was received directly from said credit bureau.
> >
> > 26D. The verification of employment and verification of deposits were requested and received by the lender or its duly authorized agent without passing through the hands of any third persons and are true to the best of the lender's belief and knowledge.
> >
> > 26E. This application was signed by the borrower after Section I, II and V were completed.
> >
> > 26F. This proposed loan to the named borrower meets the income and credit requirements of the governing law in the judgement of the undersigned.
> >
> > 26G. The names and functions of any duly authorized agents who developed on behalf of the lender any of the information or supporting credit data submitted are as follows:

If no agent is shown above, the undersigned certifies that all information and supporting credit data were obtained directly by the lender.

21. The borrowers in the DeLeon, Dominguez, Lara, Requena, Sosa, and Tripp transactions believe that their Form 92900 was signed by them at closing, because they do not recall signing loan related documents on other days. The Forms 92900 in all of these transactions bear handwritten dates of execution which appear to have been inscribed on the forms by the borrowers. In each instance, the date of execution is 1-3 days before the date the loan closed. [redacted] Dominguez attributed the inconsistent dates to a possible "mistake." All of the transactions at issue in this case were closed by title companies. The Russell's Form 92900 was executed at closing, which Stratford attributes to "rare, exigent circumstances." (***Rutledge***, Tr. pp. 215-258, 305-346; Govt. Exhs. 2, 3, 6B, 7, 8, 10, 11, 17A, 18, 19, 21A, 22, 23, 68A, 69, 70; Affidavit of Rick E. Smith dated June 1, 1993).

22. Walker and Phillips do not believe that any Forms 92900 in their transactions were signed at closing, and they have no knowledge of Bosse or Ewing furnishing any borrower with verification forms. Both Walker and Phillips processed their transactions in accordance with Stratford's "strict policy precluding a loan from being underwritten prior to a Stratford employee verifying the information and obtaining the signature of borrowers on the Form 92900." Both recall that the verifications relied upon by Stratford were sent directly by Stratford by mail or courier and returned directly to Stratford. (Affidavit of Jan Walker dated June 1, 1993; Affidavit of Greta Phillips dated June 18, 1993).

The Quality Control Plan

23. During the week of September 24-28, 1990, John H. Lynam, Field Representative, HUD Office of Lender Activities and Land Sales Registration, Monitoring Division, conducted a mortgage loan origination review of Stratford. During that week, Lynam examined the quality control plan ("QCP") maintained by Stratford. Lynam noted the following deficiencies in the Stratford QCP, based upon the requirements of HUD Mortgagee Letter 89-32, dated December 26, 1989 ("ML 89-32"):

A) The plan calls for the review of every 10th loan closed without regard for the type (i.e. VA, FHA, FNMA, etc.). ML 89-32 requires that 10% of all FHA loans closed be reviewed;

B) The plan does not ensure that Mortgage Insurance Premiums are submitted within 15 days of loan closing and that late charges and interest penalties are properly submitted;

C) The plan does not ensure that the mortgagee does not employ any individual who is debarred, suspended, or subject to a Limited Denial of Participation (LDP);

D) The plan does not provide for a review of rejected loans;

E) The plan does not ensure that all loans submitted by the mortgagee to FHA for mortgage insurance endorsement are processed by employees of the mortgagee or its approved Loan Correspondents; and

F) The plan does not ensure that a face to face interview was performed with the mortgagor prior to signing the fully completed loan application Form HUD 92900 and submission of the loan for underwriting. (Govt. Exh. 129A).

24. ML 89-32 set forth certain requirements for mortgagee QCPs that were not included in the QCP then in use by Stratford. Stratford did not immediately comply with ML 89-32 because Stratford did not receive ML 89-32 until it was brought to Stratford's attention by Steve Kottman in December of 1990. Prior to ML 89-32, HUD did not require a specific QCP to be implemented by mortgagees, although guidelines for quality control procedures were provided in HUD Handbook 4060.1, Mortgagee Approval Handbook, since 1980. The original QCP complied with these requirements. Only six of the transactions involved in this case took place after ML 89-32 was issued. Fourteen of the twenty transactions at issue were closed before the issuance of ML 89-32. The Chatham, Deleon, Lara, Malone, Pratt, and the Requena transactions were closed subsequent to the issuance of ML 89-32, between February 6, 1990, and April 13, 1990. No relevant transaction was closed by Stratford after April 13, 1990. There is no evidence, direct or circumstantial, sufficient to establish that Stratford was timely provided with a copy of ML 89-32 by HUD, and there is no evidence in this record sufficient to establish that Stratford was otherwise chargeable with knowledge of the requirements set forth in ML 89-32 when the six relevant loans were closed. ML 89-32 states that failure to comply with its requirements is grounds for an administrative sanction by the MRB. (Govt. Exhs. 3, 8, 11, 16, 19, 23, 35, 42, 50, 55, 58, 63, 66, 70, 73, 84, 95, 107, 116, 129; Affidavit of Peter C. Tabisz dated June 1, 1993).

25. Stratford adopted and has maintained a written QCP since the company was formed. The QCP originally adopted by Stratford complied with HUD requirements prior to the publication of ML 89-32. Stratford's original QCP consisted essentially of a compliance audit of Stratford loan files to determine whether Stratford and its employees were complying with applicable Federal, state, and private lending requirements. Under this QCP, loan file audits were to be conducted on a random basis. Every tenth loan file closed was to be pulled by the quality control unit performing the audit. The audits entailed the following procedures:

(1) Reverification of employment.
(2) Reverification of deposit as of the date originally ordered.
(3) Reverification of credit status and balances by a different credit bureau.
(4) Comparison of the applicant's signatures for consistency.
(5) Comparison of the information on the original handwritten application to the final application.

(6) Ordering a review appraisal from a different appraiser to test market value consistency.
(7) Check owner occupancy.
(8) Check legal documents to include note, deed of trust, assignments, survey, title report, and loan disclosures (initial and final).
(9) Check overall documentation for sufficiency.
(10) Check underwriting judgement for reliability and conformity to program and investor requirements.

All audit discrepancies and exceptions noted in writing in the audit log and on the Audit Exception Report, including exception, probable cause, recommendations for solutions, and frequency were given to the Chief Executive Officer for review on a monthly basis. This QCP also contained eight amendments which imposed additional audit requirements. (Stratford Mortgage Corporation Quality Control Program, Exh. 1, Respondent's Brief in Support of Motion for Ruling on the Merits dated June 1, 1993; Affidavit of Peter C. Tabisz dated June 1, 1993; Affidavit of Rick E. Smith dated June 1, 1993).

26. By memorandum dated December 4, 1990, Stratford brought its QCP into compliance with ML 89-32. In August, 1992, Stratford entered into a contract for quality control services with Mortgage Professional Services ("MPS"), of Houston, Texas. MPS designed a QCP for Stratford, and performs independent auditing functions for Stratford on newly originated loans, closed loans and/or rejected loans. The MPS quality control program significantly exceeds the requirements imposed by ML 89-32.

Stratford has also contracted with MPS for contract underwriting services. Although MPS's underwriter does not have the authority to issue corporate approval for Stratford under the DE program, the use of MPS for a pre-closing pre-audit alleviates file discrepancies and inconsistencies before Stratford commits to the loan. This review, by an independent third party who has never seen the file, helps eliminate mistakes. (Respondent's Brief in Support of Motion for Ruling on the Merits dated June 1, 1993, Exh. 2; Affidavit of John Christy dated May 28, 1983; Affidavit of Peter C. Tabisz dated June 1, 1993; Affidavit of Rick E. Smith dated June 1, 1993).

27. After the MMD audit of 1990, Stratford imposed restrictions on Rutledge. As a result, Stratford implemented a system to verify in advance of closing the existence of a face-to-face interview, the employment status of borrowers, and the source of downpayments. Stratford also limited Rutledge's sources of business to person who Stratford knew to be completely legitimate. Greta Phillips is no longer employed by Stratford. (Affidavit of Peter C. Tabisz dated June 1, 1993).

Applicable Regulations

The MRB may impose sanctions, including proposed withdrawal of a mortgagee's HUD/FHA approval, when any report, audit, investigation or other information before the Board discloses that a basis exists 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), 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:

> (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 requirements 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

The Government asserts that the alleged acts of Stratford constitute cause for a three-year withdrawal of Stratford's HUD/FHA mortgagee approval pursuant to 24 C.F.R. §§ 25.9 (g), (j), (k), (p), and (w). 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. § 25.9. A DE lender such as Stratford 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 approve only quality loan applications for publicly funded mortgage insurance.

Failure to adhere to HUD program requirements and prudent lending practices jeopardizes 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 who intentionally subvert the law pose a greater risk than those who are careless or imprudent. Thus, all mitigating factors are to be considered in reviewing the scope of this administrative sanction, 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. § 25.9; *See generally* ***Horizon Savings Ass'n.***, HUDBCA No. 91-5946-M12 (Sep. 1, 1992).

Although the regulations applicable to withdrawal of mortgagee approval do not specifically address the concept of present responsibility or the prohibition against using a sanction for punitive purposes, the withdrawal of mortgagee approval is a debarment-type sanction. The restriction against the punitive application of sanctions developed in the law of debarment and suspension is equally valid, by analogy, to this area of the law. ***Horizon Savings Ass'n.***, *supra* at p. 17. The Government concedes in its complaint that present responsibility is the applicable standard in this case.

HUD is proposing the withdrawal of Stratford's mortgagee approval as a DE lender based upon allegations that Stratford committed willful, serious, and repeated violations of HUD regulations and guidelines. HUD generally charges that Stratford participated in a scheme with developers, realtors and salespersons to circumvent HUD requirements; caused false statements to be submitted to HUD for the purpose of influencing HUD to insure mortgages; willingly or recklessly permitted realtors and others not entitled to do so under HUD regulations to provide undisclosed funds to mortgagors, thus aiding and enabling mortgagors to avoid making the required minimum investment in the properties; failed to conduct proper face-to-face interviews with borrowers; failed to implement and maintain a written quality control plan; submitted a loan for insurance that involved a strawbuyer; and had borrowers sign HUD Forms 92900 at closings after the loan was approved by the underwriter.

Face-to-Face Interviews

The evidence clearly reveals that in the majority of the transactions at issue, Rutledge did not conduct a face-to-face interview with borrowers, and there is little evidence, if any, that the face-to-face interviews were conducted by another Stratford employee. However, there is no evidence to establish that Stratford had knowledge of the fact that Rutledge was not conducting these interviews, nor any evidence that Stratford had reason to know or

should have known of this deficiency. To the contrary, the evidence establishes that Stratford was reasonably relying on Rutledge's representations that he had conducted face-to-face interviews in the transactions at issue, as evidenced by his initials in the appropriate block on the initial loan applications, and as evidenced by the fact that the forms were filled-out in Rutledge's hand. There is no evidence in this case which would establish that Stratford's reliance on Rutledge's representation was unreasonable, in any respect, nor is there evidence which would establish that Stratford was somehow chargeable with knowledge of Rutledge's breach of duty or that non-Stratford employees were conducting face-to-face interviews.

False Statements / False Certifications/ Quality Control Plan

The gravamen of HUD's complaint against Stratford is that Stratford either willfully participated in the fraudulent transactions, or negligently caused the fraud to occur, and that Stratford exacerbated the problem by failing to implement and maintain a quality control plan that met HUD guidelines. To support its charges against Stratford, HUD's complaint avers facts related to each of the transactions involved in this matter which HUD claims violates its requirements. Stratford admits that certain technical violations of HUD requirements occurred in a number of the transactions, but denies that it willfully participated in the fraud which occurred, or that it caused the fraud to occur. Stratford further asserts that, along with HUD and the public, Stratford was also a victim of the fraudulent scheme at issue. For the reasons stated below, I find that the Government's case must fail for want of proof.

There is no question that false statements were made by borrowers in a significant number of the transactions at issue. Typically, false statements were made with respect to the borrower's cash investment and the source of funds for this cash. Likewise, there is no question that these misrepresentations and false statements were caused, in large part, by the intentionally improper and unscrupulous activities of builders, developers, and sellers not connected with Stratford, and to some extent by Rutledge's failure to conduct face-to-face interviews. However, the evidence in this case is insufficient to establish knowledge of these irregularities on the part of Stratford. As stated above, the evidence is insufficient to establish that Stratford was aware of the fact that Rutledge was allowing employees of developers and real estate agents to conduct face-to-face interviews, or that Rutledge was aware of the fraud that was blossoming around him. Evidence of willing or knowledgeable participation did not surface in the ***Rutledge*** case. Likewise, there is insufficient evidence in this case to establish that any other employee of Stratford participated in or was otherwise aware of the fraud. The evidence which the Government submitted in this case to attempt to prove Stratford's knowledge is not convincing, and fails to establish that Stratford was a willful and knowledgeable participant in the scheme.

For the same reasons, the evidence in this record is insufficient to establish that deficiencies in Stratford's loan processing and underwriting procedures were a substantial contributing cause of the fraud. The Government's evidence is sufficient to establish that Stratford's loan processing procedures were in need of improvement in the time period in

question. For example, Stratford's loan processor and underwriter failed to detect a clear discrepancy in a social security number in the Rodgers transaction, and there is some question with respect to the authenticity of certain signatures in the DeLeon transaction. In 1987, the Hutcherson transaction was overinsured because of a mistake in calculating the amount of the insurable debt. I do not, however, find such evidence to be indicative of a lack of present responsibility, because the errors appear to be attributable to human error and oversight, a problem which Stratford recognized early on and corrected. There is no evidence in this record that such problems were anything other than isolated errors. This evidence establishes that Stratford needed some "tightening" in its procedures, and Stratford has provided convincing evidence that it has done just that. Moreover, the MRB did not propose the withdrawal of Stratford's mortgagee approval for deficient loan processing procedures.

In addition, the Government did not present evidence going to the sufficiency of Stratford's loan processing or underwriting procedures. Stratford, on the other hand, has submitted affidavits from four key employees which address, at some length, the loan processing and underwriting procedures utilized by Stratford during the time-frame at issue. The procedures set forth by Stratford appear reasonably thorough and prudent on their face, and the evidence is insufficient to establish that Stratford was not following these procedures at the time the fraudulent transactions occurred. Stratford argues that the fraud occurred despite the soundness of its procedures, because it was a well-rehearsed scheme that was difficult to detect. In the absence of evidence to the contrary, Stratford's argument has merit. I find, accordingly, that the Government has failed to establish that Stratford negligently caused the fraud to occur.

The Government also argues that Stratford's certifications on numerous Forms 92900 were false because Stratford made its certification on many Forms 92900 prior to the execution of the borrower's certification. This argument is incorrect and specious. The lender's certification states, in relevant part, at Block 26E of the form, that the application was signed by the borrower after certain sections of the form were completed. There is no evidence in this case that any borrower signed a Form 92900 in blank, and there is no evidence that the requisite sections of the form were not filled out at the time Stratford made its certification. Therefore, the Government has failed to establish that Stratford's certifications were false. *See Renee Divins*, HUDBCA No. 92-C-7511-D30 (Jun. 4, 1992), at 15.

The Government also argues that in a number of transactions (DeLeon, Dominguez, Lara, Requena, Russell, Sosa, and Tripp), Forms 92900 were signed at closing by the borrowers, implying that the loans received DE underwriting approval before the Forms 92900 were executed. Stratford asserts that it has a strict policy precluding a loan being underwritten prior to a Stratford employee verifying the information and obtaining the borrower's signature(s) on the Form 92900. Stratford also asserts that on rare occasions and due to exigent circumstances, a Form 92900 might be reviewed with the borrowers and the signatures obtained on the same day as closing, but that in such an instance, the signed Form

92900 is returned to Stratford's office and submitted to the underwriter, who must approve the loan based on the information in the Form 92900, prior to releasing the loan documents for closing.

There is no question that the Form 92900 must be completed and signed prior to the underwriting of the loan. It is undisputed that in at least one transaction (Russell), the Form 92900 was not signed by the borrowers until the day of closing. In certain other transactions, the borrowers believe that the Forms 92900 were signed at closing. I do not find this evidence persuasive. In all but the Russell transaction, the dates on the Forms 92900 were earlier than the date of closing. There were no explanations for this inconsistency, except in the Dominguez transaction, where the borrower speculated about a possible mistake. Even assuming that the borrowers' recollections are correct, this evidence does not establish, *ipso facto*, that any of the Forms 92900 were signed before the loan was underwritten. It would be no less reasonable to infer that the Form 92900 was signed earlier in the day and that Stratford subsequently gave its underwriting approval prior to closing. In every transaction except Russell, the Forms 92900 bear dates for borrower signatures that are one or more days prior to the closing date. There is no evidence in this case that any borrower was instructed by anyone to back date any Form 92900, nor any hint that this occurred. Moreover, in light of the numerous false statements made by the borrowers in these transactions, I find their credibility highly questionable. I also find it troubling that there is no evidence in this case from the title company employees who conducted these closings. Such evidence could be extremely probative because the observations of title company employees of any irregularities at the closing could be useful.

For the reasons set forth above, I find that the Government has not carried its burden of proof in establishing that Stratford underwrote these loans prior to the execution of the Forms 92900. I further find that the Government has not established that Stratford either willfully participated in the making of the false statements at issue, or that Stratford caused the making of the false statements at issue.

Barring a finding that Stratford either willfully participated in the fraudulent transactions, or that Stratford negligently caused the fraud to occur, the Government could still establish cause for the imposition of a sanction if it established that Stratford either had reason to know of the fraud, or that Stratford should have known of the fraud. The "reason to know" standard imposes no duty of inquiry; it merely requires that a person draw reasonable inferences form other information already known by him. *See* ***Kisser v. Cisneros***, 14 F.3d 615 (D.C. Cir. 1994), *citing* ***Novicki v. Cook***, 946 F. 2d 938, 941 (D.C. Cir 1991). "Should know," on the other hand, implies that the person owes another the duty of ascertaining the fact. ***Novicki v. Cook***, *supra* at 942; ***Paul Knight***, HUDBCA No. 92-G-7560-D40 (Apr. 6, 1993). At common law, a person should know a fact if:

> [a] person of reasonable prudence and intelligence, or of the superior intelligence which [such a person may have] would ascertain the fact in question in the performance of his duty to another, or would govern his conduct upon the assumption

that such a fact exists. Restatement, Second, Torts § 12(2); Restatement Second, Agency § 9.

The Restatement provides that an individual's negligent conduct is a legal cause of harm to another if: (a) his conduct is a substantial factor in bringing about the harm, and (b) there is no rule of law relieving the individual from liability because of the manner in which his negligence has resulted in harm. *See* Restatement, Second, Torts § 431; 57A Am. Jur. 2d, Negligence § 475 (1992), and cases cited therein; ***McClure v. Allied Stores of Texas, Inc.***, 608 S.W. 2d 901 (Tex. 1980).

For a number of reasons, I conclude that the Government has not established either that Stratford had reason to know of the false statements at issue, or that Stratford should have known of the false statements at issue. Under the "had reason to know" standard, the Government would have to establish that the loan documents for these transactions contained "red flags," i.e., evidence that should have caused either the loan processor, the underwriter, or both to conclude that there was a reasonable likelihood of fraud in a particular transaction, and as a result, to further inquire. The mere fact that a source of funds block on a Form 1003 was not filled-in, as was the case in many of the transactions at issue, is not dispositive, because verifications and source of funds letters were obtained which contained valid explanations for the source of funds. In addition, there is no evidence that it was unusual for a debtor not to know the source of funds for these payments at the time of filling out the initial loan application, and it would not be illogical to conclude that this might be a fairly typical occurrence with borrowers who barely qualify for FHA-insured loans. A recently opened bank account would not necessarily comprise a "red flag," because there are a number of equally reasonable inferences that can be drawn from that fact. In addition, there is no evidence in this case of any discernible pattern of deficiencies in these transactions. Moreover, as the transactions at issue were scattered over a lengthy time-period and processed by several different individuals, I cannot conclude that any discernible pattern existed in the paperwork for these transactions that should have caught Stratford's attention, nor can I conclude that the discovery of any isolated problem with a particular transaction would have led Stratford to discover the fraud. Under the circumstances, I find this evidence insufficient to establish that Stratford had reason to know of the fraud.

With respect to the "should have known" standard, there is little evidence in this case going to the processing and underwriting procedures used by Stratford, and the Government has submitted no evidence with respect to the prudence of the processing and underwriting procedures that were followed by Stratford. In the absence of such evidence, the Government has failed to establish that Stratford was not using reasonable prudence in its loan processing and underwriting procedures. The evidence is also insufficient to raise a question with respect to whether Stratford was reasonably relying on Rutledge to perform loan origination activities. The sworn testimony of Stratford officials going to Stratford's reasonable reliance upon Rutledge is unrebutted, and there is no evidence which would establish that Stratford's reliance upon Rutledge at the time was imprudent or misplaced.

A complete review of the paperwork for the transactions at issue raises no significant loan processing or underwriting deficiencies, and none were raised by the MMD in its review, with the exception of the cited deficiencies in the Stratford quality control plan. Based upon the foregoing, I find the evidence insufficient to establish that Stratford should have known of the fraud.

The Government also argues that at the time of the audit in September, 1990, Stratford's quality control plan failed to comply with HUD's requirements set forth in ML 89-32, in that the plan did not: (1) call for a review of ten per cent of all FHA loans closed; (2) ensure that mortgage insurance premiums are submitted within 15 days of closing, with late charges and interest properly credited; (3) ensure that the mortgagee did not employ persons debarred, suspended, or under a Limited Denial of Participation; and (4) provide for face-to-face interviews with borrowers prior to execution of the loan for underwriting.

With respect to these arguments, Stratford contends that: (1) these allegations are not properly before the Board because they were not pleaded in the complaint; (2) Stratford did not receive ML 89-32 in timely fashion and was not immediately aware of its requirements for quality control plans; (3) Stratford immediately amended its quality control plan to conform with ML 89-32 when Stratford became aware of its existence; (4) the quality control plan implemented by Stratford prior to gaining knowledge of ML 89-32 provided for a review of ten percent of all loans closed by Stratford, including FHA loans; (5) it was Stratford's policy that face-to-face interviews be conducted by its loan officers prior to the closing of FHA insured loans; (6) it was always Stratford's policy not to employ persons debarred, suspended, or under an LDP, and that Stratford has not employed such persons; (7) Stratford submits all mortgage insurance premiums to HUD within 15 days of closing, pursuant to HUD's policy; and (8) adoption of ML 89-32 at the time it was issued would not have prevented the fraud in this matter. Only six of the transactions in this case occurred after issuance of ML 89-32.

Stratford's argument that the alleged defects in its quality control plan are not properly before this Board is incorrect. The complaint in this matter clearly states that HUD was basing its action, in part, upon a finding by the MMD that Stratford had failed to implement a quality control plan that was in accordance with the Department's requirements. Stratford was long ago informed of the specifics of this allegation, and has not argued that it has been prejudiced by the general nature of the allegation in the complaint. *See* 24 C.F.R. § 26.10(b). Based upon Stratford's defense against this allegation, I find that Stratford has not been prejudiced in its defense of this matter by the general nature of this allegation in the complaint. Moreover, if Stratford needed additional information with respect to this charge, it should have sought such information through discovery. Under the circumstances, I find this argument to be without merit.

There is some evidence in this case which establishes that, for a time after its issuance, Stratford's QCP did not meet all of the requirements of ML 89-32, and in this respect, the Stratford QCP was "deficient." However, this evidence is insufficient to

establish cause for the withdrawal of Stratford's mortgagee approval, whether the deficiencies are considered in isolation from the loan transactions at issue in this matter, or in conjunction with these transactions. While the evidence establishes a failure by Stratford temporarily to fully comply with a number of the requirements set forth in ML 89-32, it is difficult to fault Stratford, because HUD has failed to establish either that it provided the mortgagee letter to Stratford in timely fashion, or that Stratford was otherwise on notice of the requirements of the letter. There is also some evidence that Stratford's loan processing policies and quality control plan were in accord with HUD's policies which pre-dated ML 89-32, and the evidence shows that Stratford timely amended its quality control plan to conform with ML 89-32 when Stratford learned of its existence. There is also uncontroverted evidence which establishes that Stratford now has in place a quality control plan which exceeds HUD's requirements. This evidence constitutes a substantially mitigating circumstance. Moreover, there is no evidence in this matter which establishes a nexus between Stratford's quality control plan and the fraud which occurred in a number of the transactions at issue. In the absence of such a nexus, it would be baseless speculation to connect Stratford's quality control plan with any of the defects in the loan transactions at issue. This allegation fails for lack of proof.

Other Issues

The Government argues that the Pratt transaction was an improper "strawbuyer" transaction. The basis of this charge is the undisputed fact that when [redacted] Pratt failed to qualify for a loan, her daughter, [redacted] Pratt, was substituted as the buyer. In order to establish this charge, the Government would have to prove, as a threshold fact, that [redacted] Pratt had no intention of occupying the premises. There is no evidence that [redacted] Pratt did not intend to occupy the premises. Stratford obtained an Affidavit of Occupancy from [redacted] Pratt to corroborate her intention regarding occupancy, and there is no evidence which establishes that [redacted] Pratt did not occupy the premises. I find, accordingly, that the Government has not established that Stratford had knowledge, actual or constructive, that [redacted] Pratt did not intend to occupy the premises, or that she did not actually do so.

An issue was raised in the Government's complaint with respect to certain loans closed by Stratford which were originated by its loan correspondent, Bent Tree Marketing, Inc. This issue is not within the Board's jurisdiction in this case, because it was not raised in the MRB notice to Stratford dated April 4, 1991, and there have been no amendments to that notice. *See* 24 C.F.R. § 26.10(b). Accordingly, I find that the issue was improperly alleged in the Government's complaint. Moreover, there has been no development of the facts by the Government with respect to this issue, nor any argument or citation of legal authority in support of the Government's position on this issue. Based upon the foregoing, this issue was not considered in reaching the determination in this case.

Conclusion

The Government has failed to establish by a preponderance of the evidence that Stratford committed willful, serious, and repeated violations of HUD regulations and program requirements. While the evidence clearly establishes that a group of developers, realtors, and salespersons conspired with borrowers to circumvent HUD minimum investment requirements, and that the transactions at issue were pervaded by false statements which were the lynch-pin of the fraudulent scheme, the evidence falls far short of establishing that Stratford had either actual or constructive knowledge of the scheme, or that imprudence on the part of Stratford was a substantial contributing cause of the scheme. There is no question that Rutledge's lax practices contributed to the success of the scheme, and it is likely that the wrongdoers took full advantage of the fact that Rutledge was less than fully vigilant. However, the Government has failed to established that Stratford either participated in the scheme or had either actual or constructive knowledge of it. In this respect, the Government's brief does not even address the "reason to know" or "should have known" standards. Although the Government has submitted some evidence purporting to establish actual knowledge by Rutledge, not Stratford, comprised chiefly of unsworn statements from borrowers, this evidence is insufficiently probative to prove actual knowledge. Moreover, the actions of these borrowers in making numerous, self-serving false statements in order to qualify for their loans, casts doubt upon their credibility. Under the circumstances, I find the Government's allegation that Rutledge had actual knowledge of certain fraudulent actions to be unconvincing in establishing any culpable knowledge on the part of Stratford, the Respondent in this proceeding.

The Government also has not established by a preponderance of the evidence that Stratford "caused" other alleged violations of HUD program requirements. Although there is some evidence in this case bearing on the issue of whether Rutledge might have been allowing certain borrowers to hand-carry certain verifications, this evidence is far from preponderant. The Government's evidence is opposed by affidavits from Rutledge and other Stratford employees, who vehemently deny engaging in such acts. The verifications at issue also contain certifications of mailing by appropriate certifying officials, which corroborates Stratford's position that the verifications were properly handled by Stratford's loan processors, and there is no evidence that any of the allegedly hand-carried verifications ever became part of a loan file. The Government has not met its burden of proof with respect to the handling of these verifications. Nor has the Government established that Stratford was either falsely certifying HUD Forms 92900 or executing such forms after the loans had been closed. Stratford admits that it over-insured one loan, and that certain discrepancies in loan-related documents were not resolved as a result of human error. These facts are insufficient to demonstrate a lack of present responsibility, because there is no evidence that anything other than isolated mistakes were involved, and because Stratford has taken significant steps to minimize the possibility that such mistakes will recur in the future.

To Stratford's credit, the evidence clearly establishes that Stratford has made impressive and significant enhancements in its quality control and underwriting procedures. I

find it mitigating that Stratford brought its quality control plan into compliance with ML 89-32 shortly after being informed of the deficiencies, and I find it substantially mitigating that Stratford has had in place for some time an extremely thorough and sophisticated automated quality control system which contains numerous and redundant checks and balances. I also find it substantially mitigating that Stratford is utilizing an independent contract underwriter to conduct pre-underwriting services. *See* ***Arc Asbestos Removal Co., Inc.***, HUDBCA No. 91-5791-D25 (Apr. 12, 1991) (where the Board viewed corrective action which provided HUD with a significant degree of protection from future improper conduct as a mitigating circumstance). I also note that these transactions occurred four to seven years ago, and that the fraud was limited to a narrow group of wrongdoers. The passage of time, when coupled with corrective action, is also a mitigating circumstance. *See* ***Victor Zarrilli and Mark Twain Bank***, HUDBCA No. 89-4509-D47 (Nov. 28, 1990).

Based upon the foregoing, I do not find that it is presently in the public interest to withdraw Stratford's mortgagee approval, and I find Stratford to be presently responsible. I further find that it would be punitive to impose a sanction upon Stratford at this date solely for the "deterrent effect" which a sanction might have, and I will not impose a sanction solely on that basis. *See* ***U.S. v. Bizzell***, 921 F.2d 263 (10th Cir. 1990); citing ***U.S. v. Halper***, 490 U.S. 433, 448 (1989) (in a case involving HUD, the 10th Circuit observed that if a civil sanction, such as debarment, can not be characterized as remedial, but only as a deterrent, it constitutes punishment).

For the foregoing reasons, Stratford's mortgagee approval shall not be withdrawn.

Timothy J. Greszko
Administrative Judge