UNITED STATES OF AMERICA
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
OFFICE OF HEARINGS AND APPEALS

In the Matter of:	
VINSON MORTGAGE SERVICES, INC.	16-JM-0076-MR-008
Respondent.	August 14, 2017

Appearances

Ross A. Fisher, Barrett R. McVary, and Brian A. Dupré, Attorneys
United States Department of Housing and Urban Development, Washington DC
For Petitioner

Jeffrey K. Lucas, Attorney
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For Respondent

INITIAL DECISION AND ORDER

BEFORE: J. Jeremiah MAHONEY, Chief Administrative Law Judge

On May 5, 2015, the Mortgagee Review Board ("Board") of the United States Department of Housing and Urban Development ("HUD") issued a *Notice of Violation*, alleging that Respondent failed to meet HUD recertification requirements related to its Fiscal Year (FY) 2013 financial statements and cure of audit findings. Respondent timely responded and provided additional documents to HUD. On March 15, 2016, the Board issued a *Notice of Withdrawal/Notice of Administrative Action* ("NOAA") withdrawing approval of Respondent as a Federal Housing Administration (FHA) mortgagee for one year. On April 8, 2016, Respondent filed a *Notice of Appeal* requesting a hearing to challenge the NOAA.

On April 11, 2016, this matter was referred to the Chief Administrative Law Judge. The Court issued a *Revised Notice of Hearing and Order* dated February 22, 2017, scheduling the hearing to commence on March 21, 2017. The first two days of the hearing were held, as scheduled, in Washington, DC, and a third day was held by videoconference between Washington, DC and St. Louis, MO. The hearing lasted a total of three days, March 21, 22, and April 26, 2017. The Parties filed Post-hearing briefs on June 5, 2017 and, with an extension of time, filed Reply briefs on July 10, 2017.

Applicable Law and Guidance

FHA Approval of Mortgagees. The National Housing Act ("the Act"), Pub. L. No. 84-345, 48 Stat. 1246 (1934), 12 U.S.C. §§ 1701 *et seq.* created the Federal Housing Administration and the Board, provided for the insurance of mortgages by the federal government, and established the Mutual Mortgage Insurance Fund, with which the government could guarantee qualifying mortgages. To be eligible for FHA insurance, the Act requires that all qualifying mortgages shall "[h]ave, or be held by, a mortgagee approved by the Administrator as responsible and able to service the mortgage properly." 12 U.S.C. § 1709(b)(1). Pursuant to the Act, the FHA established requirements that mortgagees must satisfy to obtain, and to annually renew, approval to originate FHA-insured loans. These are set forth at 24 C.F.R. Part 202 and the FHA Title II Mortgagee Approval Handbook 4060.1, REV-2 (2006).

Under 24 C.F.R. § 202.5(g), the mortgagee must provide to the HUD Secretary a copy of its audited financial statements within 90 days of its fiscal year end and furnish such other information as the Secretary may request. HUD-approved Title II non-supervised mortgagees are subject to the HUD Uniform Financial Reporting Standards. 24 C.F.R. § 5.801(a)(5). Under those standards, the mortgagee "must provide to HUD such financial information as required by HUD... on an annual basis... [and these] must be... [p]repared in accordance with Generally Accepted Accounting Principles ["GAAP"] as further defined by HUD in supplementary guidance." 24 C.F.R. § 5.801(b)(1).

Against the backdrop of one of the most significant real estate crises in U.S. history, HUD revised its regulations to increase the net worth minimum benchmarks for all annual mortgagee recertification packages submitted after May 2013. Federal Housing Administration: Continuation of FHA Reform; Strengthening Risk Management Through Responsible FHA-Approved Lenders, 75 Fed. Reg. 20718, 20733 (Apr. 20, 2010). In its explanation of the changes to the net worth requirements, HUD stated that the requirements had not been adjusted since 1993 and that the changes were being made "to ensure that FHA-approved mortgagees are sufficiently capitalized for the financial transactions occurring, and concomitant risks present, in today's economy." Id. at 20718.

The applicable net worth requirement is set out at 24 C.F.R. § 202.5(n)(3)(i) and states that:

> [i]rrespective of size, ... each approved lender or mortgagee, for participation solely under the FHA single family programs, shall have a net worth of not less than $1 million, plus an additional net worth of one percent of the total volume in excess of $25 million of FHA single family insured mortgages originated, underwritten, purchased, or serviced during the prior fiscal year, up to a maximum required net worth of $2.5 million. No less than 20 percent of the applicant's or approved lender or mortgagee's required net worth must be liquid assets consisting of cash or its equivalent acceptable to the Secretary.

HUD issued the FHA Title II Mortgagee Approval Handbook ("Handbook") to offer guidance and further clarification to mortgagees and participants in the FHA's Title II program.

The Handbook informs lenders that "mortgagees must meet specified net worth requirements for initial approval and to maintain approval." FHA TITLE II MORTGAGEE APPROVAL HANDBOOK 4060.1, REV-2 at ch. 2-5. "An approved mortgagee must maintain at least the minimum required adjusted net worth at all times. If at any time it falls below the required minimum, the mortgagee must notify the Lender Approval and Recertification Division and submit a Corrective Action Plan. Failure to comply is grounds for administrative action by the Mortgagee Review Board." Id. at ch. 6-21. If an FHA-approved lender represents that the net worth deficiency was cured *before* issuance of the audit report, "HUD reviews the notes to the financial statement to determine if there has been a subsequent event that brings the mortgagee's net worth to FHA requirements." Id. at ch. 4-5 (B)(5)(a). However, if an FHA-approved lender purports to cure the net worth deficiency after issuance of the audit report, HUD requires that the lender provide documentation establishing a "sufficient amount of capital has been contributed to the company to correct the [net worth] deficiency." Id. at ch. 4-5 (B)(5)(b). Further, the Handbook specifies that "[t]he mortgagee's corrective action plan must describe the form of the capital contribution, the exact date of the contribution, and the amount or value of the contribution." Id. Finally, the Handbook states that where an analysis of the mortgagee's electronic "submission and notes ... reveals that the mortgagee's adjusted net worth does not meet FHA requirements [such violation] is grounds for administrative action by HUD's Mortgagee Review Board." Id. at ch. 4-5 (B)(5)(c).

The Authority of the Mortgagee Review Board. The Act also established the Board and empowered it to take certain actions, including a withdrawal of any mortgagee found to be engaging in activities that violate FHA requirements or nondiscrimination requirements. 12 U.S.C. § 1708(c)(1). Whenever a "report, audit, investigation, or other information before the Board discloses that a basis for administrative action exists, the Board shall take one of the following actions: (1) Letter of reprimand; (2) Probation; (3) Suspension; (4) Withdrawal; and, (5) Settlement. 12 U.S.C. § 1708(c)(3) (emphasis added). In determining which administrative action should be taken, the Board considers, among other factors, the seriousness and extent of the violations, the degree of mortgagee responsibility for the occurrences, and any other mitigating or aggravating facts. 24 C.F.R. § 25.8.

Under 12 U.S.C. § 1708(c)(3)(D), the Board "may issue an order withdrawing a mortgagee if the Board has made a determination of a serious violation or repeated violations by the mortgagee." The Board "shall determine the terms of such withdrawal, but the term shall be not less than 1 year [and if] the violation is egregious or willful, the withdrawal shall be permanent." Id.

The HUD regulation at 24 C.F.R. § 25.6 provides, in relevant part, that:

> [a]ny administrative action imposed under 12 U.S.C. § 1708(c) shall be based upon one or more of the following violations:... (e) The failure of a nonsupervised mortgagee to submit the required annual audit report of its financial condition prepared in accordance with instructions issued by the Secretary...; (g) Failure to comply with any agreement, certification, undertaking, or condition of approval listed on, or applicable to, ... a mortgagee's application for approval ...; (j) Violation of the requirements of any contract or agreement with the Department, or violation of the

> requirements set forth in any statute, regulation, handbook, mortgagee letter, or other written rule or instruction...

In situations where the Board seeks to impose a withdrawal, it must issue a notice that describes the nature and duration of the administrative action, specifically states the reasons for the action, and informs the mortgagee of its right to a hearing regarding the administrative action and of the manner and time in which to request a hearing. 24 C.F.R. § 25.9(b); see also 12 U.S.C. § 1708(c)(4).

Hearing Procedures. When requested, hearings are to be on the record and conducted by an Administrative Law Judge (ALJ). 24 C.F.R. § 25.10(b). The hearing shall be conducted in accordance with the applicable provisions of 24 C.F.R. Part 26 with specific modifications. 24 C.F.R. § 25.10(c). HUD shall prove the respondent's liability and any aggravating factors by a preponderance of the evidence. Respondent shall prove any affirmative defenses and any mitigating factors by a preponderance of the evidence. 24 C.F.R. § 26.45(e). In determining the appropriate outcome, "the court is required to consider the same regulatory requirements which the Board was bound to consider in the first instance," and "shall issue an initial decision based only on the record." Puller Mortgage, HUDALJ 89-112-MR, slip op. at 8 (HUDALJ Oct. 17, 1990); R&G Mortgage, HUDALJ 07-052-MR, slip op. at 13 (HUDALJ Nov. 20, 2007); see also 24 C.F.R. § 26.50(a).

Findings of Fact

Vinson Mortgage Services, Inc. ("Vinson Mortgage") is a non-bank entity, founded in 2006, that originates and underwrites conventional and FHA-insured home mortgage loans. The company currently has approximately 75 employees. Vinson Mortgage's current owners, Ray "Shawn" Vinson, III and Kevin D. Vester, purchased the company in November 2014 and, since that time, the company has had no other owners. Mr. Vinson has served as President of Vinson Mortgage since 2006. Mr. Vester has worked as an officer for Vinson Mortgage since the company's incorporation in 2006 and, at all relevant times, Mr. Vester has served as Vice President of Operations. Since November 2014, Mr. Vester has also served as Vinson Mortgage's Chief Operating Officer.

Vinson Mortgage's home mortgage loan revenue is derived from two sources: the fees it collects from borrower-applicants from application through closing and the proceeds it receives when it sells an issued home mortgage loan post-closing to another entity.

Vinson Mortgage's Participation in the FHA Title II Program

On November 19, 2010, Vinson Mortgage applied for approval to participate in FHA's Title II program for single-family mortgages. At the time of its application, Vinson Mortgage agreed to comply with the requirements of the Secretary of Housing and Urban Development, which include, but are not limited to, the National Housing Act, HUD's regulations, FHA handbooks, and mortgagee letters with regard to using and maintaining its FHA lender approval.

The FHA approved Vinson Mortgage to participate in the Title II FHA loan program on December 20, 2010, and issued Vinson Mortgage the lender identification number 24381. In the

December 20, 2010 approval letter, HUD informed Vinson Mortgage that Vinson Mortgage was required to comply with Title II Mortgagee Approval Handbook 4060.1, REV. 2 and all subsequent mortgagee letters. Since receiving FHA approval, Vinson Mortgage has been a non-supervised mortgagee as that term is defined in 24 C.F.R. § 202.7. Approximately half of Vinson Mortgage's loan volume consists of FHA loans.

HUD requires FHA-approved lenders to annually complete a recertification process through the Lender Electronic Assessment Portal ("LEAP") in order for the lender to maintain its FHA approval. As part of the FHA recertification process, Vinson Mortgage was required to submit annual audit reports through LEAP. These annual audit reports were required to include two components: a financial statement audit of the Vinson Mortgage and a compliance audit of each of Vinson Mortgage's major HUD programs.

Vinson Mortgage's FHA Title II program was a major HUD program for which a compliance audit was required. To meet HUD requirements, the audit report must show whether the company had an adjusted net worth in excess of the regulatory minimum as of December 31, 2013, and whether the company met and maintained an adjusted net worth in excess of the regulatory minimum throughout Fiscal Year 2013.[1] In addition, Vinson Mortgage is required to submit a Corrective Action Plan in response to any findings identified by the auditor in every audit report submitted to HUD.

The Original FY 2013 Audit Report

The company retained the firm of Clifton Larson Allen LLP to audit Vinson Mortgage's financial statements for Fiscal Year 2013 (the "Original FY 2013 Audit Report"). Vinson Mortgage was responsible for the preparation and fair presentation of the financial statements in the Original FY 2013 Audit Report. In a letter dated March 31, 2014, to Clifton Larson Allen, Messrs. Vinson and Vester stated that "Note 13 to the consolidated financial statements discloses all the matters of which we are aware that are relevant to the Company's ability to continue as a going concern, including significant conditions and events, and management plans."

The Original FY 2013 Audit Report is dated March 31, 2014, and was provided late to HUD (due to problems with LEAP) on September 24, 2014. The Original FY 2013 Audit Report stated that Vinson Mortgage was required to have a minimum adjusted net worth of $2,173,378 for Fiscal Year 2013. However, it concluded that Vinson Mortgage's adjusted net worth for Fiscal Year 2013 was $357,641, and that the company "ha[d] a significant lack of sufficient capital." The Original FY 2013 Audit continued, "There is a shortfall of approximately $1.8 million needed in order to meet the minimum amount required using HUD guidelines." It also noted, "[a] formal plan has not been adopted by [Vinson Mortgage] to inject the necessary capital. As of March 31, 2014, the necessary capital has not been raised by [Vinson Mortgage]." As such, the Original FY 2013 Audit Report stated under the heading, "Basis for Disclaimer of Opinion," that Vinson Mortgage "has a significant lack of sufficient capital and does not have a formal plan to inject the necessary capital."

The Original FY 2013 Audit Report also stated that Vinson Mortgage's "CFO resigned during mid 2013 and has not been replaced," that management of Vinson Mortgage did "not have

[1] Vinson Mortgage's Fiscal Year 2013 ended on December 31, 2013.

the full ability to adequately prepare [a] consolidated financial statement," that "[a]dequate skills and abilities do not exist inside [Vinson Mortgage] to properly prepare the consolidated financial statements," and that "[t]he potential for unreliable and incomplete information exists due to the lack of proper knowledge." It also noted that "[w]orking capital is extremely low and [Vinson Mortgage] has failed to meet the minimum net worth as stated by HUD," that Vinson Mortgage's "[c]urrent assets minus current liabilities reveals a significant deficiency," and that "[t]he potential for [Vinson Mortgage] not being able to meet cash flow demands exists and the long-term viability of the Company is at risk due to these capital issues." In Finding 2013-5, the report further stated that "[w]orking capital" was "approximately $32,000 at year end," and that Vinson Mortgage was "short of the HUD net worth requirement by approximately $1,800,000." This Finding stated as a "Recommendation," that a "proper business plan must be adopted by the Company to fix the lack of working capital. Additionally, [Vinson Mortgage] is in need of a capital injection in order to meet the HUD minimum net worth requirement."

In response, Vinson Mortgage stated that "[o]wnership is working to obtain an [Small Business Administration (SBA)] loan (hereafter, "SBA Loan"). The proceeds from that loan will be injected into the company as working capital. Going forward, management will ensure net worth does not drop below minimum requirement." However, Vinson Mortgage's Corrective Action Plan was not implemented before March 31, 2014, the audit date of the Original FY 2013 Audit Report. Indeed, the documentation for the SBA Loan was not completed until November 2014.

The SBA Loan

The SBA Loan is a business loan by Fortune Bank that is insured by the SBA pursuant to the 7(a) loan program. The language of the SBA Loan states that the "specific purpose of this loan is: [t]o pay off the company's existing accounts payable and to provide working capital." The SBA Loan notes that, "Borrower may not use an oral statement of Lender or SBA to contradict or alter the written terms of this Note" and further states that "[o]ral agreements . . . to forebear from enforcing payment of a debt . . . are not enforceable. . . To protect you (Borrower(s)) and us (Creditor) from misunderstanding or disappointment, any agreements we reach covering such matters are contained in this writing, which is the complete and exclusive statement of the agreement between us, except as we may later agree in writing to modify it."

The SBA Loan is comprised of at least six documents signed by Mr. Vester or Mr. Vinson or both as officers of Vinson Mortgage, and identifies the Borrower as Vinson Mortgage Services, Inc.; Kevin D. Vester; and Ray "Shawn" Vinson III. The SBA Loan states that each Borrower is "jointly and severally liable" for the SBA Loan and the SBA Loan's Commercial Security Agreement identifies the Grantor as Vinson Mortgage Services, Inc.; Kevin D. Vester, and Ray "Shawn" Vinson III. In addition, the SBA Loan's Commercial Security Agreement includes, in the definition of Collateral, assets for which Vinson Mortgage is the exclusive owner.

The original principal amount of the SBA Loan was $932,000. The SBA Loan's Disbursement Request and Authorization identifies the SBA Loan as being made "to two individuals and a Corporation." On November 21, 2014, $906,324 was disbursed to the Borrowers as follows: $453,162, or one-half of the amount of the SBA Loan disbursed to an

account owned by Mr. Vinson; and $453,162, or one-half of the amount of the SBA Loan disbursed to an account owned by Mr. Vester. On November 25, 2014, Mr. Vinson and Mr. Vester each transferred amounts of $453,162 from their individual accounts to a separate account owned by Vinson Mortgage.[2]

The FHA Review of the Original FY 2013 Audit and Respondent's Response

On March 12, 2015, Robert May, a Level 2 Auditor in the Federal Housing Administration, Office of Lender Activities and Program Compliance emailed Mr. Vinson noting that the Original FY 2013 Audit Report submission was deficient. In his email, Mr. May asked Mr. Vinson to submit the following into the LEAP system:

- An independent auditor's report on the financial statements and supplemental computation of adjusted net worth, and on compliance that expresses an unqualified or qualified opinion;
- A Corrective Action Plan for the adjusted net worth noncompliance that a) states the exact date, amount, source of the cash infused to remedy the noncompliance and b) provides a plan for monitoring noncompliance monthly going forward;
- A copy of the complete (all pages) company bank statements for the months in which deposits were made to offset the adjusted net worth deficiency; and
- A separate management written corrective action plan on letterhead for each internal control finding cited by the IPA.[3]

On May 5, 2015, the Board, through its Secretary, Nancy Murray, issued a Notice of Violation alleging Vinson Mortgage failed to meet HUD/FHA recertification requirements. Specifically, the Notice of Violation stated that HUD was considering taking an administrative action against Vinson Mortgage and also considering imposing civil money penalties because Respondent had failed to "... Submit an Acceptable Audited Financial Statement(s) and Supplementary Reports and/or timely submit required cure documents via HUD's Lender Electronic Assessment Portal..."

By letter dated June 5, 2015, Vinson Mortgage responded to the Notice of Violation and Mr. May's March 12 email. In its response, Vinson Mortgage disputed some of the conclusions in the Original FY 2013 Audit by Clifton Larson Allen and represented that the company's new owners had contributed capital to increase its net worth. In support, Vinson Mortgage attached the FY 2014 Audit Report by its new independent auditors, Mueller Prost, purporting to demonstrate correction of all the previous findings including the net worth deficiency noted in the Original FY 2013 Audit by Clifton Larson Allen. The FY 2014 Audit represented that the

[2] Although stipulated fact #58 in HUD's March 17, 2107 Prehearing Statement listed this date as November 21, 2014, the exhibit cited lists the date as November 25, 2014. The latter date is confirmed by Respondent's bank statement that lists the date of the wire transfer as November 25, 2014.

[3] Mr. May testified that this request was primarily based on HUD Handbook 4060.1 Rev. 2 ch. 4-5. And, the reason he asks for full, un-redacted bank statements is "to verify that the contribution went into the accounts of the company" and "because sometimes they deposit money one day and take it out the next, or two weeks later..."

net worth deficiency had been corrected by capital contributions by Mr. Vinson and Mr. Vester and by retained profits in 2014.

On December 15, 2015, Mr. Vester sent an email to Edward Muckerman, a staff member of the Board. As part of Respondent's corrective action, Mr. Vester attached to the email the previously shared FY 2014 Audit Report, and bank statements covering the period from November 1, 2014 to November 30, 2014. The bank statements included: (1) a deposit entry described as an "INCOMING WIRE TRANSFER" on November 24, 2014 in the amount of $453,162.00; (2) a withdrawal entry described as a "FUNDS TRANSFER TO SV" on November 24, 2014 in the same amount of $453,162.00; and, (3) a deposit entry described as an "INCOMING WIRE TRANSFER" on November 25, 2014, in the same amount, $453,162.00.

The Second FY 2013 Audit

The Board informed Vinson Mortgage that its FHA-approval had been withdrawn for a period of one year through a NOAA, dated March 15, 2016. The NOAA stated the basis for the one-year withdrawal was Vinson Mortgage's violation of HUD/FHA recertification requirements for the fiscal year ending December 31, 2013. Specifically, the NOAA stated the basis for the withdrawal was Vinson Mortgage's failure to timely submit acceptable audited financial statements via HUD's LEAP.

After the issuance of the NOAA, Vinson Mortgage requested that Mueller Prost audit Vinson Mortgage's financial statements for Fiscal Year 2013 (the "Second FY 2013 Audit Report"). The Second FY 2013 Audit Report is dated October 4, 2016, and was submitted to HUD as an attachment to an email sent by Jeffrey Lucas, counsel for Respondent, to Ross Fisher, counsel for HUD, on October 13, 2016. The Report stated that Vinson Mortgage was required to have a minimum adjusted net worth of $1,559,652 for Fiscal Year 2013 to meet the requirements of 24 C.F.R. § 202.5(n)(3). However, the Report stated that the company's adjusted net worth for Fiscal Year 2013 was $419,456, which is a deficiency of $1,140,196. The Second FY 2013 Audit Report noted that Vinson Mortgage's "[n]et worth is not in compliance with HUD guidelines," and stated that there was a "risk that HUD could remove FHA lending rights." The Second FY 2013 Audit Report also concluded, "Shareholder's equity is underfunded," and further stated that "[s]hareholders should contribute additional paid-in capital to meet the funding requirements."

Respondent's management was responsible for ensuring that the financial statements used by Mueller Prost to prepare its audit reports were presented fairly and consistent with GAAP.[4] However, Vinson Mortgage did not disclose the SBA Loan as a liability of Vinson Mortgage in its financial statements for the Second FY 2013 Audit Report, nor did Respondent's management provide the SBA Loan documents to Mueller Prost until 2017—after the completion of the FY 2014 Audit Report and the Second FY 2013 Audit Report.[5] Instead,

[4] HUD Mortgagee Letter 2010-38 sets out that the audited financial statements submitted by mortgagees must be "acceptable." Audited financial statements are "acceptable" when they are prepared in accordance with GAAP, Generally Accepted Government Auditing Standards (GAGAS), and HUD's Office of Inspector General's Handbook 2000.04, "Consolidated Audit Guide for Audits of HUD Programs."

[5] Ms. Bax-Kurtz indicated she did not become aware that Respondent, Vinson Mortgage, was listed as one of the borrowers on the SBA insured loan until 2017.

Respondent's management represented to Mueller Prost that Mr. Vester and Mr. Vinson personally obtained the loan and provided those proceeds as capital contributions.

Jeanette Bax-Kurtz was the engagement partner and lead auditor at Mueller Prost LLC for both the FY 2014 Audit Report and the Second FY 2013 Audit Report. In that capacity, Ms. Bax-Kurtz and her audit team were responsible, in part, for ensuring that Mueller Prost met its obligations with regard to the Second FY 2013 Audit Report. Ms. Bax-Kurtz acknowledges that GAAP requires full disclosure of the information related to the SBA Loan. In her view, the statements from Respondent's management regarding the SBA Loan to Mueller Prost were incomplete and were insufficient to meet the applicable auditing standards. After being presented with the SBA Loan, she understood the terms to mean that Respondent could be liable for the full amount of the outstanding loan balance. In her view, the FY 2014 Audit Report does not fairly present the SBA Loan, does not include a full description of that loan, and does not state whether Respondent's assets were pledged as collateral for the loan. She believes GAAP requires initial and subsequent measurement of the SBA Loan and these were not included in the FY 2014 Audit Report.

In addition, Ms. Bax-Kurtz acknowledges the Audit Report by Mueller Prost does not inform HUD that Respondent was a borrower on the SBA loan or whether Respondent pledged assets as collateral for the loan as required by GAAP. As of the time of the hearing, Mueller Prost had not reached a final decision as to whether or not the entire SBA loan should have been listed as a liability in the Second FY 2013 Audit Report, but their then current view was that it should not have been listed as a liability. Ms. Bax-Kurtz did not know whether listing the SBA Loan proceeds as a capital contribution in the Second FY 2013 Audit Report was proper given that Respondent was also a borrower on the loan.

Mr. Wendell Conner, a Certified Public Accountant and the Director of HUD's Quality Assurance Subsystem in the Real Estate Assessment Center who oversees HUD auditors under the Uniform Financial Reporting Standards regulation, testified at the hearing about how HUD would expect certain transactions to be reported. Mr. Conner testified that HUD would expect a loan with joint and several liability, like the one in this case, to be treated as a liability in its entirety. Mr. Conner testified that where the reporting entity is a borrower, HUD would expect two entries in their financial statements, one in working capital and one in liabilities. He testified that HUD would not consider the loan proceeds as "paid-in-capital."

As of the date of this *Initial Decision and Order*, Vinson Mortgage has not provided HUD with audited financial statements stating that, for Fiscal Year 2013, Vinson Mortgage's adjusted net worth was in excess of the regulatory minimum established pursuant to 24 C.F.R. § 202.5(n)(3).

Discussion

At its core, this case revolves around Respondent's FY 2013 financial statements and the admitted violation of HUD's regulatory requirement for minimum net worth as set out in both the Original FY 2013 Audit Report and the more recent Second FY 2013 Audit Report. In addition, HUD rejected Respondent's corrective actions as set out in the FY 2014 Audit Report. The net worth of the mortgagee is one of the primary measures HUD uses to analyze and manage

risk to its FHA Title II program. Therefore, both the violation of this requirement and the submission of an audit report noting this violation without a proper cure may be considered serious or significant.

HUD argues that its May 5, 2015 Notice of Violation and March 15, 2016 NOAA, including the underlying rejection of Respondent's purported corrective actions, were appropriate because Respondent's submissions, the Original FY 2013 Audit Report and the FY 2014 Audit Report, did not include an acceptable audit or acceptable corrective actions. HUD further argues that Respondent's corrective actions failed to meet the requirements of HUD's Handbook for corrective actions and that Respondent agreed to be bound by those guidelines. In addition, HUD argues that the corrective actions reported by Respondent failed to properly disclose the source of the capital contribution, failed to sufficiently address the net worth violation, and did not accurately represent Respondent's risk to the loan guarantee program. Therefore, HUD argues that the proposed one-year withdrawal from the program is appropriate.

Respondent makes the following five arguments in its defense. First, it argues that HUD's notice was not consistent with HUD regulations and violates the Due Process Clause. Second, Respondent argues that HUD requirements that are not specified by code or regulation are unenforceable. Third, Respondent believes that it properly corrected or cured the net worth noncompliance because, despite the specific terms of the loan, the owners intended for that debt to be a personal loan and not one where Respondent had liability. Fourth, Respondent asserts that the proposed withdrawal of participation from the FHA loan program for one year is disproportionate to the violation and will have a significant negative impact on Respondent and the community that it serves. Fifth (and for the first time), Respondent argues by belated affirmative defense that the Chief Administrative Law Judge presiding in this case does not have jurisdiction because his appointment violates the Appointments Clause of the U.S. Constitution.[6]

I. HUD's Notice to Respondent Was Sufficient to Meet Due Process Requirements.

As ruled at the hearing and reiterated here, this Court concludes that HUD provided Respondent sufficient notice of its violation, and its failure to submit an acceptable audit report and other required cure documents for recertification purposes to meet procedural due process requirements. Respondent, through both informal and formal procedures, presented its arguments and defenses. Respondent was not prohibited from communicating with HUD personnel, either directly prior to the NOAA, or through counsel once the hearing process commenced. Further, this Court concludes that any imprecise language in the Notice of Violation or the NOAA was harmless error.

"Due process is flexible and calls for such procedural protections as the particular situation demands." Mathews v. Eldridge, 424 U.S. 319, 334 (1976) (quoting Morrissey v.

[6] This Court notes that Respondent did not adduce any evidence that the Chief ALJ's appointment in this matter violates the Constitution. In fact, as the Government's brief points out, Respondent's closing brief cited one source of publicly available information that wholly undercuts this defense—Respondent noted that the HUD Office of Hearing and Appeals webpage states that the appointment of the Chief ALJ was made by the HUD Secretary. Because this defense was not raised at the hearing, and because Respondent apparently failed to conduct any discovery on this issue, no other relevant facts were presented on the record. Therefore, Respondent has not proven this affirmative defense by a preponderance of the evidence.

Brewer, 408 U.S. 471, 481 (1972)). "The fundamental requirement of due process is the opportunity to be heard 'at a meaningful time and in a meaningful manner.'" Id. at 333 (quoting Armstrong v. Manzo, 380 U.S. 545, 552 (1965)).

Taken together, HUD's Notice of Violation, the March 12, 2015 email from Robert May, which specifically focused on the net worth violation in the Original FY 2013 Audit Report submission, other communications with Board staff, and the NOAA, were sufficient for the particular informal and formal procedures. See Capitol Mortg. Bankers, Inc. v. Cuomo, 222 F.3d 151, 155-156 (4th Cir. 2000) (holding that informal procedures used in termination of an FHA lender, *without opportunity for hearing*, did not violate procedural due process). The NOAA also provided sufficient notice that HUD had rejected Respondent's purported corrective actions and that a hearing on the record was available. After requesting the hearing, Respondent submitted additional documentation including the Second FY 2013 Audit. Respondent had the full assistance of counsel and the benefit of a full hearing on the record which was extended to a third day to accommodate the testimony of Respondent's lead auditor by videoconference from St. Louis. At no point did HUD's actions or inactions deny Respondent the opportunity to present its defenses.

This Court rejects Respondent's proposed formalistic reading of the HUD regulation at issue, 24 C.F.R. § 25.9, because Respondent had actual notice and the failure to include additional regulatory provisions was harmless error. First, Respondent was aware from the Original FY 2013 Audit Report submitted to HUD and subsequent communications with Mr. May, the Level 2 HUD auditor, that it had failed to meet HUD's net worth requirement and that a corrective action plan was also required. Respondent submitted responsive materials to a Board staff member. In HUD's view, the deficiency under 24 C.F.R. § 202.5(g) was because the Audit Report and subsequent submission did not demonstrate compliance with all the recertification requirements or the required cure. These concerns proved to be well-founded given the testimony of Respondent's auditor discussed above. Although a more complete NOAA also could have cited 24 C.F.R. § 202.5(n)(3)(i), because Respondent had actual notice of this violation, the opportunity for discovery, and a hearing on the record, such omission was harmless error.

II. Respondent Violated HUD Regulations on Net Worth and Uniform Financial Reporting.

Respondent argues that it can only be held responsible for a violation of statute or regulation. This Court notes that 24 C.F.R. § 24.5(j) sets out that "[v]iolation of the requirements of any contract or agreement with the Department, or violation of the requirements set forth in any statute, regulation, handbook, mortgagee letter, or other written rule or instruction..." is a basis for the Board to take administrative action. This Court must treat all HUD regulations as valid, and thus must reject Respondent's argument that violations of the HUD Handbook 4060.1 REV. 2 and the interpretations in Mortgagee Letter 2010-38 cannot be a basis for administrative action.

Starting with the foregoing analysis that the net worth requirements for recertification and for audit submissions must be prepared consistent with GAAP, there is substantial evidence that

Respondent violated these regulations and those violations are sufficient basis for a one-year withdrawal.

Respondent has admitted, both in the stipulation of facts and through its submission of its Original FY 2013 Audit, its FY 2014 Audit, and the Second FY 2013 audit, that for FY 2013, Respondent violated HUD's net worth requirement at 24 C.F.R. § 202.5(n)(3)(i). As noted above, the auditors informed Respondent that this could be a basis for adverse action by HUD. Based on the approximately $1.8 million shortfall noted in the Original FY 2013 Audit Report or the $1,140,196 net worth violation listed in the Second FY 2013 Audit Report, and the fact that net worth is an important measure in HUD's assessment of risk, the Board's NOAA is reasonable and supported by substantial evidence.

The Board also had before it the FY 2014 Audit Report which purported to show correction of the net worth deficiency but which raised concerns for HUD's auditor as to how the SBA guaranteed loan was recorded. At the hearing, Respondent also submitted the Second FY 2013 Audit Report seeking to further show that the Original FY 2013 Audit Report was inaccurate and that the capital contribution from the SBA Loan corrected the violation. However, Ms. Bax-Kurtz, the lead auditor for Respondent's FY 2014 Audit Report and for the Second FY 2013 Audit Report, admitted that with regard to the SBA Loan, these two audits were not prepared consistent with GAAP because Vinson Mortgage management committed a material omission by not fully disclosing the terms of the SBA Loan. Submitting financial reports that were not prepared consistent with GAAP is violation of 24 C.F.R. § 5.801(b)(1). More importantly, because the SBA Loan was not properly recorded in those Reports, the conclusions regarding correction of the net worth violation are not reliable. Taken together with the above considerations, the Board's NOAA and determination that this was a serious violation which merits a one year withdrawal remains reasonable and is supported by substantial evidence.

III. Respondent Failed to Comply with HUD Handbook 4060 REV. 2.

Respondent's failure to follow the HUD Handbook and Mortgagee Letter 2010-38 provides additional support for the NOAA. See 24 C.F.R. § 25.6(j). HUD Handbook 4060.1, REV. 2 ch. 4-5 (B)(5)(b) sets out that where the mortgagee purports to cure the net worth deficiency after issuance of the audit report, HUD requires that the lender provide documentation establishing a "sufficient amount of capital has been contributed to the company to correct the [net worth] deficiency."[7]

Here Respondent's corrective actions to address the net worth deficiency involved obtaining a loan with joint and several liability among Respondent and the co-owners, Mr. Vinson and Mr. Vester. Despite the specific terms of the loan documents and the prohibition of modifications without express written consent by the lender, the co-owners testified as Respondent's management that they relied on an "oral agreement" between the two owners (subsequently reduced to written form)[8] to treat the debt as, and represent to its auditors that it

[7] Because the deposit of the SBA Loan proceeds occurred after the Original FY 2013 Audit Report, this Court is applying the corrective action criteria that apply to actions after the audit is issued and rejects the approach taken in the Second FY 2013 Audit Report.

[8] At the hearing, Respondent's Exhibit 23, a two-page typed document dated February 28, 2017, was introduced as purported evidence of the owners' oral agreement reached on June 30, 2014.

was, a personal loan for which they alone would be held responsible, despite the fact that Respondent was listed as a co-borrower and that its assets were pledged as collateral. Neither the lending bank, nor the guarantor SBA, nor HUD were made aware of the private agreement between the co-owners when the loan was approved and its proceeds used to appear as paid-in capital. In fact, the co-owners each signed the loan document in their personal capacity and as officers on behalf of the company. To all the world the two individuals and Respondent appeared jointly and severally liable to repay the loan. Neither the SBA, HUD, nor the lending bank were on notice or approved otherwise.

At the hearing, Ms. Bax-Kurtz, Respondent's lead auditor, testified that she did not know whether the characterization of the SBA Loan proceeds as a capital contribution in the Second FY 2013 Audit Report was proper. Mr. Conner testified that in HUD's view, the proceeds of the loan were working capital and not "paid-in-capital." The discussion of the capital contributions was based on the SBA guaranteed loan where Respondent was a co-borrower. Ms. Bax-Kurtz testified that in light of the additional information, the auditors were reviewing the matter, but had not made a final decision as to whether to include the entire SBA Loan as a liability.

The corrective actions, using the proceeds from the SBA Loan taken out by both Respondent and co-owners and pledging Respondent's assets as collateral, did not meet the requirements of HUD Handbook 4060.1 REV. 2 ch. 4-5. The Audit Reports that Respondent relied upon were not prepared consistent with GAAP as required by both regulation and Mortgagee Letter 2010-38. Respondent's own auditor was reviewing how the SBA Loan should have been reported with regard to liability and whether it was, in fact, a capital contribution. This failure to comply with the HUD Handbook and Mortgagee Letter provides additional support for rejecting Respondent's corrective actions and for the appropriateness of the NOAA. Moreover, the co-owners' professed belief that they could simply ignore specific loan terms and modify them privately through an oral agreement suggests a distinct additional risk to the FHA program.

IV. Withdrawing Respondent from the FHA Program would negatively impact Respondent.

As a participant in the FHA program, Respondent provides two tangible benefits to its community. It employs approximately 75 individuals and provides a needed service in the form of federally-insured mortgages to an underserved community. The imposed one year withdrawal would result in a need to significantly downsize the company and, because half of its loan volume is comprised of FHA loans, the company's survival would be at risk. Because the Board's deliberations are privileged, it is not clear as part of the record the extent to which the negative impact of a withdrawal was considered in imposing the suspension.

Although this Court weighs the negative impact of a one-year withdrawal as a mitigating factor, Respondent did not demonstrate that the sanction is disproportionate to the violation. Respondent's management had a duty to disclose the terms of the SBA Loan to its auditors and to HUD, but failed to do so. As discussed above, this represents a dual risk, one of lack of transparency by not conforming to GAAP, and also a potential financial risk in not fully curing the net worth deficiency. Based on the record herein, this Court finds no other mitigating factors. And on balance, the NOAA and withdrawal is clearly supported by substantial evidence

and is reasonable. The Secretary, however, has the discretion to consider Respondent's present business status, current viability, and current compliance with the law and FHA guidance before execution of the imposed withdrawal, or any lesser enforcement action.

Conclusion

For the reasons set forth above, this Court concludes that Respondent was provided sufficient notice to meet the due process standard and that any omission from the formal NOAA was harmless error. Further, the Board's NOAA and withdrawal of Respondent from the FHA program for one year is reasonable, not arbitrary and capricious, and supported by substantial evidence. Specifically, Respondent submitted audit reports documenting, and admitted to, a FY 2013 violation of the net worth requirement. Respondent's proposed corrective action was deficient because it did not conform to GAAP and violated the HUD Handbook. Net worth is an important measure of financial risk that HUD considers to be serious. Likewise the failure to meet HUD's Uniform Financial Reporting Standards and conform to GAAP, denies HUD the ability to evaluate whether the corrective actions were sufficient.

Accordingly, Respondent's appeal of the Board's action withdrawing approval of Respondent as a Federal Housing Administration (FHA) mortgagee for one year is DENIED.

So **ORDERED**,

J. Jeremiah Mahoney
Chief Administrative Law Judge

Notice of appeal rights. The appeal procedure is set forth in detail in 24 C.F.R. § 26.52. This order may be appealed to the Secretary of HUD by either party within 30 days after the date of this decision. The Secretary (or designee) may extend this 30-day period for good cause. If the Secretary (or designee) does not act upon the appeal within 30 days, this decision becomes final.

Service of appeal documents. Any petition for review or statement in opposition must be served upon the Secretary by mail, facsimile, or electronic means at the following:

U.S. Department of Housing and Urban Development
Attention: Secretarial Review Clerk
451 7th Street, S.W., Room 2130
Washington, DC 20410

Facsimile: (202) 708-0019
Scanned electronic document: secretarialreview@hud.gov

Copies of appeal documents. Copies of any Petition for Review or statement in opposition shall also be served on the opposing party(s), and on the HUD Office of Administrative Law Judges.

Judicial review of final decision. Judicial review of the final agency decision in this matter may be available, as appropriate, under 5 U.S.C. §702.

CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing **INITIAL DECISION AND ORDER**, issued by J. Jeremiah Mahoney, Chief Administrative Law Judge, in HUDOHA 16-JM-0076-MR-008, were sent to the following parties on this 14th day of August, 2017, in the manner indicated:

Cinthia Matos

Cinthia Matos, Docket Clerk

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