

Legal Opinion: CIS-0092

Index: 4.225

Subject: Escrow Commitment Procedure for Section 203(k) Program

November 25, 1996

MEMORANDUM FOR: John J. Coonts, Director for  
Office of Insured Single Family Housing, HSI

FROM: John J. Daly, Associate General Counsel  
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SUBJECT: Escrow Commitment Procedure for Section 203(k) Program

In your memorandum dated November 13, 1996, you requested written advice regarding whether the escrow commitment procedure currently used for some Section 203(k) loans to for-profit investors and non-profit organizations is consistent with the National Housing Act (NHA) and its implementing regulations. We have concluded that an escrow commitment procedure could be developed that is consistent with the NHA and regulations but that the manner in which the maximum mortgage amount now is calculated under the current escrow commitment procedure described in HUD Handbook 4240.4 can lead to a mortgage amount that exceeds the maximum mortgage amount permitted by Section 203(k) of the NHA.

Applicable Provisions of Statute, Regulations and Handbook

Statutory Provisions

Section 203(g) of the NHA generally limits FHA-insured single family mortgages to owner-occupied residences. Section 203(g), however, does not apply to mortgages insured under Section 203(k).

Under the NHA, FHA could permit all Section 203(k) mortgagors--whether owner-occupants or not--to be eligible for the same maximum percentage of financing as Section 203(b) mortgagors: 97 percent of the first \$25,000 of appraised value, 95 percent of appraised value over \$25,000 up to \$125,000, and 90 percent of appraised value over \$125,000. There is one important statutory distinction between Section 203(b) mortgages and Section 203(k) mortgages when calculating the maximum mortgage amount. Appraised value is determined by an appraisal of a completed home for Section 203(b) mortgages, but the NHA requires appraised value for Section 203(k) mortgages to be calculated instead as "an amount not to exceed the sum of the estimated cost of rehabilitation and the Secretary's estimate of the value of such property before rehabilitation [i.e., "as-is" value]." Any anticipated increase in value resulting from rehabilitation that exceeds the estimated cost of rehabilitation (i.e., developer profit) must be disregarded. This special definition of appraised value applies to all types of

Section 203(k) mortgages without any express exception.

## Regulations

FHA regulations for the Section 203(k) program (24 CFR Section 203.50) do distinguish between owner-occupants and other mortgagors. When the mortgagor is an owner-occupant, the maximum mortgage amount is to be calculated as provided in the regulation for Section 203(b) owner-occupants except using the special Section 203(k) definition of appraised value. When the mortgagor is not an owner-occupant, the maximum mortgage amount permitted by the regulations is calculated using an 85 percent loan-to-value ratio, again using the special Section 203(k) definition of appraised value, "or such higher limit, not to exceed the limits set forth in [regulations for owner-occupant mortgages] as the Secretary may prescribe." If the Secretary does prescribe a loan-to-value ratio over 85 percent, the Section 203(k) regulations require the procedure known as "escrow commitment" under which any loan proceeds in excess of an 85 percent mortgage are held in escrow until an eligible owner-occupant mortgagor assumes the mortgage. If the assumption does not occur by a date specified by FHA (currently 36 months after closing for a nonprofit organization and 18 months for other investors), the escrow account is used for partial prepayment of the insured mortgage.

The Section 203(k) regulations permit a higher percentage of financing for investors when the escrow commitment procedure is used. The regulations do not--and legally cannot--alter the statutory special definition of appraised value for Section 203(k) mortgages.

## Handbook Provisions

The original June 1980 version of Handbook 4240.4 for the Section 203(k) program had no specific discussion of the escrow commitment procedure. It did repeat the statutory special definition of appraised value. Revision 1 to the handbook issued in August 1989 appears to represent the first FHA attempt to permit Section 203(k) investor mortgage amounts based on value after rehabilitation. Paragraph 1-10 of Revision 1 states:

To allow for maximum owner-occupant financing when the loan is assumed (by an owner-occupant acceptable to HUD) and to avoid the extra cost for a new mortgage, the mortgage may be based on the market value after rehabilitation. The difference between the downpayment requirements for an owner-occupant and an investor would be retained in an escrow account. [Underlining added.]

Revision 2 of the handbook, issued in September 1991 after the Section 203(k) regulations were amended to specifically recognize the escrow commitment procedure, continued to provide for an escrow commitment procedure with a mortgage amount based on value after rehabilitation.

## How Can the Statute Be Interpreted?

Unless Section 203(k) can be interpreted in a manner that permits a mortgage amount to be based on value after rehabilitation, the escrow commitment procedure as described in the current Revision 2 of Handbook 4240.4 exceeds FHA's legal authority.

The literal language of Section 203(k)(3)(A) provides no exceptions to the special definition of appraised value that uses "as-is" value before, not after, rehabilitation of the property. We have examined a number of possible theories that might justify deviation from the literal language but conclude that none are likely to be accepted by a court. The theories are discussed below in abbreviated fashion.

The Supreme Court has said the following about an agency's authority when construing statutory language:

When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, as always, is the question of whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter . . . . If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute . . . . If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.

Chevron U.S.A. v. NRDC, 467 U.S. 837, 8420844 (1984).

This language gives no particular significance to agency interpretations of a statute not expressed in regulations. As noted above, the only FHA statement that escrow commitment mortgages could be based on after-improved value appears in a handbook revision that does not have the legal significance of a regulation. More importantly, in Section 203(k)(3)(A) Congress has "directly spoken to the precise question at issue": appraised value for purposes of applying the statutory loan-to-value ratios under the Section 203(k) program is an amount that cannot exceed the sum of estimated as-is value and estimated cost of rehabilitation. This language leaves HUD some leeway to determine how as-is value and cost of rehabilitation are to be estimated. There is no indication, however, of any leeway in the statutory language to use after-improved value to increase the maximum mortgage amount.

## Implied Exception?

In permitting use of after-improved value to increase the statutory mortgage amount for escrow commitment cases, FHA has acted as if there is an implied exception to the special Section 203(k) definition of appraised value so that it does not apply to mortgagors who intend to sell the rehabilitated property instead of retaining it as an investment or personal residence. As a general rule, courts have held that exceptions to statutes are not to be implied, 1 Sutherland on Statutory Construction, <sup>1</sup> 47.11 (5th ed.). On rare occasions, courts have considered it necessary to imply an exception to the literal language of a statute to avoid a result that produces absurd results or thwarts the obvious purpose of a statute. We do not think the language in Section 203(k) presents one of those occasions.

The obvious purpose of the special Section 203(k) definition of appraised value is to limit FHA's insurance exposure to the amounts needed to accomplish a mortgagor's immediate objective--to purchase and rehabilitate a house. If the mortgage is based on the after-improved value as permitted by the handbook, a second objective--permitting the developer to be compensated from the mortgage for profit resulting from the increased value derived through rehabilitation--also could be accomplished. We have found no evidence, however, that Congress so clearly intended to accommodate this second objective so that FHA is permitted to disregard express statutory language in order to achieve that objective. The Supreme Court has cautioned that "[c]ourts are not authorized to rewrite a statute because they might deem its effects susceptible of improvement," *Badaracco v. Commissioner*, 464 U.S. 386 (1984).

## Legislative History; Congressional Ratification or Acquiescence

We have located no relevant legislative history in congressional reports or debate that helps to understand the relevant statutory provision or that suggests that it means something other than what it says. There also is no evidence of subsequent congressional acquiescence in, or ratification of, the HUD handbook that sets out HUD's method of implementing the escrow commitment process. There is no provision in the Section 203(k) regulations that clearly indicates that after-improved value will be used to increase the mortgage amount. Even if the wording of Section 203.50(k) on escrow commitment--when read in tandem with confusing punctuation in <sup>1</sup> 203.50(f)(1)(i)--were susceptible to this interpretation, there was no formal opportunity for Congress to accept or reject this interpretation. There was no pre-publication review of the escrow commitment language of the regulation because it was added only at the final rule stage of the full rulemaking process for the so-called "Investor rule."

## History of Agency Implementation

If there were room for different agency interpretations of the statutory language defining "appraised value" for

Section 203(k) purposes, the manner of agency implementation could be significant, particularly if the implementation represents an official agency interpretation nearly contemporaneous with the statutory enactment and if the implementation were through regulations. FHA's implementation of Section 203(k) does not present a persuasive case for giving special significance to the approach to appraised value that has been adopted in the handbook.

The special Section 203(k) definition of appraised value was enacted in 1978. In FHA's implementing (proposed and final) rules published in 1979 and 1980, the only significance given to after-improved value was as a factor that could lead to a mortgage amount lower than the amount permitted by the statute on the basis of as-is value plus costs of rehabilitation. It might be argued that the 1990 addition of regulatory language permitting an escrow commitment procedure represented an attempt to introduce a binding agency interpretation of the statute supporting the handbook approach to appraised value. This argument would be based on the conclusion that there would have been no practical purpose for introducing an escrow commitment procedure that did not allow after-improved value to be used in calculating the mortgage amount because a mortgage amount using "as-is" value would be assumable only by a mortgagor willing and able to pay enough cash to cover a developer's speculative profit. A typical FHA mortgagor does not have enough cash for this purpose. Even without clear statutory language, we doubt that courts would accept such an argument as grounds for treating the regulation, which mentions after-improved value only in the context of decreasing the mortgage amount, as an interpretation allowing after-improved value as a basis for increasing the mortgage amount. We are even more uncertain that courts would accept an interpretation expressed in such an obscure manner as a basis for upholding a deviation from the statutory language at issue.

#### Options

Since we conclude that courts are likely to find that FHA does not have the legal authority to insure Section 203(k) mortgages based on the value of rehabilitated property if that value exceeds the estimated as-is value plus the estimated cost of rehabilitation, we do not think that there is a legal basis for FHA to continue issuing Mortgage Insurance Certificates for such mortgages. It is our understanding the only such Section 203(k) mortgages at issue are the mortgages for investors, including non-profit organizations, that are originated under the escrow commitment procedure.

Many escrow commitment mortgages already have been endorsed for insurance so that contracts of insurance exist even though the mortgage amounts are not consistent with statutory requirements. Since the mortgage amounts in these cases were calculated in accordance with FHA instructions in Handbook 4240.4, we do not think the improper mortgage amount calculation can fairly be said to involve mortgagee fraud or misrepresentation. Section 203(e) of the NHA, therefore, makes

these existing contracts of insurance incontestible, and no corrective FHA action is available.

There is no legal principle that permits FHA knowingly to continue to insure new escrow commitment mortgages with mortgage amounts that are not consistent with statutory requirements. It may be awkward for FHA to refuse to insure mortgages that were processed and closed in accordance with a long-established HUD handbook, but the desire to provide equitable treatment is not legal justifications for deviating from the clear statutory language regarding maximum mortgage amounts. Case law indicates that courts are without equitable powers to provide redress in such a situation. The law continues to be as stated by the Supreme Court in 1893 in *Hedges v. Dixon County*, 150 U.S. 182:

The established rule . . . is that equity follows the law, or . . . `that wherever the rights or the situation of the parties are clearly defined and established by law, equity has no power to change or unsettle those rights or that situation . . . . Courts of equity can no more disregard statutory and constitutional requirements than can courts of law. They are bound by positive provisions of a statute equally with courts of law.'

FHA can consider one approach that would mitigate any adverse effect on mortgagors. We do not think it is necessary legally for FHA to refuse to endorse Section 203(k) mortgages that were closed in excess of the statutory maximum mortgage amounts due to reliance on the handbook if, prior to endorsement, the outstanding balance were reduced to an amount in conformity with the statutory language. This alternative could be accomplished by applying some of the escrowed funds as a partial prepayment.

#### Conclusion

Since the NHA specifically defines the manner in which appraised value must be calculated for all Section 203(k) mortgages, courts probably would hold that FHA's handbook provision that permits another method of calculation for Section 203(k) escrow commitment mortgages is without legal authority. Therefore, we do not think there is a legal basis for additional Section 203(k) mortgage insurance being issued without confirmation that the current mortgage balance is at, or below, an amount that reflects the as-is value rather than the after-improved value of a property.