

UNITED STATES OF AMERICA
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
OFFICE OF ADMINISTRATIVE LAW JUDGES

In the Matter of:

FIRST SECURITY MORTGAGE
COMPANY

Respondent.

HUDALJ 90-137-MR

Dane M. Narode, Esq.
For the Department

Donald M. Bingham, Esq.
For the Respondent

Before: William C. Cregar
Administrative Law Judge

INITIAL DECISION AND ORDER

Introduction

Respondent, First Security Mortgage Company ("First Security"), through its President, Gary B. Hobbs, appeals from the withdrawal of its HUD-FHA mortgagee approval for an indefinite period by the Mortgagee Review Board ("the Board") of the U.S. Department of Housing and Urban Development ("HUD" or "the Department") by notice dated December 22, 1989. The Board also determined that the withdrawal should be effective immediately upon receipt of the notice. 24 C.F.R. Sec. 25.5 (d)(4)(i). The notice alleges that Respondent's actions constitute grounds under 24 C.F.R. Sec. 25.9, (c),(j),(p) and (w).¹ Respondent's appeal is dated January 2, 1990. The hearing was

¹The Department has elected to treat the December 22, 1989, letter as its complaint in this matter. This letter also contains allegations that Respondent violated unspecified regulations in 24 C.F.R. Part 390, and refers to requirements applicable to GNMA II mortgage backed securities. The purported violation of 24 C.F.R. Part 390 is too vague to be actionable. Despite references in the letter to requirements applicable to GNMA II mortgage backed securities, the Department's attorney has advised that they are not in issue in this case. Accordingly, these allegations have not been considered.

initially scheduled to commence on February 1, 1990, however, following a joint motion to stay the proceedings pending settlement negotiations, the case was rescheduled to begin on March 8, 1990, in the event settlement was not reached. The parties were unsuccessful in reaching a settlement and a hearing was held in Tulsa, Oklahoma on March 8 and 9, 1990. Post-hearing briefs were filed on April 26, 1990.

The notice of December 22, 1989, states that the withdrawal of mortgagee approval is based upon Respondent's 1) failure to pay securities holders under the Government National Mortgage Association ("GNMA") mortgage-backed securities program, and 2) improper transfer of approximately \$1.1 million from a custodial account held for GNMA to the Respondent's own corporate account which resulted in unauthorized use of these funds.² The Board determined that the Respondent's actions were "egregious or willful" and were, therefore, sufficiently serious to justify the imposition of a withdrawal of approval for an indefinite period. 24 C.F.R. Sec. 25.5 (d)(2).

Respondent does not dispute the claim that it transferred a total of \$1.1 million from the GNMA custodial account to its own account, that the GNMA security holders were not paid, or that this was improper. It asserts that rather than being willful, the acts were taken during a period of intense confusion and amounted to a mistake. Respondent contends that the Department has failed to meet its burden to demonstrate that its actions were willful, rather than the result of negligence or irresponsibility. Res. Brief, p. 34.

Findings of Fact

Background

GNMA is a government corporation within HUD. It provides guarantees against default to investors who purchase GNMA backed securities and insures that these investors will be timely paid on a monthly basis. GNMA is required to make good any losses sustained by a securities holder within 24 hours. Funds used to replace losses come from the United States Treasury. Tr. p. 343.

Loans sold on the secondary market are combined into "pools".³ Each time a pool is originated a GNMA Guaranty agreement is executed. Tr. p. 339. Under the terms of this agreement the issuer⁴ guarantees the timely payment of principal and interest on securities backed by a pool of mortgages insured by HUD, the Department

²The letter also contains a claim that Respondent failed to remit mortgagee insurance premiums to HUD. However, this allegation did not constitute a basis for the action and was not involved in this case.

³ GNMA I pools have a fixed rate. The issuer makes out a check to the securities holders. GNMA II pools have a variable rate. Tr. p. 402. This matter only involves GNMA I pools.

⁴An "issuer" may be the loan originator, or a purchaser from the original issuer. It is the institution which collects the funds from the borrowers and transmits these funds to the securities holders. Tr. p. 335. First Security acted as an issuer.

of Veterans Affairs, or the Farmer's Home Administration.

Appendix 19 of GNMA Handbook 5500.1 sets forth the terms of the Guarantee Agreement. Govt. Ex. 3. Section 4.01 of Appendix 19 provides:

The issuer shall remit to the holders all payments to be made under the terms and conditions of all securities issued and outstanding under this agreement, such payment to be made in a timely manner such that holders can reasonably be expected to receive payment by the 15th day of each month, with final payment to be only on receipt by the Issuer of the securities.

Section 8.01 of Appendix 19 provides:

Any failure by the Issuer to remit to the holders thereof any payment to be made under the terms and conditions of the securities issued and outstanding under this Agreement, under and in accordance with such terms and conditions, and as set forth and provided in section 4.01 above, shall constitute an event of default under this Agreement, as of the date of such payment.

Issuers are required to establish and place the funds belonging to the securities holders into a custodial principal and interest ("P & I") account. Govt. Ex. 3, Sec. 4.11. The money collected in the P & I account is due to the holders on the 15th of every month. Govt. Ex. 3., Sec. 4.01, supra. The issuer is also responsible for making "advances" to cover delinquent payments resulting from the late payments of mortgagors. The issuer is expected to "reach into its pocket" and make these payments to investors. Id., Sec. 4.03; Tr. p. 336. If and when the delinquent amount arrives, it belongs to the issuer together with late fees. Recouped delinquent payments and late fees may be removed by the issuer from the P & I account. Id., Secs. 411, 412. They can also be accumulated by the issuer.⁵ Tr. pp. 367, 368. However, strict accounting is required. Books and records must be kept and a loan by loan accounting must be possible. A failure accurately to record these transactions is, itself, a violation of GNMA requirements. Govt. Ex. 3, Sec. 4.05; Tr. p. 337. Withdrawal from the P & I account of funds which do not belong to the issuer is prohibited even for a short time. Tr. p. 342.

In the event the funds in the P & I account are insufficient to cover the amounts due securities holders, so that checks issued by the issuer "bounce", GNMA must cover these amounts within 24 hours. This money comes from the United States Treasury and results in a loss to the taxpayers. Tr. p. 343. Even though the funds are eventually made good by the U.S. Treasury, the return of checks for insufficient funds to securities holders also

⁵Service fees, the fees earned by the issuer for servicing the account, may also be withdrawn or accumulated.

adversely affects the credibility of the mortgage-backed securities program. Tr. p. 342.

Respondent is a mortgage lender, incorporated in the State of Oklahoma on June 23, 1981, and doing business in that state. It became a HUD-approved lender in August 1981, and obtained approval as a GNMA issuer in October of that year. Tr. p. 47. Prior to the action taken by HUD, it originated and serviced mortgages on residential properties insured by HUD or the Veterans Administration now the Department of Veterans Affairs. These mortgages constituted 88 percent of its business. Prior to the action of HUD's Mortgagee Review Board withdrawing HUD-FHA approval, Respondent had 72 employees in six offices and in some years originated as much as \$180 million in loans. Tr. p. 48. From its incorporation, Gary B. Hobbs served as President and Chief Executive Officer of First Security, and owned 80 percent of the stock. Tr. p. 49.

Cross Roads Financial Services, Inc. ("Cross Roads") is a subsidiary of Cross Roads Savings and Loan. Tr. p. 51. Cross Roads is primarily a lender but, like First Security, was in the mortgage origination business. In the late 1980's Cross Roads sought greater penetration of the Tulsa market.⁶ First Security needed a source (warehouse) to fund the loans it originated. Tr. p. 50. The two institutions began dealing with each other in May 1987. In September 1988, they signed a Joint Venture Agreement by which First Security agreed to originate loans to be funded by Cross Roads, and Cross Roads would discontinue its origination activities. First Security could sell the loans in the secondary mortgage market and keep any profit it made if the original loan price exceeded the sales price of the loan. Tr. p. 60. The agreement also provided for arrangements for the sale and exchange of servicing and sub-servicing rights and fees⁷ between these companies. Govt. Ex. 28, Tr. pp. 60-65.

Cross Roads also acted as First Security's GNMA custodian. As custodian, Cross Roads would certify First Security's GNMA pools. Certification involves the review

⁶Mortgage origination serves to increase the profit opportunities of a lender by providing revenues from the resale of loans, the opportunities to earn servicing fees, and maintenance of escrow accounts. Escrow accounts do not require the payment of interest to the investor by the custodian. The custodian, on the other hand, may invest these funds and retain the interest earned. Tr. pp. 55-57.

The term "escrow" has both generalized and particularized meanings. In the general sense it is used to refer to a custodial fiduciary account. This is the sense in which it is referred in the Departmental regulation cited in this case. 24 C.F.R. Sec. 25.9 (c). It also is understood by the parties in this case to refer to the type of custodial account used for the receipt and remittance of payments for taxes and insurance, as opposed to repayments of principal and interest on mortgage loans. To avoid confusion "escrow" account used in the latter sense is referred to as "tax escrow" account.

⁷"Servicing" includes collecting the payments for the holder of the mortgage, i.e., the GNMA backed security holder, remitting taxes and insurance, annual reporting, making advances to cover delinquent loans and guaranteeing against loss in the event of foreclosure. Sub-servicing includes all of the above with the exception of making advances and acting as a loan guarantor. Tr. p. 65. Fees are charged for each of these tasks based on a percentage of the loan. First Security would retain the servicing by selling the loans "service retained". Cross Roads would buy the servicing from First Security for 2.2 percent of the mortgage amount. Cross Roads would then resell the sub-servicing rights back to First Security. Govt. Ex. 28, Sec. III.

and certification of certain documents evidencing the existence of mortgages and security interests when the pool is created. This is a precondition for the issuance of a bond. First Security would obtain these documents and deliver them to Cross Roads. These documents include the mortgage note, the title binder, title insurance policy, survey, and FHA or VA loan approval for each mortgage in the pool. Tr. pp. 120-121. Once a bond was issued, it was delivered to the purchaser and the remittance would be put into an account at Cross Roads.

As originally envisioned by First Security and Cross Roads, First Security would have two corporate accounts at Cross Roads which were to be used for these transactions. The first account, known as the joint venture account, was to be used for secondary market sales and the funding of loan originations. Funds were to have been transferred from accounts at Cross Roads established for each of First Security's Branches. The second account was to have been used for the receipt and disbursement of service and all other ancillary fee income. Tr. pp. 71-73.

In fact, only one corporate account was used to transfer funds between First Security and Cross Roads. This account is referred to as the General and Administrative (G & A) Account. Each day employees of Cross Roads would be told by First Security's employees how many loans were closed and the amount in checks written by First Security on its G & A account which needed to be covered. Tr. p. 76. In theory, funds sufficient to meet these obligations would then be placed in the G & A account by Cross Roads.⁸ Servicing fees charged to GNMA and proceeds from secondary market sales also flowed into and out of the G & A account.⁹

⁸In practice, Cross Roads only covered some of the obligations as they were incurred. As discussed below, this eventually resulted in First Security issuing checks which were not funded by Cross Roads.

⁹For example, servicing fees charged to GNMA were charged against the custodial Principal and Interest (P & I) account. First Security would issue a check against the P & I account. GNMA would be informed, and the check would go into the G & A account. Another check would be written to Cross Roads for its portion of the fee or Cross Roads would debit the G & A account.

The funds belonging to securities holders collected by First Security pursuant to its agreements with GNMA were placed in the GNMA Principal and Interest ("P & I") Account at Cross Roads. This account was used for the receipt and subsequent transfer to GNMA securities holders of money collected by the loan servicer. As described above, it is a custodial trust or fiduciary account. Tr. p. 335. With the exception of moneys owed by securities holders for servicing, late fees, and the recoupment of "advances" made to cover delinquent loans, this money is the property of the securities holders and not the custodian. Tr. pp. 335-336. In this regard it is similar to the tax escrow account used for the deposit of taxes and insurance premiums. Govt. Ex. 3, Sec. 4.13.

First Security's Operating Problems

Between November 1988 and April 1989, First Security faced three interrelated problems which resulted in the transfer of funds from the custodial account belonging to GNMA.

1) Around the time the joint venture was entered into, First Security purchased a \$700,000 note from Cross Roads. This note was secured by \$63,000 of Cross Roads Savings and Loan stock (63 percent of the stock issued by Cross Roads Savings and Loan). In addition, First Security paid \$350,000 in cash immediately and another \$200,000 some time later. Tr. p. 101. As part of this arrangement First Security was permitted to place two individuals on Cross Roads' Board of Directors. Tr. p. 99.

This arrangement did not meet with the approval of the Federal Home Loan Bank Board (FHLBB) because it was entered into without a "change of control application" having been filed and approved by the FHLBB. Govt. Ex. 4, p. 48. Mr. Hobbs and employees of the FHLBB met in September and December 1988 in Topeka, Kansas, in an attempt to resolve this matter. On February 16, 1989, Gates Williams, at that time the Executive Vice President of Cross Roads, telephoned Mr. Hobbs informing him that Cross Roads had received a letter from the FHLBB stating its concern that Cross Roads had grown too fast. According to the FHLBB's letter, Cross Roads had exceeded the FHLBB's 12.5 percent standard for annual growth, and, in fact, had reported a six month growth rate of 178 percent on an annualized basis. Res. Ex. 8. Cross Roads was told to reduce its growth and cease doing business with First Security.

A meeting was held on February 23, 1989, again in Topeka. Tr. pp. 93,94. At this meeting Mr. Hobbs was told by FHLBB employees that Cross Roads was growing too fast, and it wanted a "change of control application" to be filed with the Board, together with the resignation of the two First Security Directors on Cross Roads' Board of Directors. Tr. pp. 110-111. Following the meeting, First Security submitted a "change of control application" and removed its personnel from the Board of Directors of Cross Roads. Tr. p. 104,110. Despite these actions by First Security, the FHLBB insisted on a severance of the existing financial relationships between Cross Roads and First Security.

2) Another problem faced by First Security was the lack of accounting for funds

flowing into and out of its G & A account at Cross Roads. When the joint venture was set up, two accounts were to have been established. In fact one account was used for all transactions. These transactions included loan origination, secondary market sales, servicing fees, and subservicing fees. Tr. pp. 76,80-85. Although it had originally been planned that Cross Roads would fund each day's loan originations as they were presented, Cross Roads did not follow this procedure. Rather, Cross Roads would fund only some of the loans at any one time. There was no accounting for the amounts flowing into and out of the G & A account from November 1988 to March 1989.¹⁰ First Security at no time received reconciliation reports from Cross Roads. Tr. p. 89.

3) On March 26, 1989, Cross Roads, at the direction of the FHLBB, refused to certify First Security's GNMA pools. Tr. p. 131.¹¹ As a result, bonds could not be issued since the pooling process could not be completed. Because the bonds could not be issued, payments were not remitted to Cross Roads. This resulted in Cross Roads' not having sufficient funds to cover First Security's loan sales commitments. Tr. pp. 122,131. Because Cross Roads was First Security's only approved GNMA custodian, First Security was unable to honor its loan sales commitments. Tr. p. 131. By late March 1989, Cross Roads stopped funding First Security's checks. Tr. p. 117.

The Fund Transfers

First Security acted as an agent for Cross Roads in seeking to purchase loan servicing rights from other financial institutions. It did so because Cross Roads lacked sufficient staff to locate willing sellers and make the arrangements for these purchases. Tr. p. 140. Once the sellers were located, First Security would purchase the servicing rights and sell them to Cross Roads. First Security would receive a fee from Cross Roads for its services in arranging the sale. In late March 1989, First Security negotiated the sale from Liberty Mortgage, another GNMA issuer, of the servicing rights for approximately \$53 million in loans pledged for GNMA pools. Tr. pp. 139-141.¹²

¹⁰Mr. Hobbs testified that in December he learned that the accounts didn't balance in December. In January First Security found errors, and, in February, Cross Roads was still working on those errors. Tr. p. 138.

¹¹A week later the FHLBB relented and permitted certification on a "case by case" basis. Tr. p. 127.

¹²Other purchases were pending at this time with Corinthian Mortgage, Southwest Mortgage Corp., and Allied Mortgage. Tr. p. 142.

While the arrangements were being made to purchase the servicing rights to Liberty's GNMA securities, Mr. Hobbs of First Security and Mr. Williams, now President of Cross Roads, were attempting, with the assistance of counsel, to straighten out the tangled affairs of these institutions because the FHLBB was now threatening to shut down Cross Roads. In order to satisfy the FHLBB, these institutions needed to reconcile the G & A account and enter into an agreement severing their financial arrangements. Meetings took place in the law offices of attorneys for Cross Roads, on April 4, 1989, and continued through April 1989. On April 12, 1989, the reconciliation having been partially developed,¹³ First Security and Cross Roads signed an Agreement and Release. Govt. Ex. 29. The purpose of this agreement was to terminate the obligations of the parties to the joint venture. Paragraph 1.6 of this agreement states that First Security owed Cross Roads the sum of \$5,027,525.54 for loans that Cross Roads had funded but for which it had not received payment. Attached to the agreement is a schedule of mortgage loans which First Security warrants would, if sold in the secondary market, equal or exceed the amount. The agreement provides that First Security will sell these loans for the benefit of Cross Roads. In fact, the schedule lists loans with a value of \$4,300,119.40. Accordingly, there was a cash shortfall of \$727,406.14. However, there was no understanding that this deficit would be covered immediately, or even that the loan schedule was complete¹⁴ or valued accurately.¹⁵ Tr. p. 266.

On April 11, 1989, during one of these meetings held to reconcile the G & A account, the transfer of the principal and interest payments in the amount of \$1,523,948.99 purchased by Cross Roads through First Security arrived at Cross Roads via wire. Govt. Ex. 6. The incoming wire on its face indicates it is a payment of principal and interest and is to go into the First Security P & I account. It states, "GNMA POOL FUNDS TO SECURITY FOR REMITTANCE."

This wire transfer from Liberty Mortgage was deposited in the First Security P & I account on April 11, 1990, and \$1,100,000 was withdrawn and placed into the First Security G & A account the following day, at the express direction of Mr. Hobbs. Govt. Ex. 5, Tr. p. 440. This left a balance of approximately \$400,000 from the wire in the P & I account. Mr. Hobbs orally authorized the transfer of this \$1.1 million from the P & I account, telling Gates Williams, the President of Cross Roads, to transfer this amount. Tr. p. 480. Mr. Williams requested written confirmation of the transfer. Accordingly, a

¹³The agreement was not intended to be the final adjustment. Mr. Hobbs' attorney, Benjamin Abney, testified that the account continued in a state of chaos after the agreement was signed. Mr. Abney stated that he was positive that the amount each institution owed the other had not been established as of the date of the hearing. Tr. p. 264.

¹⁴Respondent submitted evidence it claimed Cross Roads owed it in excess of \$2 million of the purchase of servicing rights and other debts. See Res. Brief, p. 18; Res. Exs. 24, 26, 31. Paragraph 1.7 of the Agreement and Release states that Respondent declines to release any claims it might have against Cross Roads.

¹⁵The last sentence of Article 1.6 of the Agreement and Release recognizes the possibility that these loans could be either overvalued or undervalued. Govt. Ex. 29.

letter to Mr. Williams was typed later that day and signed by Mr. Hobbs. It states:

The wire received today by you has been deposited by error into the wrong account. Please accept this letter as authorization to put a hold on or to make an internal transfer of those moneys in the amount of \$1,100,000 from the P & I account into our General & Administrative Account.

We will be able to determine an exact amount that should be transferred tomorrow. Govt. Ex. 12.

At the time this money was transferred there was a negative balance in the G & A account of approximately \$240,000. Tr. p. 534.

On April 12, 1989, two cashiers checks in the amounts of \$857,606.14 and \$52,799.43 were drawn on the G & A account. The checks, signed by Robert Baker,¹⁶ identify the remitter as "First Security Co./Gary Hobbs." They also contain the notation, "partial payment". No written authorizations for these withdrawals were produced at the hearing.¹⁷

¹⁶Robert M. Baker was the Executive Vice President of Cross Roads and a former President. Tr. p. 451.

¹⁷During the subsequent audit Mr. Williams told the auditor, Charlie Hendrickson of Coopers and Lybrand, that letters of authorization existed. However, only three (including the April 12, 1989, authorization to transfer 1.1 million) were ever turned over to Mr. Hendrickson and entered into evidence. Tr. pp. 400,421.

Between April 12, and April 19, 1989, there were nine separate transfers of funds from the P & I account to the G & A account. The journal tickets for these transactions either state that they were to cover "exception items",¹⁸ , to balance the G & A account, or that the transfers were authorized by Mr. Hobbs. Two of the transfers were reversed. These are listed below in chronological order:

Date	Amount	Date Reversed
April 12, 1989	\$225,000.00	Not Reversed
April 13, 1989	\$ 29,000.00	Not Reversed
April 13, 1989	\$220,000.00	Not Reversed
April 14, 1989	\$112,089.67	April 17, 1989
April 17, 1989	\$306,575.67	April 19, 1989
April 17, 1889	\$140,000.00	Not Reversed
April 18, 1989	\$ 77,775.90	Not Reversed
April 18, 1989	\$ 22,006.57	Not Reversed
April 19, 1989	\$308,119.14	Not Reversed

The record contains two letters, signed by Mr. Hobbs, which authorize only two of these transfers. These are the April 13, 1989, transfer of \$29,000 and the April 17, 1989, transfer of \$140,000. Govt. Exs. 4 p. 13, 16, 18. The letters are dated, respectively, April 13, 1989, and April 17, 1989.¹⁹ There are no letters signed by Mr. Hobbs which authorize the other seven transfers.

First Security did not make its April payment to GNMA security holders who, as a result, were paid out of treasury funds. The loss to the United States treasury is approximately \$1.8 million. This figure is based on the amount that should have been in the P & I account plus other matters of expense such as the cost of the audit. Tr. p. 357. The actions of Mr. Hobbs and First Security caused this loss.

In subsequent investigations Mr. Hobbs made no attempt to conceal any information and cooperated during the audit. Tr. pp. 325,184. He did not elect to exercise his rights under the Fifth Amendment. He contacted Mr. Wagner at GNMA soon after he learned that checks were being returned for insufficient funds. First Security never paid back the money, or made a partial payment,²⁰ nor was any money

¹⁸An "exception item" is an overdrawn account or check. Tr. p. 399.

¹⁹Mr. Hobbs claims that he only authorized one of these transfers. He believed this transfer was supported by sufficient funds in the account. He claims that it was his intention to supersede the first withdrawal with the second withdrawal. He stated that he was calling out amounts to a secretary who was typing them on the word processor. Tr. p. 189. He thought the first transaction had been overridden by the second. Instead both transactions went through.

The dates shown on these authorizations are four days apart. Since there is no other support for Mr. Hobbs' assertion that they were written on the same day, I do not credit his explanation.

²⁰Funds for restitution would had to have come from continued operations by First Security. GNMA has been unwilling to permit this.

paid out of Mr. Hobbs' personal finances to reimburse the United States for its losses.

Discussion

I

Mr. Hobbs asserts that the congruence of the FHLBB's attempts to sever the financial relationships between Cross Roads and First Security, with the urgent need to reconcile the G & A account, resulted in confused and anxious meetings, his own confusion and anxiety, and, finally, in his mistaken transfer of funds out of the P & I custodial account. His account is summarized in the following three paragraphs.

On the afternoon of either April 4th or 5th, while working with Cross Roads' attorneys in attempting to reconcile the First Security accounts at Cross Roads, he received a phone call from Roger Brown, a Vice President of First Security and manager of its servicing department. Govt. Ex. 31, p. 6. Mr. Brown stated that Liberty was ready to close on the sale of its servicing and wanted to send out the April principal and interest remittance to security holders. He also claims Mr. Brown told him that Liberty wanted First Security to fund an "advance" of \$400,000 to cover Liberty's anticipated delinquencies. Tr. pp. 142-145. Mr. Hobbs testified that he remembers thinking:

. . . delinquencies must be higher than we thought. Maybe this package wasn't as good as I thought it was, and then the second thought I had was it's early in the month so that, you know, who knows²¹. . . and then the third thought I had was well, we'll get the money back. . . and I just went on to the next thing. . . I didn't think about it. Tr. pp. 145-6.

Mr. Hobbs claims he told Mr. Brown to send the \$400,000, that the money would come out of the G & A account, and that the conversation lasted thirty seconds. Tr. p. 146.²² Mr. Hobbs further claims that, based upon his experience, the average advance made by First Security prior to this time was between \$90,000 and \$100,000. Tr. p. 254.

On April 11, 1989, Mr. Hobbs was again working on the reconciliation of its accounts with Cross Roads. Govt. Ex. 4, p. 49. He had a conversation with an unnamed person at First Security who stated that Liberty now wanted First Security to make the April remittance and they were going to send First Security the P & I money." Tr. p. 167. He claims that when this conversation occurred, he was under the impression that the \$400,000 "advance" had been sent to Liberty. Sometime later the group was looking at wire fund transfers when, according to Mr. Hobbs, a wire from Liberty in the amount of \$1.5 million came in. Someone asked where it went and Mr. Hobbs asked, where the wire came from. He testified: "And they said, 'Its from Liberty, That's got to be

²¹The earlier in the month an advance is estimated, the higher the figure will be, as fewer payments will have been received by the issuer.

²²No transfer in the amount of \$400,000 was ever sent to by First Security to Liberty. Tr. p. 151.

the P & I money.²³ Thinking that he was replacing the \$400,000 he had previously sent to Liberty and confusing this amount with the \$1.1 million principal and interest payment, Mr. Hobbs then directed that the \$1.1 million be placed in the G & A account instead of the \$400,000. Tr. pp. 149,168. Following this, Mr. Williams requested him to sign an authorization. He told Mr. Williams that he would type one up when he got back to the office. Tr. p. 169. The authorization signed by Mr. Hobbs, quoted above, was typed later that day.

Mr. Hobbs believes that Cross Roads then took advantage of the situation to use the money improperly transferred from the P & I account to the G & A account for its own purposes. He denies having authorized all but one of the subsequent nine transfers from the P & I account or having authorized the two withdrawals from the G & A account.

²³The transcript as quoted inserts corrections submitted by Mr. Hobbs after the conclusion of the hearing which accurately states his actual testimony. See, April 8, 1990 letter from Mr. Hobbs to Mr. Bingham. There is no direct evidence that Mr. Hobbs looked at the wire. He testified that he heard what it was and gave his instructions based on what he heard. Tr. pp. 168-169.

II

I do not credit Mr. Hobbs' account that Mr. Brown told him that Liberty wanted to make an "advance" in the amount of \$400,000, that he failed to check on whether the advance had been sent, and, a week later, mixed up what he thought was the return of this amount with the principal and interest payment. The figure of \$400,000 in delinquencies is totally beyond any realistic projection which could have been made at that time based on the size of the loan portfolio being acquired and First Security's prior experience with advances. In addition, I do not credit his claim that he, an experienced banker, mixed up huge sums of money and then failed to correct the error later that day when the "mixup" was placed before him in writing.

By Mr. Hobbs' own account, Liberty's \$53 million in mortgages would generate a monthly estimated principal and interest payment (passthrough) of \$750,000 to \$800,000. Tr. p. 197. Over half of these loans would have to be delinquent to support the figure for the advance allegedly quoted by Mr. Brown. As evidenced by the audit report, the size of this figure is well beyond anything experienced by First Security in its servicing of its own GNMA loan portfolios and beyond Mr. Hobbs' claim that First Security's average monthly advance was approximately \$100,000. There are at least two ways of estimating the amount of First Security's prior experience with advances based upon the financial information in the audit report. One method is to estimate the amount of delinquencies based upon the average delinquency rate for January through March 1989. Another method is to estimate the actual amount of delinquent loans for a typical previous month, e.g., March 1989, based on the actual amount of delinquent loans for April 1989 (which has been supplied in the audit report).

According to the audit report, the delinquency rate (the number of delinquent loans divided by the total number of loans) based on the percentage of delinquent loans ranged between 2.7 percent and 3.4 percent on First Security's existing GNMA I portfolio from January 25, 1989 to March 25, 1989. Govt. Ex. 4, pp. 21. The average passthrough was approximately \$230,000 out of a loan portfolio of approximately \$30 million in GNMA loans. Id.²⁴ If one assumes that the amount of delinquent loans are typical of the amounts of the other loans,²⁵ the amount of the delinquencies in January through March 1989, would have approximated \$7,200 per month.²⁶ There is no basis for an inference that First Security ever experienced a loan delinquency in the amount of 50 percent of the passthrough.

²⁴On April 25, 1989, this rate jumped to 5 percent of a total monthly passthrough of approximately \$775,000 dollars.

²⁵This assumption is justified because there is no indication in the record that 5 percent of the loans could account for 50 percent of the passthrough amount.

²⁶This figure is derived by averaging the "fixed installment control" for the months of January through March and multiplying that amount by the average delinquency rate. Govt. Ex. 4, p. 21; Tr. p. 403. For April the amount is higher. \$775,000 multiplied by 5 percent yields \$38,750. This is still well below the \$100,000 figure claimed by Mr. Hobbs.

The second method involves estimating the actual amount of delinquent loans prior to April 25, 1989 which is the only date by which the actual amount of delinquent GNMA I loans can be calculated. On that date, the total amount of delinquent GNMA I loans was only \$52,690.28 out of a passthrough of \$774,482.55, less than half of the average of \$100,000 claimed by Mr. Hobbs, and not even near the extraordinary amount of \$400,000. Govt. Ex. 4, pp. 23-25. On March 25, 1989, the passthrough was \$265,984.69. If it is assumed that ratio of delinquencies to passthroughs remained the same from month to month, the amount of delinquent loans in March would have approximated \$18,000. In fact, the figure probably would be less as the delinquency rate increased from March to April 1989.

These estimates are supported by testimonial evidence. Mr. Hendrickson, the auditor, testified that Roger Brown supplied a figure of \$14,000 for previous advances made by First Security prior to April 1989. Tr. p. 401. This figure is much closer to the estimate of \$7,200 - \$18,000 obtained by the other methods than the \$100,000 estimate supplied by Mr. Hobbs. Mr. Hobbs has neither indicated how he derived the figure of a \$100,000 average monthly advance by First Security, nor furnished support for his claim that it was plausible for him to believe that the sale of the Liberty servicing entailed an advance of \$400,000.²⁷ On the contrary, the amounts derived by either method of estimation closely approximate the amount related by Mr. Brown to Mr. Hendrickson.

The claim that Mr. Hobbs mixed up these huge sums of money after doing the math in his head is highly unlikely because he ratified this "mistake" later that day when he signed the written authorization for the transfer, knowing that the note contained a factually incorrect statement.²⁸

The written authorization to transfer \$1.1 million provided Mr. Hobbs with an opportunity to correct the misstatement purportedly made to Mr. Williams. It was in writing, and, by virtue of having to be signed, would have given Mr. Hobbs pause to reflect and correct his mistake. The fact that he did not use this opportunity to reverse himself not only constitutes strong evidence that there was no "mixup", it constitutes another violation of his fiduciary duty to the GNMA security holders as well.

The statement in the written authorization that the wire was deposited in the wrong account is false. Govt. Ex. 5. In fact, \$1.5 million was placed in the right account

²⁷Nor is it likely that an advance payment due out early in the month would be so much greater than First Security's previous experience of approximately \$14,000. There is no evidence historical or otherwise, of any sudden, huge influx of funds between the 1st of the month when the payments were due and the 12th of the month when the remittance was made.

²⁸The record is insufficient to establish whether Mr. Hobbs' explanation is an after-the-fact "reconstruction" made to fit the amount of the transfers. This explanation supposes that Cross Roads needed an amount in excess of \$1 million to cover existing and anticipated delinquent checks. The urgency for this transfer would have arisen from the threat of the FHLBB closing down Cross Roads.

and Mr. Hobbs knew this. Tr. p. 205.²⁹ In addition, I have concluded that Mr. Hobbs is unlikely to have acted this carelessly.³⁰

²⁹Mr. Hobbs blames Gates Williams or Cross Roads attorney David Cameron for telling him what to put in the letter. He stated he does not know why he used the term, "wrong account". Following the incidents between Cross Roads and First Security which the parties were now trying to resolve, Mr. Hobbs would have been unlikely to have trusted Mr. Williams or Cross Roads to this extent, if at all. Accordingly, I do not credit this statement.

³⁰Despite the testimony of his attorney, Mr. Abney, that Mr. Hobbs is not a "detail person", I conclude from observing his demeanor and hearing his testimony that he is a very intelligent individual in possession of considerable knowledge of banking practices. He had been in the banking business at least since 1981 and was familiar with the strict accounting requirements required by the GNMA agreements.

I conclude that the purported conversation between Mr. Hobbs and Mr. Brown on the 4th or 5th of April 1989, did not take place. In addition, I do not credit Mr. Hobbs' assertion that he did the math in his head and, without checking the current balances, mixed up \$1.1 million and \$400,000. Accordingly, Respondent has failed to establish its defense that its actions were excusable or justifiable.

III

The Government asserts that the Respondent's acts constitute grounds for withdrawal of approval under 24 C.F.R. Section 25.9, subsections (c), (j), (p), and (w). These provisions state that withdrawal may be imposed for:

(c) (t)he use of escrow funds for any purpose other than that for which they were received;

(j) (v)iolation of the requirements of any contract with the Department, or violation of the requirements set forth in any statute, regulation, handbook, mortgage letter, or other written rule of instruction;

(p) (b)usiness practices which do not conform to generally accepted practices of prudent lenders or which demonstrate irresponsibility;

(w) (a)ny other reason the Board, Secretary or Hearing Officer, as appropriate, determine to be so serious as to justify an administrative action.

The authority of the Board to withdraw approval is the authority to refuse permission to continue to participate in HUD-FHA insurance programs. It is similar to the authority to debar contractors and participants. Debarment is a sanction which may be invoked by HUD as a measure for protecting the public by ensuring that only those qualified as "responsible" are allowed to participate in HUD programs; *Stanko Packing Co. v. Bergland*, 489 F. Supp. 947, 949 (D.D.C. 1980); *Roemer v. Hoffman*, 419 F. Supp. 130, 131 (D.D.C. 1976). "Responsibility" is a term of art used in government contract law. It encompasses the projected business risk of a person doing business with HUD. This includes his integrity, honesty, and ability to perform. The primary test for debarment is present responsibility although a finding of present lack of responsibility can be based upon past acts. *Schlesinger v. Gates*, 249 F.2d 111 (D.C. Cir. 1957); *Roemer, supra*.

The record establishes and Respondent admits that it transferred \$1.1 million in escrow funds from the custodial account it maintained and that GNMA bond holders were not paid. Respondent contends that once the transfer was made, Cross Roads made "use" of the funds, not Respondent, and, therefore, it cannot be charged with having violated subsection (c). The plain language of subsection (c) does not state a

requirement that there be a demonstration that the entity effecting the transfer made use of the funds itself, or even that the actual use made of the funds be identified. The subsection plainly states that a violation occurs if the funds were not used for their intended purpose. In this situation improper use occurred because the funds became unavailable to the GNMA bond holders, i.e., the purpose for which the funds were to be used. Accordingly, the Department has demonstrated by a preponderance of evidence that the action of the Board comes within the ground for taking an action set forth in 24 C.F.R. Sec. 25.9(c).

The record also establishes and Respondent admits that it failed to remit payments to holders in a timely manner. This violated the requirement set forth in Section 4.01 of Appendix 19; hence, it also violated the Guarantee Agreements entered into with GNMA by which it accepted the responsibilities of an issuer of GNMA-backed securities. Accordingly, the Department has demonstrated by a preponderance of evidence that the action of the Board comes within the ground for taking an action stated in 24 C.F.R. Sec. 25.9(j).

The transfer of funds and the failure to reverse this transfer was without legal authority. Respondent has supplied an explanation in the form of an excuse which is not believable. Even if the excuse were believable, it does not amount to a justification for the transfer of the GNMA funds or the failure to reverse that transfer. The unjustified transfer of funds, the failure to reverse that transfer, and the failure to pay GNMA bond holders establish that Respondent's business practices do not conform to generally accepted practices of prudent lenders and demonstrate irresponsibility.³¹ In addition, by not taking early action to require Cross Roads to make a proper accounting of funds within the First Security G & A account, Respondent made possible the panic situation forced upon First Security and Cross Roads by the FHLBB. The Department has demonstrated by a preponderance of evidence that the action of the Board comes within the ground set forth in 24 C.F.R. Sec. 25.9 (p).

These sloppy business practices also provide evidence of a serious risk to the public posed by continued dealings with Respondent and fall within the phrase "any other reason" for taking an administrative action. The failure to reverse the transaction on April 11, 1990 and the authorization by Mr. Hobbs of two transfers out of the P & I account on April 13th and 17th also constitute reasons for taking an administrative action. Accordingly, the Department has met its burden to demonstrate by a preponderance of evidence that the action of the Board comes within the ground set forth in 24 C.F.R. Sec. 25.9(w).

IV

³¹Even if Mr. Hobbs' account were believable, which it is not, funds were transferred from the GNMA custodial account without any attempt having been made by Respondent to assure that these funds belonged to it and not to innocent third parties to whom it owed a fiduciary responsibility. In this regard, I accept the testimony of Joseph Wagner, an employee of GNMA, that the authorization of a funds transfer in excess of a million dollars based upon a guess or mental estimate of what was in the account is simply not an acceptable practice among prudent lenders. Tr. pp. 381-382.

Title 24 C.F.R. Section 25.5(d)(2) states that, "A withdrawal may be for an indefinite period for egregious or willful violations by the mortgagee."

While admitting in its answer and in the testimony of its President, Mr. Hobbs, that it had an obligation to pass the mortgage principal and interest funds through to security holders and that it did not do so, Respondent contends that the Government has failed to demonstrate by a preponderance of the evidence that Respondent's conduct was "egregious or willful".³² Respondent bases its contentions on a purported lack of evidence of a demonstration it received a benefit, that there was any urgency to make a payment to Cross Roads, the lack of any writing signed by Mr. Hobbs authorizing all but two of the subsequent transfers, and Mr. Hobbs' subsequent actions in alerting GNMA and cooperating in subsequent investigations.³³

The Department contends that the Respondent's acts were sufficiently serious to warrant withdrawal for an indefinite period because its acts were "egregious or willful". HUD contends that Mr. Hobbs knew exactly what he was doing when he transferred the funds because First Security was in a financial "crunch". Cross Roads was about to be prevented from doing any further business with First Security and in desperation, First Security grabbed a source of cash that it had easy access to, the GNMA P & I account. Govt. Brief, p. 14.

"Willful", "wanton" and "reckless" have been grouped together as meaning an aggravated form of negligence. Their usual meaning is that ". . .the actor has intentionally done an act of an unreasonable character in disregard of a known or obvious risk that was so great as to make it highly probable that harm would follow. . . ." *Prosser and Keeton on The Law of Torts* at 213, Fifth Ed. West Publishing Co. (1984). It is to be distinguished from "mere mistake resulting from inexperience, excitement or confusion, and more than mere thoughtlessness or inadvertence, or simple inattention." *Id.* at 214.

Respondent is, in effect, contending that the Government's evidence is insufficient to establish the motive or any benefit to First Security. Therefore, Respondent contends HUD has failed to prove willfulness by a preponderance of the evidence. First Security's

³²Although somewhat ambiguous, Respondent's post-hearing brief appears to assert that this purported failure of proof, in addition to mitigating the penalty, exonerates the Respondent from any liability. This is not the case. A violation may still be found even if the conduct is not "willful or egregious". Otherwise, the language quoted in Section 25.5(d)(2) would be meaningless. In addition, the grounds themselves quoted above do not require a showing of any particular mental state as part of a basis for imposing a sanction. Rather, the administrative action depends on the "nature and extent" of the violations. 24 C.F.R. Sec. 25.5.

³³I have also considered Mr. Hobbs' notification of GNMA and his subsequent cooperation during the investigation of this matter as factors which could possibly mitigate the seriousness of the sanction taken by the Board.

contentions are unpersuasive. The record contains sufficient evidence of willfulness, even assuming that there is insufficient evidence of motive. In this regard, the Department is not required to prove the motives which underlay Respondent's actions.³⁴

³⁴See, note 28, supra. It is possible to infer a motive without accepting the Respondent's view of what this motive must be.

It has not been established that there was a request by Liberty for First Security to make an advance in the amount of \$400,000, or that Respondent's President, Mr. Hobbs, mixed up 1.1 million and \$400,000. The record does reflect, however, that he was afforded the opportunity to reverse this transaction and did not do so. Accordingly, the evidence establishes that Mr. Hobbs was not acting from "excitement or confusion, . . . mere thoughtlessness or inadvertence, or simple inattention." Rather, the absence of this conversation, Mr. Hobbs' failure to reverse his oral instruction to Mr. Williams, together with evidence that Mr. Hobbs signed at least two written authorizations for withdrawals³⁵ without knowing how much was in the account,³⁶ establish that the money was knowingly diverted in total disregard of the obvious consequence that the GNMA security holders would not be paid.

The record also establishes that First Security's diversion of funds and the consequences of that diversion were "egregious." "Egregious means "conspicuously bad" or "flagrant". Respondent, without justification, transferred a large sum, 1.1 million, in funds belonging to GNMA securities holders maintained in a fiduciary account to its corporate account, failed to reverse this transaction when it had the opportunity to do so, and failed to make the required payments to GNMA securities holders.³⁷ Respondent's President, Mr. Hobbs, authorized two subsequent transfers from the P & I account without knowing how much, if any, funds in that account belonged to First Security. Tr. p. 187. Mr. Hobbs also contributed to a situation in which there was no accounting of the funds in

³⁵It is possible that seven out of nine transfers from the P & I account were done without Mr. Hobb's knowledge or permission. It is also possible that he did not know of or authorize the two cashiers checks drawn out of the G & A account. Even so, the record is sufficient to establish that Mr. Hobbs transferred 1.1 million dollars out of a fiduciary account and, later that week, authorized at least two withdrawals of a portion of those funds from the G & A account, knowing that such transfers were improper.

³⁶His explanation is instructive. He states:

I did authorize--I authorized one additional transfer which I thought could be supported by the amount of our previous month's advance by the difference--in my mind there was still this number out there that we never reconciled, additional money that was owed to us from the wire. I thought the 1.5 million plus the 400, I had rounded that off and so there would be more money to us.

So I thought there was other money in that account which would be repayment money to First Security, and would be acceptable. I didn't sit down and figure it out before I did it. Tr. p. 187.

³⁷However unlikely Mr. Hobb's explanation, his account, even if it were true, does not inspire confidence in the way in which this financial institution was run. According to his own account, he did not ascertain whether \$400,000 was an accurate figure for the amount of the advance to be made on the Liberty loans when he had over a week to do so. Nor did he make any attempt to find out how much First Security had in the P & I account. Although I find implausible his assertion that he did the math in his head and got mixed up, such an action by a thrift executive would be reckless in the extreme. No amount of confusion or anxiety can excuse these actions.

the G & A account. This had begun in November and continued to April. Rather than demand an immediate accounting as a condition of continuing to do business with Cross Roads, he waited until the action of the FHLBB forced him to obtain an accounting. In the meantime, First Security continued to originate loans and seek other business. These actions resulted in a total loss to the United States Treasury of approximately 1.8 million dollars.

CONCLUSION AND ORDER

Upon consideration of the entire record in this case including the seriousness and extent of the infractions, the degree of mortgagee responsibility for the occurrences together with mitigating factors, the Department has established by independent and preponderant evidence that sufficient grounds exist for a withdrawal for an indefinite period of Respondent's HUD-FHA mortgagee approval for the reasons set forth in 24 C.F.R. Secs. 25.9 (c),(j),(p) and (w) and 25.5 (d)(2). The Department has also demonstrated that, based upon these past acts, continued business dealings with Respondent pose a significant present risk to the public fisc. Accordingly, it is

ORDERED that,

the action of the Mortgagee Review Board is affirmed.

/s/

WILLIAM C. CREGAR
Administrative Law Judge

Dated: August 24, 1990.