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

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| In the Matter of:<br><br>SUNDIAL CARE CENTER, INC.,<br><br>and<br><br>TERESA WONG,<br><br>Respondents. | HUDALJ 08-055-CMP<br><br>March 25, 2009 |

**Appearances**

Phillip Kesaris, Attorney; Dane Narode, Attorney;
United States Department of Housing and Urban Development, Washington, D.C.
For the Complainant

Joanna Rosen, Attorney; David Buoncristiani, Attorney;
Howrey LLP, San Francisco, CA
For the Respondents

## INITIAL DECISION AND ORDER

BEFORE: J. Jeremiah MAHONEY, Chief Administrative Law Judge (Acting)

**Procedural History**. On July 18, 2008, the Secretary of the United States Department of Housing and Urban Development ("HUD") filed a Complaint for Civil Money Penalties ("Complaint") against Sundial Care Center, Inc. ("Sundial") and Teresa Wong ("Ms. Wong"), pursuant to Section 537(c) of the National Housing Act, 12 U.S.C. §1735f-15, and its implementing regulations under 24 C.F.R. Part 30. The Complaint contains 22 counts alleging that the Respondents knowingly and materially paid out project funds for expenditures that were neither reasonable operating expenses nor necessary repairs of the project, without statutory authority or the written approval of HUD.[1] The Complaint sought civil money penalties totaling $245,000.

[1] Prior to the hearing, the Government elected not to pursue Counts 23 to 25, which were originally included in the Complaint, and which involved the expenditure of project funds for training a project employee.

On November 5-7, 2008, this Court held a hearing in San Francisco, California. The parties filed Post Hearing Briefs on December 9, 2008, and Reply Briefs on December 22, 2008. Accordingly, this case is ripe for decision.

**Background**. In 1999, Ms. Wong was contemplating investing in an assisted-living facility, and contacted a consultant who specialized in the assisted living business. The consultant told her that he needed to find a non-profit sponsor for an assisted living project because the developers "[had] an internal argument among the partners [and so did not] have the funding to put down the down payment. (Hearing Transcript [HT] 293:14-295:13.) Ms. Wong believed that the project in question was a "government sponsored project" and that "everything was in place" for the project to go forward. (HT 294:25-295:2.) With that in mind, Ms. Wong approached three organizations, but could not find a sponsor that was both interested in the project and acceptable to HUD. (HT 295:18-297:9.) Thereafter, Ms. Wong formed Sundial to pursue the project because she had "invest[ed] much time and effort into the project" and thought "this is a good project." (HT 297:10-16.) This was the first HUD-insured project in which Ms. Wong invested. (HT 370:15-17.)

While Ms. Wong was not involved in appraising the project or preparing the application for HUD insurance, she "decided to go along" with the project because of the value of the loan HUD insured and the projected revenues and occupancy rate after three periods. (HT 297:21-298:12; 366:23-367:20; 368:12-369:24.) Ms. Wong testified: "[I]f [HUD were] willing to insure the loan, and it's a non-recourse loan, this is the value that they agree on, there must be something, a good project." (HT 367:16-20.) Ms. Wong further testified: "I look at HUD as my partner. . . . I was told by HUD employees that I am their client. . . . [I]f I have something I need, I can go to them." (HT 367:10-11; 371:20-25.)

Ms. Wong signed several documents, including a Regulatory Agreement for Multifamily Housing Projects ("Regulatory Agreement"), prior to beginning construction on the Sundial project. (HT 219:9-20; 220:6-13; 372:10-13; 373:5-9.) Ms. Wong testified that she did not read the Regulatory Agreement "precisely" before signing because she "was under the instruction of a lawyer." (HT 219:24-220:2; s*ee also* HT 373:1-13.) Ms. Wong also testified that "no one at HUD explain[ed] . . . what the provisions of the Regulatory Agreement meant," and that she did not review the Regulatory Agreement after signing it. (HT 220:14-18; 373:10-13.)

After starting operations, Ms. Wong learned that, in addition to one "small . . . and old" facility, the Sundial Care Center would have to compete with a brand-new nearby facility that had also been funded by a HUD-insured loan. (HT 370:5-14; 377:20-381:11.) Sundial's second management company ended its contract after determining, based on its own study of the project and the market, that Sundial could not become profitable. (HT 387:8-17.) In 2002, Ms. Wong contacted both the project lender and HUD to discuss the project's financial challenges. (HT 389:25-392:6.) As part of the ensuing discussions, Ms. Wong learned that, if Sundial met certain conditions, it could obtain an operating deficit loan insured by HUD. (393:9-394:15.) Ms. Wong testified: "I never want[ed] to think about . . . default[ing] the project." (HT 396:16-17.)

While waiting to qualify for an operating deficit loan, Ms. Wong sought funding "from all [the] resource[s] [she] could grasp," eventually obtaining access to funds from the Van Ness Care Center, Inc. ("VNCC"), the San Francisco Care Center, LLP ("SFCC"), and from a

personal credit line obtained by Nick and Alice K. Wong from the Bank of America. (Joint Set of Stipulated Facts and Exhibits ("SF") ¶ 10, HT 428:15-17.) The existence of some of this external funding was disclosed in the audited financial statements provided to HUD, but the payments at issue were not acknowledged therein. (*See, e.g.*, RX 12.)

In reviewing the financial statements submitted by the Respondents for the year ending December 31, 2003, the HUD Real Estate Assessment Center ("REAC") identified interest payments made on the Bank of America line of credit as a possible unauthorized distribution of funds, and sought clarification on the point from the Respondents. (HT 315:5-13.) The Respondents assert that they heard nothing further from HUD after responding to the inquiry. (Respondent's Post-hearing Brief ("RPB") 6 and 17 (citing HT 316:10-17).)

When the project's request for a $1.1 Million operating loss loan was denied, the Respondents ceased making mortgage payments, and began to repay loans made by VNCC and SFCC. (HT 428-430.) When asked if it was her "impression that after the project is in default that you didn't have to pay the mortgage payments anymore," Ms. Wong affirmed: "That's why they call it default." (HT 432:3-7.)

**Statutory Scheme.** HUD is a Federal Executive Department of the United States Government.[2] As part of its functions, HUD insures mortgage loans to facilitate the construction and substantial rehabilitation of facilities serving as nursing homes, intermediate care facilities, board and care homes, and assisted living facilities.[3] In this capacity, HUD insured the mortgage on Sundial, a 68 bed assisted living facility. Pursuant to regulatory restrictions on project expenditures by such HUD-insured projects, civil money penalties may be imposed against "any mortgagor of a property that includes 5 or more living units and that has a mortgage insured . . . pursuant to [the National Housing Act]" and against "any officer or director of a corporate mortgagor" for the knowing and material "[a]ssignment, transfer, disposition, or encumbrance of any personal property of the project, including rents, [or] other revenues . . . or paying out any funds, except for reasonable operating expenses and necessary repairs, without the prior written approval of the Secretary." 12 U.S.C. § 1735f-15(c)(1)(A)(i), (iii), and (B)(ii).[4]

## FINDINGS OF FACT

Based on a thorough and careful analysis of the entire record, including evidence in the form of testimony and documents adduced at the hearing, the Court finds as follows:

1. Sundial is a California for-profit corporation and, at all relevant times, was the owner and mortgagor of the Sundial Care Center, a/k/a the Sundial Senior Lodge, a 68-bed assisted

[2] 42 U.S.C. § 3532.

[3] Section 232 of the National Housing Act, 12 U.S.C. §1715w.

[4] In addition to expenditures expressly approved by the Secretary, the Act provides for expenditures of project funds that will not jeopardize HUD's interest as insurer: "The payout of surplus cash, as defined by and provided for in the regulatory agreement, shall not constitute a violation . . . ." 12 U.S.C. § 1735f-15(c)(1)(B). Furthermore, the Act provides that "[t]he Secretary shall not impose penalties under this section for violations a material cause of which are the failure of the Department [or] an agent of the Department . . . to comply with existing agreements." 12 U.S.C. § 1735f-15(a).

living facility located in Modesto, California. (Joint Set of Stipulated Facts, Exhibits, and Testimony ("SF") ¶ 1);

2. Ms. Wong was, at all relevant times, the President of Sundial (SF ¶ 2);

3. HUD insured the mortgage to finance the construction of the Sundial Care Center pursuant to Section 232 of the National Housing Act (SF ¶ 3);

4. On March 1, 2000, Ms. Wong signed, on behalf of Sundial, a Regulatory Agreement for Multifamily Housing Projects with the Secretary of HUD. (Joint Exhibit ("JX") 1; Hearing Transcript ("HT") 223, 375-376.) In signing the Regulatory Agreement, the Respondents agreed to specific limitations on the disbursement of project funds;[5]

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[5] The Regulatory Agreement provides that: "in order to comply with the provisions of the National Housing Act, as amended, and the Regulations adopted by the Secretary pursuant thereto, Owners agree . . . that in connection with the mortgaged property and the project operated thereon and so long as the contract of mortgage insurance continues in effect, and during such further period of time as the Secretary shall be the owner, holder or reinsurer of the mortgage . .

* * * *

6. Owners shall not without the prior written approval of the Secretary:

* * * *

(b) Assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds except from surplus cash, except for reasonable operating expenses and necessary repairs.

* * * *

(e) Make, or receive and retain, any distribution of assets or any income of any kind of the project except surplus cash . . . .

* * * *

9. (g) All rents and other receipts of the project shall be deposited in the name of the project in a financial institution, whose deposits are insured by an agency of the Federal Government. Such funds shall be withdrawn only in accordance with the provisions of this Agreement for expenses of the project or for distributions of surplus cash as permitted by paragraph 6(e) above. Any Owner receiving funds of the project other than by such distribution of surplus cash shall immediately deposit such funds in the project bank account and failing so to do in violation of this Agreement shall hold such funds in trust . . . .

* * * *

13. (e) 'Project' includes the mortgaged property and all its other assets of whatsoever nature or wheresoever situated, used in or owned by the business conducted on said mortgaged property, which business in providing housing and other activities as are incidental thereto . . . .

(f) "Surplus Cash" means any cash remaining after:

(1) the payment of:
  (i) All sums due or currently required to be paid under the terms of any mortgage or note insured or held by the Secretary;
  (ii) All amounts required to be deposited in the reserve fund for replacements;
  (iii) All obligations of the project other than the insured mortgage unless funds for payment are set aside or deferment of payment has been approved by the Secretary; and

(2) the segregation of
  (i) An amount equal to the aggregate of all special funds required to be maintained by the project; and
  (ii) All tenant security deposits held.

(g) 'Distribution' means any withdrawal or taking of cash or any assets of the project, including the segregation of cash or assets for subsequent withdrawal within the limitations of Paragraph 6(e) hereof, and excluding payment for reasonable expenses incident to the operation and maintenance of the project.

(JX 1, Regulatory Agreement.)

5. The Sundial Care Center was never in a "surplus cash" position as defined in paragraph 13(f) of the Regulatory Agreement (SF ¶ 9);

6. Bank of America account number 02646-10668 was a general account of Sundial d/b/a Sundial Senior Lodge (SF ¶ 19);

7. Bank of America account number 02647-12794 was a general account of Sundial (SF ¶ 20);

8. VNCC, a California for-profit corporation, was at all relevant times partly owned by Ms. Wong (SF ¶ 12). Ms. Wong has been the President of VNCC since 2002, and has a 51% ownership share in the corporation (HT 216:15-24);

9. On or about July 27, 2003, Sundial and Ms. Wong authorized the payment of $10,000 to VNCC via check number 1037 (SF ¶ 10(a)); [6]

10. Between July 2003 and September 2004, Sundial and Ms. Wong paid out $116,000 to VNCC in order to repay VNCC for a loan that had previously been made to Sundial (SF ¶ 10);[7]

11. Ms. Wong was, at all relevant times, a managing general partner of SFCC, a California limited partnership that owns an assisted living facility (SF ¶ 14);

12. On or about October 15, 2004, Sundial and Ms. Wong authorized the payment of $12,000 to SFCC, via check number 2623 from Bank of America account number 02646-10668 (SF ¶ 11);

13. Between October 2003 and February 2005, Sundial and Ms. Wong paid out funds totaling $6,342.70 to cover the interest due on Nick K. Wong's and Alice Y. Wong's personal credit line with Bank of America (SF ¶ 15); [8]

14. Ms. Wong owns land that has been listed for sale at $1.2 million and was assessed for $713,776 in January 2008 (HT 226:18-20, 227:12-23, 230:11-231:22; GX 20); and,

15. Ms. Wong lost approximately $1.8 million of her own funds in the project. (Tr. 453:23-25; RX 11 and RX 12). HUD suffered a loss of $3.6 million when the note on the property was sold in 2005. (HT 243:2-6.)

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[6] Respondents withdrew their admission regarding the purpose of check 1037 prior to the hearing in this matter. (Government's Post-hearing Brief 16-17, note 11.) However, Respondents do not dispute the existence of the payment. (*See* Respondents' Post-hearing Brief 9-10.)

[7] The payments, by electronic transfer, were as follows: $50,000 (April 12, 2004); $25,000 (May 18, 2004); $18,000 (June 14, 2004); $5,000 (July 7, 2004); and $18,000 (September 13, 2004). (SF ¶ 10(f).)

[8] The payments to Nick and Alice Wong, by account debit, were in the following amounts: $373.73 (October 9, 2003); $387.04 (November 10, 2003); $373.74 (December 9, 2003); $385.35 (January 9, 2004); $387.38 (February 9, 2004); $358.71 (March 9, 2004); $382.62 (April 9, 2004); $369.45 (May 10, 2004); $382.62 (June 9, 2004); $371.08 (July 9, 2004); $392.73 (August 9, 2004); $404.52 (September 9, 2004); $408.60 (October 12, 2004); $434.37 (November 9, 2004); $932.78 (February 21, 2005).

## DISCUSSION

The Secretary's Complaint asserts that the Respondents are "liable parties" under the National Housing Act; that the Respondents paid out "project funds" without prior written permission from the Secretary for purposes other than reasonable operating expenses (or necessary repairs); and, by so doing, that the Respondents "knowingly and materially" violated the National Housing Act. The Respondents dispute each of these claims.

**Liable Party.** The Respondents deny that either Sundial or Ms. Wong is a liable party under 12 U.S.C. § 1735f-15. (Respondent's Response to Complaint for Civil Money Penalties ("Response") at ¶¶ 2-3.) However, 12 U.S.C. § 1735f-15 defines liable parties as "any mortgagor of a property that includes 5 or more living units and that has a mortgage insured pursuant to this chapter" and "any officer or director of a corporate mortgagor." The Respondents stipulate that Sundial is a corporation that, at all times relevant to this proceeding, was the owner and mortgagor of a 68-bed assisted living facility that had a mortgage insured pursuant to the National Housing Act and that Ms. Wong was the President of Sundial.[9] (SF ¶¶ 1-3.) Thus, the Court concludes that both the Respondents are liable parties for the purposes of 12 U.S.C. § 1735f-15.

**Project Funds**. The Respondents also deny that the use of project funds to make the payments at issue in this case was a violation of the National Housing Act. The term "project funds" does not appear in the National Housing Act, the implementing regulations, or the Regulatory Agreement that the Respondents signed "to comply with the provisions of the National Housing Act." However, both the National Housing Act and the Regulatory Agreement specifically constrain the "assignment, transfer, disposition, or encumbrance of any personal property of the project, *including rents [and] other revenues* . . . or paying out *any funds* . . . ." 12 U.S.C. § 1735f-15(c)(1)(B)(ii) (emphasis added). (*See also* JX 1, ¶ 6(b).) Thus, the Secretary may impose civil money penalties upon the Respondents for the unauthorized use of funds generated from the operation of the project or otherwise committed to its use. However, 12 U.S.C. § 1735f-15(c)(1)(B)(ii) does not provide a penalty for the payout of funds that do not belong to the project.

The Respondents do not identify the basis for their assertion that the funds used to make the payments at issue in this case did not consist of project funds. The Secretary argues that "[t]he 22 payouts at issue in this case consisted of funds of the Sundial Care Center project because such funds were on deposit, and disbursed from, the general operating account of the project." (Government's Post-Hearing Brief ("GPB") 13.)

Ms. Wong testified that "cash for the project" came from "the revenue we receive[d] from the tenants, from the residents" and "from the money I . . . just grab[bed] from any resource to keep the project going." (HT 374:17-25.) The Respondents expended all funds advanced by other entities to pay project expenses. (*See* HT 398:12-16, 399:13-17, 400:4-9, 408:9-12, 427:20-428:17.) Thus with the possible exception of the repayment of two deposits the Respondents claim were mistakenly deposited into Sundial's account (discussed below), the funds used to make the payments at issue in this case were generated from project revenue, and

[9] 12 U.S.C. § 1701 provides: "This chapter may be cited as the 'National Housing Act.'"

must be regarded as personal property of the project, the use of which is constrained by the National Housing Act. *See* 12 U.S.C. § 1735f-15(c)(1)(B)(ii).

**Payments made to correct "mistaken" deposits to project account**. Two Counts charge wrongful payments out of project funds that the Respondents claim were mistakenly deposited into project funds. The Secretary maintains that "if it [were] clearly documented that [a neutral and disinterested entity] made erroneous deposits into the project account . . . then HUD may not [regard] the return of such erroneous deposits to the bank as unauthorized distributions." (Government's Reply Brief ("GRB") 4.) (*See also* HT 210:11-212:6.) In other words, the Secretary distinguishes the repayment of an inadvertent deposit made by a liable party from the repayment of an inadvertent deposit made by a disinterested party, and contends that 12 U.S.C. § 1735f-15(c)(1)(B)(ii) proscribes the former while authorizing the latter.

The National Housing Act, however, does not contain the distinction made by the Secretary. While 12 U.S.C. § 1735f-15(c)(1)(B)(ii) proscribes certain payments, and authorizes others, neither proscription nor authorization depends upon the identity of the recipient of a payment. With respect to the payout of project funds, the Act distinguishes between transactions, not parties. *See* 12 U.S.C. § 1735f-15(c)(1)(B)(ii). Thus, repayment of an inadvertent deposit improperly made to a project account by a liable party must be treated the same as the repayment of such a deposit made by a disinterested party. Furthermore, because funds erroneously deposited in a project account do not belong to the project, they may be returned to their proper owner without penalty.[10] For those reasons, the claimed repayments to correct each of the claimed mistaken deposits must be examined.

***Count 1***. The Respondents assert that Ms. Wong, on July 18, 2003, mistakenly deposited $10,000 into Sundial's Bank of America account instead of VNCC's Bank of America account, and that the $10,000 payment by check number 1037 to VNCC on July 25, 2003, was made to correct this error. (RPB 9-10.) The Secretary argues that the evidence indicates this deposit constituted an intentional loan, and was not an inadvertent mistake. (GPB 15-18.)

The memo field of check 1037, the check issued to correct the alleged error, signed by Ms. Wong on July 25, 2003, reads "for repayment on loan." (GPB 16; Government's Exhibit ("GX") 9.) Furthermore, on July 14, 2005, in a memo addressed to the Office of Inspector General, Ms. Wong stated that this check "[was] written to pay [VNCC] for a short term loan for payroll." (GPB 16, GX 9.) The Secretary alleges that, apart from the check itself, "no contemporaneous written record of the purported mistaken transfer was made," and notes that

[10] The Secretary argues that the payout of funds "to rectify earlier mistaken transfers of funds into the project . . . constitutes violations [of 12 U.S.C. § 1735f-15(c)(1)(B)(ii)] because they were not for operating expenses of the project." (GRB 4.) This argument arises from the statutory language proscribing "paying out any funds . . . ," and is based on the assumption that all funds deposited in project bank accounts are necessarily project funds. (*See* GPB 12-13.) As a matter of basic statutory construction, however, the meaning of the term "any funds" may be discerned by reference to the words immediately preceding that term—*i.e.* "any personal property of the project, including rents [and] other revenues." *See* 12 U.S.C. § 1735f-15(c)(1)(B)(ii). Nevertheless, the Secretary asserts that "federal court decisions treat any funds that are in project accounts and disbursed therefrom" as subject to the restrictions set forth in 12 U.S.C. § 1735f-15(c)(1)(B)(ii). (*Id.*) The cases the Secretary relies upon to support his assertion discuss the statutory and contractual restrictions placed upon the disbursal of project funds, but do not define the term "project funds." While it may be that the National Housing Act proscribes not only the payout of the personal property of the project, but also the payout of other funds duly committed to its use, funds inadvertently transferred to the project account do not lose their character as property of their rightful owner, and so do not qualify as project funds for the purposes of 12 U.S.C. § 1735f-15(c)(1)(B)(ii).

"this supposed mistake" was not "explained or reported in the audited financial statements for the year ending December 31, 2003," and asserts: "[the] contemporaneous written statement on the check itself should be regarded as the most reliable and credible evidence . . . ." (GPB 16.)

The Respondents also cite the testimony of James McGowan's, CPA, in support of their claim. (RPB 9.) Mr. McGowan testified that, after "looking at the deposit and the repayment and the time . . ," he determined: "It was a deposit that was erroneously deposited . . . and it was corrected as soon as we found it." (HT 321:10-20.) He further affirmed that this deposit and repayment was not reported to HUD on the audited financial statement for the year ending December 31, 2003, because: "[I]t was an honest mistake and was corrected. There was no misrepresentation and it doesn't materially affect any of the accounts." (HT 321:3-322:1.)

The Secretary asserts that Ms. Wong has admitted that the July 18, 2003, transaction constitutes a loan and that the Respondents should be estopped from claiming otherwise. On April 27, 2006, when Ms. Wong commented on a draft audit report prepared by the HUD Office of Inspector General that identified payments made by Sundial to VNCC between July 2003 and October 2004 as "ineligible loan repayments and interest payments," she failed to claim that check 1037 was intended to correct an inadvertent mistaken deposit. (GPB 16, GX 17.) Ms. Wong again failed to raise the issue in her response to the Pre-penalty Notice. (GPB 16, JX 4.) In the Respondents' Response to Complaint for Civil Money Penalties, and again in the Joint Set of Stipulated Facts, the Respondents admitted that check 1037 was intended to repay a loan made by VNCC to Sundial. (*Cf.* Complaint ¶¶ 16-17 and Response ¶¶ 16-17; SF ¶ 10(a).) However, the Respondents withdrew their admission regarding the purpose of check 1037 prior to the hearing in this matter.[11] (GPB 16-17, note 11.)

Turning to the evidence, the contemporaneous notation on the check that it was for repayment of a "loan" is strong circumstantial evidence of the fact that the original deposit from VNCC was a loan to Sundial. However, the Court rejects such a finding based on other evidence in the case that clearly suggests that the Respondents did not appreciate the fact that the notation of a loan repayment out of project funds would be an admission of wrongdoing under the Regulatory Agreement and the statute. At the time, the evidence establishes that the Respondent believed (wrongly) that repayment of a loan was at least as innocent and acceptable an explanation for the transfer of project funds as would have been stating that the transfer was to correct a mistaken deposit.

Other circumstantial evidence in the record clearly outweighs any inference to be drawn from the notation of "loan" repayment. Specifically, Sundial's Bank of America Standard

[11] Notwithstanding the Respondents' withdrawal, the Secretary contends that "[t]his admission in pleading should be deemed a judicial admission that is binding on Respondents" or, alternatively, "their pleading should 'cast [their] contrary argument to the court in an unpersuasive light.'" (GPB 17 (citations omitted).) In response, the Respondents note that the Secretary did not object to the Respondents' withdrawal of Stipulated Fact 10(a), and argue "[t]he Government should therefore be estopped from now commenting on the propriety and weight such evidence should be afforded." (Respondents' Post-hearing Reply Brief ("RRB") 7-8, note 6.) Because the Respondents have withdrawn their admission that Check 1037 was used to repay a loan, their previous admission is not conclusive. *188 LLC v. Trinity Industries, Inc.*, 300 F.3d 730, 735-36 (7th Cir 2002). *See also Creedon Controls, Inc. v. Banc One Bldg. Corp.*, 470 F.Supp.2d 457, 461 (D.Del. 2007) (noting that a withdrawn pleading may not be evidence against the pleader where the withdrawn pleading "was filed under a clear misapprehension of the facts") (citing 52 A.L.R. 516). Moreover, irrespective of the status of the withdrawn admission, the Court may analyze the checking transactions and draw its own conclusions based upon all the evidence in the record.

Checking Statement for the period July 1 through July 31, 2003 shows activity in the project account from the date of deposit of the $10,000 from VNCC into Sundial's account through its subsequent withdrawal for repayment to VNCC. (*See* GX 8.) The statement unequivocally demonstrates that none of the $10,000 deposited on July 18, 2003, was used by the project. Sundial exercised dominion over these funds only to the extent necessary to return them to their proper owner. Therefore, because of the short period of time between the deposit and the correction of the alleged error—and because the funds were not drawn upon by Sundial in the interim—the Court concludes that the "loan" notation in the memo field of Check 1037 was erroneous; that the deposit was in fact a "mistake;" and that the $10,000 returned to VNCC by means of that check were never project funds. Because the $10,000 was not project funds, its return to VNCC by the Respondents was not a violation of 12 U.S.C. § 1735f-15(c)(1)(B)(ii).

***Count 7.*** The Respondents also assert that, on December 17, 2003, they mistakenly transferred $30,000 from the Bank of America account of SFCC to Sundial's Bank of America Account, and that the $12,000 payment made via check number 2623 to SFCC on October 15, 2004, was a partial payment made to correct this error. (RPB 10.) The Secretary notes the passage of ten months between the claimed mistaken deposit and the first partial repayment, arguing that the evidence indicates this deposit constituted an intentional loan, and was not an inadvertent mistake. (GPB 15-18.) The Secretary states: "The advance that had been made by [SFCC] . . . was not a mistake because Michelle Cheung, the Sundial Care Center project's bookkeeper, would have caught such a transfer error . . . when she performed a bank reconciliation at the end of the month of December 2003." (GPB 17.)

The Respondents argue that the passage of time between the date of the allegedly mistaken deposit and the first payment made to rectify the mistake is not dispositive because: "Ms. Cheung, who is not an accountant, only reconciled Sundial's and SFCC books 'whenever she had the time. She does it annually. Sometimes every six months.'" (RPB 10, citing Ms. Wong's hearing testimony at HT 419:23-24).) The Respondents respond: "Because Ms. Cheung did not reconcile these books routinely, it was possible Ms. Cheung did not discover the mistaken deposit until October 2004." (RPB 10.)

However, the Respondents do not explain how it is that this error was not identified prior to the submission of audited financial statements for the year ending December 31, 2003. Furthermore, Sundial's Bank of America Standard Checking Statement for the period November 29 through December 31, 2003 shows that Sundial used the $30,000 deposit to pay project expenses. (*See* GX 8.) Sundial would have overdrawn its account in December 2003 if it had not had the use of these funds provided by SFCC. (*Id.*) Therefore, because of the length of time between the allegedly mistaken deposit and the first payment made to correct the error, because the transfer was not recognized as erroneous in the annual financial statement submitted for the year ending December 31, 2007, and because the funds were actually expended by Sundial, the evidence establishes that the $30,000 transferred to Sundial's bank account on December 17, 2003 was intended to be a loan. It was not a mistaken transfer of funds.

**Reasonable Operating Expenses.** The Act provides that a civil money penalty may not be imposed for payment of "reasonable operating expenses." 12 U.S.C. § 1735f-15(c)(1)(B)(ii). Neither the National Housing Act, nor the implementing regulations, nor the Regulatory Agreement defines the phrase "operating expenses," leaving interpretation of the term to the

courts.[12] Federal courts interpret the phrase "operating expenses" to mean those expenses that arise from the everyday operation and maintenance of the project, which are necessary to the continued operation of the project, and which primarily benefit the project, not the owner. *Arizona Oddfellow-Rebekah Housing Inc. v. United Stated Department of Housing and Urban Development*, 125 F.3d 771, 774 (9th Cir. 1997); *United States v. Frank*, 587 F.2d 924, 927 (8th Cir. 1978); In re *RLA of Madison, Inc.*, 177 B.R. 78, 80 (Bankr. M.D. Tenn. 1994). Previous court decisions have consistently held that the repayment of owner advances is not an operating expense, even when such advances were used to pay a project's operating expenses. *See, e.g.*, *United States v. Thompson*, 408 F.2d 1075, 1080-81 (8th Cir. 1969); *United States v. Coleman*, 200 F. Supp. 2d 561, 567 (E.D.N.C. 2002); *United States v. Schlesinger*, 88 F. Supp. 2d 431, 452 (D. Md. 2000); *In Matter of Blumenfeld et al*, HUDALJ 90-1550-DB (August 28, 1992).

Included within payments at issue in this case are interest payments made on a line of credit used to pay operating expenses and the repayment of advances made by VNCC and SFCC to pay Sundial's operating expenses. (Complaint 9-23; SF 10, 11, and 15.) As noted above, the existence of at least some of these loans was disclosed in the audited financial statements provided to HUD, but the repayments at issue and the interest payments were not acknowledged therein. (*See* RX 12.) Specifically, the audited financial statements submitted to HUD for the year ending December 31, 2003, include the following notes:

> *Note 7 – Bank of America Line of Credit*
>
> The project has obtained a line of credit of $100,000 to assist in the payment of the operating expenses of the project until the occupancy will support the operations. The loan is with the Bank of America and is guaranteed by an owner of the project. None of the assets of the project were used to secure the debt. . . .
>
> *Note 9 – Advances from Affiliates*
>
> The project has borrowed funds from the owners of the project and related affiliates [with] which there is an identity of interest. . . .The repayment of the loan will depend on the ability of the project to generate the funds necessary to retire the debt through operations or sale. . . . Repayment of the debt is restricted by surplus cash.

(RX 12.)

The Respondents seek to distinguish the payments at issue in this case from the repayment of owner advances on the basis of the purpose and the identity of the recipient. Specifically, Respondents argue that the payments should be deemed reasonable operating expenses for the same reasons that certain legal expenses were found to be reasonable operating

[12] Relatively few cases have directly interpreted the term "operating expenses" as found in 12 U.S.C. § 1735f-15(c)(1)(B)(ii). The definition of "operating expenses" used in these cases conforms to the interpretation courts have applied in cases that discuss the meaning of this term in context of the section of HUD's standard Regulatory Agreement that is identical to 12 U.S.C. § 1735f-15(c)(1)(B)(ii). Because the language is identical, the term "operating expenses" as used in 12 U.S.C. § 1735f-15(c)(1)(B)(ii) will be given the same meaning that courts have found in interpreted the relevant section of the Regulatory Agreement. However, a civil money penalty may only be imposed for a violation of the statute, not for a breach of the Regulatory Agreement.

expenses in *Arizona Oddfellow-Rebekah Housing Inc. v. United Stated Department of Housing and Urban Development*, 125 F.3d 771 (9th Cir. 1997). In that case, the Ninth Circuit stated: "[O]perating expenses that are typically or predictably incurred in the course of operating a project and are within normal limits as to amount are 'reasonable,'" and concluded that "legal expenses incurred in suits arising out of the project's day-to-day business . . . should be considered 'operating expenses.'" *Arizona Oddfellow-Rebekah Housing Inc.*, 125 F.3d at 775-76.

The Respondents argue that the payments at issue in this case were "predictable" because "Sundial never had enough money to meet its financial obligations" and should be considered reasonable operating expenses because, like the legal expenses at issue in *Arizona Oddfellow-Rebekah Housing, Inc.*, they are "obligations which arose out of or were ancillary to [the] Project's operations." (RPB 7.)

The Respondents' reliance upon *Arizona Oddfellow-Rebekah Housing, Inc.* is misplaced. In *Arizona Oddfellow-Rebekah Housing, Inc.*, the Ninth Circuit determined that certain legal costs were reasonable operating expenses because the costs were "unavoidable costs of running a project," benefited the project, and "[did] not serve to advance or protect [the owner's] ownership interest." 125 F.3d at 775. In contrast, the payments at issue in this case were not unavoidable. The Respondents certified that the Bank of America line of credit was "guaranteed by an owner of the project" and that repayment of other loans was "restricted by surplus cash." (RX 12.) Because the project never generated surplus cash, the loans that gave rise to the payments at issue in this case were not even present obligations of the project. Thus, the payments at issue in this case could not have benefited the project, were unnecessary, and do not qualify as operating expenses.[13]

The Respondents also argue that their subjective belief that "any expenditure that indirectly paid one of Sundial's operating expenses or any expenditure that satisfied one of Sundial's creditors was a reasonable expense" should be upheld because "[Ms. Wong] was never provided with a legal definition of a reasonable operating expense." (RRB 5 (citing HT 23:21-25, 61:2-62:4, 103:4-7, 122:24-123:8, 126:6-15, 402:7-16, 428-429, 434:7-11, 444:3-11, 461:16-25.) As set forth below, the Respondents had notice of legal obligations incumbent upon them as beneficiaries of a mortgage insured by the United States pursuant to the National Housing Act, but failed to inquire as to the nature of these obligations. Thus, the Respondents' claim of ignorance does not preclude the Secretary from imposing a civil money penalty for the payments at issue in this case as set forth in 12 U.S.C. § 1735f-15(c)(1)(B)(ii).

Nothing prohibits a project owner from investing his or her own funds, or funds advanced by another party, in a project. Presumably, such funds would be used for the payment of reasonable operating expenses or other project purposes. However, the Regulatory

[13] The Respondents further argue that the payments at issue in this case constitute reasonable operating expenses because "these expenditures were not repayments of ongoing loans by the Owner, but payments made for bills that had come due to Sundial and for which Sundial did not have sufficient funds." (RRB 6.) The fact that proceeds of a loan to a project may be used to pay project operating expenses does not mean that repayment of the loan thereby becomes an operating expense of the project. Repayment of a loan to the project or expenses associated with such a loan may be made only as permitted by statute and the Regulatory Agreement. *United States v. Thompson*, 408 F. 2d 1075, 1080-81 (8th Cir. 1969). *See, In the Matter of Blumenfeld, et al*, HUDALJ 90-1550-DB, p.16 (August 28, 1992). Thus, the Respondents' distinction is immaterial.

Agreement prohibits and the National Housing Act penalizes repayment of such advances in order to preserve the priority of the interest of the United States in the revenues of the project. As explained by another Administrative Law Judge in deciding a debarment case:

> Project income belongs to the United States after a default. *United States v. American Nat. Bank & Trust Co., 573 F. Supp. 1319, 1323 (1983).* It is "[t]he federal policy to protect the treasury and to promote the security of federal investment which in turn promotes the prime purpose of the [National Housing] Act—to facilitate the building of homes by the use of federal credit." *United States v. Stadium Apts., Inc.*, 425 F.2d 358, 363 (9th Cir. 1970), cert. den., 400 U.S. 926 (1970) (quoting *United States v. View Crest Garden Apts., Inc*, 268 F.2d 380, 383, (9th Cir. 1959)). Owner-creditors are uniquely able to use their position to [improperly] remove project funds belonging to the United States.

*In the Matter of Blumenfeld et al*, p. 16, HUDALJ 90-1550-DB (August 28, 1992). Furthermore, even before default, the United States has an interest in ensuring that project funds are not unnecessarily diverted from paying off a mortgage insured by the United States.

The Respondents—and other project owners similarly situated—are not without recourse. Both the Regulatory Agreement and the National Housing Act provide for the repayment of advances in two ways. First, the owner may take a distribution when the project is in a surplus cash position. 12 U.S.C. § 1735f-15(B). (JX 1.) Second, the owner may withdraw funds previously advanced to the project after obtaining written permission from the Secretary. 12 U.S.C. § 1735f-15(B)(ii). (JX 1.) However, any other withdrawal violates the terms of the Regulatory Agreement and triggers a penalty under the National Housing Act, because it denies project revenues to HUD in the event of a default. In fact, in the instant case, the Respondents admitted that Ms. Wong felt no obligation to make mortgage payments after she decided that default had become inevitable, choosing instead to use project revenues to repay funds previously advanced to the project by others. (HT 431:25-432:6; 433:15-434:2.) The repayment of loans to Sundial—and the payment of interest expenses on the line of credit made available to Sundial—were not operating expenses of Sundial. Thus, imposing a penalty under 12 U.S.C. § 1735f-15(c)(1)(B)(ii) is appropriate because the Respondent's decision to repay advances made to the project denied the United States the benefit of funds that should have been available (and used) to meet the Respondents' mortgage obligation.

**Knowledge of prohibitions.** Civil money penalties may be imposed for violating 12 U.S.C. § 1735f-15(c)(1)(B)(ii) only if liable parties "knowingly and materially" take the actions proscribed therein. 12 U.S.C. § 1735f-15(c)(1)(B). "Knowingly" means "having actual knowledge of or acting with deliberate ignorance of or reckless disregard for [these] prohibitions." 12 U.S.C. § 1735f-15(h).

The Government argues that the Respondents "knew or should have known" that the expenditures that are the subject of this proceeding were "improper" because the Regulatory Agreement—which Ms. Wong executed in her capacity as President of Sundial—prohibits those activities that are penalized by 12 U.S.C. § 1735f-15(c)(1)(B). (Compl. ¶ 9(a); JX 1, Regulatory

Agreement, ¶¶ 6(b) and 9(g).) The Respondents claim they are not responsible for knowing the terms of the Regulatory Agreement because Ms. Wong did not read the Regulatory Agreement, and because the Secretary has not shown that the Respondents had constructive knowledge of its terms. (RRB 1-2.) The Respondents argue: "The Government, as the one who has the burden of proving the Respondents knowingly violated the law has the burden of proving 'knowledge' [and] has the burden of proving that Ms. Wong had the opportunity to read and comprehend the Regulatory Agreement before signing [it]." (*Id.*)

Generally, "one who signs a contract is bound by its provisions and cannot complain of unfamiliarity with the language of the instrument." *Circuit City Stores, Inc. v. Ahmed*, 283 F.3d 1198, 1200 (9th Cir. 2002) (quoting *Madden v. Kaiser Found. Hosps.*, 552 P.2d 1178, 1185 (Cal. 1976)). Thus, the Respondents are accountable for knowing and complying with the Regulatory Agreement, whether or not Ms. Wong actually read and comprehended its terms, and the terms of the Regulatory Agreement may be used to show that the Respondents had constructive knowledge of the prohibitions found in 12 U.S.C. § 1735f-15(c)(1)(B)(ii).

Turning to whether the Respondents had constructive knowledge of the statutory prohibitions, they assert that the language of the Regulatory Agreement cannot be used to satisfy the knowledge element of 12 U.S.C. § 1735f-15(c)(1)(B) because it does not sufficiently identify the relationship between the restrictions found in the Regulatory Agreement and the penalties found in the statute. The Respondents state:

> [T]he Regulatory Agreement Respondents signed is a 'business agreement.' Nowhere in the Regulatory Agreement does it state that violations of this 'business agreement' constitute a violation of 12 U.S.C. § 1735f-15(c)(1)(B)(ii). Nowhere does the Regulatory Agreement indicate that HUD may pursue civil money penalties in the name of the United States Government if the Respondents violate this 'business agreement.' . . . Accordingly, the fact that [Ms. Wong] signed the Regulatory Agreement does not mean that [the Respondents] knowingly violated the law."

(RPB 2.)

Contrary to the Respondents' assertion that the Regulatory Agreement does not refer to the National Housing Act, the Regulatory Agreement states that the Respondents agreed to the terms thereof "[i]n order to comply with the provisions of the National Housing Act, as amended, and the Regulations adopted by the Secretary pursuant thereto." (JX 1, Regulatory Agreement, first unnumbered paragraph.) Thus, the Regulatory Agreement shows that the Respondents were informed of the applicability of the National Housing Act, including 12 U.S.C. § 1735f-15(c)(1)(B)(ii). The Respondents are also chargeable with knowledge of general statutes of the United States, and they undertook a duty to be aware of the provisions of this statute.

Next, the Respondents contend that Ms. Wong's execution of the Regulatory Agreement cannot satisfy the knowledge requirement because "the proffer that the Respondents knowingly violated the law because 'Ms. Wong signed the Regulatory Agreement' is not independent proof of knowledge." (RPB 2.) The Respondents argue that:

> Under the Government's reasoning . . . the existence of a Regulatory Agreement alone is all that is necessary to establish knowledge. The United States Code contains a separate "knowledge" element for a reason; that essential element is mooted if all HUD has to do is point to the existence of a Regulatory Agreement [. . .], thus enabling the Government to bypass the 'knowingly' element."

(*Id.*)

The Respondents also suggest that HUD is responsible for Ms. Wong's ignorance, stating: "HUD does not require Owners, such as the Respondents, to take any type of education or course on the requirements and restrictions of Section 232 programs" or even "require Owners to certify that they have reviewed the Handbook." (RPB 2-3 (citing HT 116:17-19, 128:12-129:3, and 131:1-14).) Finally, the Respondents assert that "Ms. Wong never ignored the Regulatory Agreement or intended to violate it [because] she did not understand the Regulatory Agreement well enough to have either consciously ignored it or violated it." (RPB 2.)

The Respondents are correct in stating that the Secretary has not proved that the Respondents had actual knowledge of the prohibitions set forth in 12 U.S.C. § 1735f-15(c)(1)(B)(ii). However, their argument that Ms. Wong did not have constructive knowledge of these prohibitions is unavailing. In this case, the Regulatory Agreement set forth the prohibitions found in 12 U.S.C. § 1735f-15(c)(1)(B)(ii), and also clearly identified the applicability of the National Housing Act to this transaction between the Respondents and HUD. Ms. Wong was represented by counsel when she signed the Regulatory Agreement, and had ample opportunity both before and after the signing to read the document and investigate any provision that she did not understand. HUD was not responsible for Ms. Wong's failure to read the Regulatory Agreement that she signed, and HUD had no duty to provide her additional guidance or training.

Moreover, the Respondents' accountant testified that, when he audits HUD-insured projects, he "makes a point of pointing out" to the project owners "the rules and the severity of the rules," and specifically testified that he told "the rules" to Ms. Wong. (HT 336:7-337:19.) Even if Ms. Wong did not understand the Respondents' contractual obligations and the statutory penalties for breach of those obligations, she had access to professionals who could explain both.

The Regulatory Agreement is "the most significant document" for HUD insurance. (HT 113:4-9.) In addition to being a business agreement, the Regulatory Agreement served as HUD's notice to the Respondents of the applicability of the National Housing Act to the operation of the project. It also specifically prohibited the activities penalized by 12 U.S.C. § 1735f-15(c)(1)(B)(ii). The Act provides that "knowingly" may mean "acting with deliberate ignorance of or reckless disregard for" the prohibitions set forth in 12 U.S.C. § 1735f-15(c)(1(B)(ii). 12 U.S.C. § 1735f-15(c)(1)(B). Because the Regulatory Agreement prohibits the activities penalized by 12 U.S.C. § 1735f-15(c)(1)(B)(ii), the Respondents' failure to read and understand the Regulatory Agreement constitutes deliberate ignorance of the prohibitions set forth in 12 U.S.C. § 1735f-15(c)(1)(B)(ii). On the facts of this case—as a direct result of Ms. Wong's reckless disregard for HUD's notice— the Respondents failed to take notice of (and heed) applicable statutory requirements, and made payments out of project funds contrary to the

proscriptions of 12 U.S.C. § 1735f-15(c)(1)(B)(ii).[14] Accordingly, the Court finds that the Respondents' statutory violations were "knowing." *See* 12 U.S.C. § 1735f-15(h).

**Material violations.** Before a civil money penalty may be imposed, a liable party must not only "knowingly," but also "materially" take an action prohibited by 12 U.S.C. § 1735f-15(c)(1)(B)(ii). 12 U.S.C. § 1735f-15(c)(1)(B). While the word "materially" is not defined in the National Housing Act, the implementing regulations specify that "materially" means "[i]n some significant respect or to some significant degree." 24 C.F.R. § 30.10 (2008).[15]

As set forth in the Order on Secretarial Review, *In Matter of Associate Trust Financial Services*, HUDALJ 96-008-CMP, dated September 15, 1997 ("*Associate Trust* Order"),[16] materiality is determined by considering the "totality of the circumstances," including the factors set forth in 24 C.F.R. § 30.80. *See Crestwood Terrace Partnership*, HUDALJ 00-002-CMP (January 30, 2001). These factors—to be considered in determining the amount of a civil money penalty—consist of the gravity of the offense, the violator's history, if any, of prior offenses, the violator's ability to pay the penalty, any injury to the public, any benefits received by the violator, the extent of potential benefit to other persons, deterrence of future violations, the degree of the violator's culpability, harm to tenants, and such other matters as justice may require. 12 U.S.C. § 1735f-15; 24 C.F.R. § 30.80.

The Respondents argue that "the Government must establish that each expenditure was significant [. . .] [and] must present evidence that HUD balanced [all of the factors listed in 24 C.F.R. § 30.80] in determining that each of the Respondents' expenditures [was] material." (RPB 3.) However, 24 C.F.R. § 30.45(e) provides for the imposition of a penalty for either "[a] consistent pattern of violations . . . or a single violation . . . ." As the Secretary asserts, if the Respondents' payments constitute a consistent pattern of violations, materiality may be determined in aggregate. That being said, the fact that a particular payment was made may be more significant in determining its materiality, than in determining its corresponding penalty.[17]

Furthermore, the Government need not address every one of the factors listed in 24 C.F.R. § 30.80 to establish materiality. Sufficient evidence for one or more of the factors, "if sufficiently compelling," may lead to the conclusion that the Respondents materially took a prohibited action. *See Associate Trust* Order at p. 6. Likewise, "ultimate financial loss is not a predicate for imposing a civil money penalty." Civil Money Penalties 56 Fed. Reg. 23,622 at 23,625 (May 22, 1991). This means that the actual loss realized by HUD does not affect the issue of materiality. As used in 12 U.S.C. § 1735f-15(c)(1)(B), the word "materially" refers to the relationship between a liable party and the prohibited action, not to the connection between the

[14] *Ergo*, constructive knowledge is not necessarily assumed in every case where a Regulatory Agreement has been executed.

[15] The definition of "materially" found in the relevant HUD regulations has since been modified. *See* Civil Money Penalties: Certain Prohibited Conduct, 74 Fed. Reg. 2751 (Jan. 15, 2009), now codified at 24 C.F.R. § 30.10, effective February 17, 2009.

[16] The *Associate Trust* Order is attached as exhibit 4 to the Government's Prehearing Brief.

[17] Thus, one may determine that each of the interest payments for Nick Wong's Bank of America credit line (Counts 8 through 21) were "significant" in the sense that they were material violations of the statute, without concluding that they each required imposition of a significant penalty.

prohibited action and the loss, if any, suffered by HUD. Because some of the factors listed in 24 C.F.R. § 30.80 have no logical relationship to the significance of the relationship between the Respondents and the prohibited action, only those factors that logically relate to materiality will be considered here. *See Yetiv v. U.S. Dept. of Housing and Urban Development*, 503 F.3d 1087, 1090-91 (9th Cir. 2007). The Secretary contends that the 24 C.F.R. § 30.80 factors relevant to materiality in the present case are the gravity of the offenses, injury to the public, and degree of the violator's culpability. (GPB 19-20.) Suffice it to say that the totality of the circumstances establish the materiality of these factors as significant with respect to the Respondents' charged misconduct in this case.[18]

**Affirmative Defenses.** The Respondents also offer the following affirmative defenses in this matter.

***Waiver.*** The Respondents allege that HUD waived its right to pursue a penalty for the Bank of America line of credit interest payments. (Response, ¶ 145; RPB 17.) As noted above, REAC sought clarification regarding interest payments made on the Respondents' Bank of America line of credit after reviewing financial statements submitted by the Respondents for the year ending December 31, 2003. (HT 315:5-13.) The Respondents allege that they heard nothing from HUD after responding to the inquiry, and assert that from HUD's silence following the inquiry, the Respondents may properly infer an intent by HUD to waive its right to impose a penalty. (RPB 6 and 17 (citing HT 316:10-17).) In order to show that HUD waived its right to enforce 12 U.S.C. § 1735f-15(c)(1)(B)(ii) with respect to the payments on the Bank of America line of credit, the Respondents must not only show that HUD knew that the Respondents had taken an action that could be penalized by the statute, but also prove that HUD intended to abandon its right to impose the penalty, and that it did so "in unmistakable terms." *See, United States v. Philip Morris, Inc.*, 300 F. Supp. 2d 61, 69-70 (D.D.C. 2004). In this case, HUD's silence is not sufficient evidence of intent to waive its right to seek a penalty because the record does not show whether the inquiry was resolved or remained an open matter. Certainly, there is no record of communication between HUD and the Respondents that provided assurances as to imposition of penalties for previous (or future) payments on the line of credit. Therefore, Respondents' waiver defense fails.

***Negligence and Estoppel.*** The Respondents also allege that, after negligently creating an environment in which the Sundial Project was bound to fail by insuring the loan for a nearby assisted living facility, HUD recklessly encouraged the Respondents to put their own money into the project without revealing that HUD could impose civil money penalties for the withdrawal of such funds. (Response, ¶ 148; RPB 11-14.) Respondents further argue that HUD should be estopped from imposing a penalty on the Respondents because HUD "led Ms. Wong to believe that she had to invest her own money into Sundial" and "did nothing to dispel [Ms. Wong's] apparent misapprehension regarding her rights and liabilities vis-à-vis her investments in the [p]roject." (RPB 14.)

In order to establish the affirmative defense of negligence, and in order to reach the remedy of estoppel, the Respondents must show that HUD's actions reasonably caused the Respondents to make the payments at issue in this case. Ms. Wong convincingly testified that

[18] See further discussion of these factors in penalty assessment, *infra.*

she thought she would be able to withdraw the funds advanced to maintain Sundial operations while seeking an operating loss loan, and that she felt "cheated" when the loan was not approved. However, the Respondents do not allege that HUD made any statements that reasonably could be construed as abridging the terms of the Regulatory Agreement, signed by Ms. Wong, in which she agreed to "comply with the provisions of the National Housing Act." (*See* HT 402:7-16, 426:8-427:19, and 434:3-11; *and* JX 1.) Thus, the Respondents' negligence defense is without merit and, therefore the Respondents cannot obtain the remedy of estoppel.

***Laches and Unclean Hands.*** The Respondents also argue that this action should be barred by the equitable doctrines of *laches* and "unclean hands." (Response, ¶¶ 142-43; RPB 14-16.) In order for these doctrines to apply against the government, however, the Respondents must show that HUD is seeking to enforce commercial, as opposed to public, rights. *Cf. United States v. Administrative Enterprises, Inc.*, 46 F.3d 670, 673 (7th Cir. 1995) (noting that laches may be used as a defense against the government where "the government is seeking to enforce either on its own behalf or that of private parties what are in the nature of private rights") (citing *Clearfield Trust Co. v. United States*, 318 U.S. 363, 369 (1943) *and Kelley v. Thomas Solvent Co.*, 714 F. Supp. 1439, 1451 (W.D. Mich. 1989) ("Where the defenses of unclean hands or laches have been used against the government when it is asserting public rights, courts have repeatedly held that equitable principles will not be applied to thwart public policy or the purpose of federal laws") (citations omitted).).

The Respondents assert that HUD must be enforcing its commercial rights because the Regulatory Agreement is a "business agreement" and "at times HUD makes money at the note sale of defaulted section 232 Projects." (RPB 14-15.) [19] This assertion suggests that the Respondents have misunderstood the nature of this proceeding. HUD is not seeking civil money penalties to enforce the Regulatory Agreement or any other "business agreement." This is not a breach of contract action in which the Government is acting in the manner of a private party. This is a regulatory action brought by the United States Government acting in its sovereign capacity for the purpose of imposing money penalties for violations of a civil law; a specific provision of the National Housing Act. The Secretary's jurisdiction to impose civil money penalties derives from that statute—not from the Regulatory Agreement. *See Yetiv v. U.S. Dept. of Housing and Urban Development*, 503 F.3d at 1090 (9th Cir. 2007). The Regulatory Agreement is a tool used by HUD in promoting housing as a public good while minimizing taxpayer losses. *In Matter of Blumenfeld et al*, HUDALJ 90-1550-DB (August 28, 1992). *See also* 12 U.S.C. §1715w(a) and (d) (Setting forth the public purposes for which mortgage insurance for assisted living facilities is authorized). Civil money penalties are a sanction HUD is authorized to use to protect the public. *See Yetiv, supra*, at 1090, *and Entercare, Inc.*,

[19] The Respondents' brief asserts that HUD seeks to enforce a business agreement by resorting to a civil action for civil money penalties. (RPB 15.) When discussing HUD's responsibilities for overseeing and counseling Respondents with respect to the Regulatory Agreement and the provisions contained there, the Respondents state that HUD sought to immunize itself in the label of "business." (*Id.*) The Respondents further claim that, when they raised the affirmative defenses of laches and unclean hands, HUD sought the shelter of its federal government status. (*Id.*) The Respondents state: "HUD cannot have it both ways. In the business world, business people treat a breach of a business agreement as a breach of contract and damages flow accordingly. In the business world, insurers take responsibility for the fact that their own investments fail." (*Id.*) The Respondents conclude that "HUD may not claim breach of a business agreement with one hand and then pursue civil money penalties with the other." (*Id.*)

HUDALJ 01-061-CMP (December 31, 2002).[20] Laches and unclean hands are not valid defenses in this proceeding because HUD is not seeking to enforce a contract, but is seeking to vindicate its statutory rights, to protect the public's interest in the proper use of public housing funds, and, thus, to promote housing as a public good.

***Breach of Contract***. Finally, the Respondents allege that that the mortgage insurance premium paid by the Respondents established a contract between HUD and the Respondent's lender to provide certain benefits to the Respondents, including "oversight services." (Response, ¶ 147; RPB 17.) The Respondents further allege that HUD failed to provide these services, and that the Respondents have standing to enforce the contract as a third-party beneficiary. (RPB 17-18.) The Respondents explain: "The only oversight HUD offered [Respondents] was the bare minimum required of it by the HUD Handbook." (*Id.* at 18.)

The mortgage insurance premium is a "charge for the insurance of the mortgage" that is payable annually by the mortgagee to HUD. 12 U.S.C. § 1713(d); *See also*, 12 U.S.C. § 1715(f); 24 C.F.R. § 207.252 (*See also* HT 133:21-136:8.) It is not a contract for oversight services. Moreover, the Respondents' admission that HUD provided the minimum oversight required by the HUD Handbook renders the claim that HUD failed to provide such services meaningless. Therefore, the Respondents' breach of contract defense fails for want of proof.

**Penalty Factors.** The Respondents are jointly and severally liable for penalties imposed. As noted above, 24 C.F.R. § 30.80 specifies that aggravating and mitigating factors be considered in determining the appropriate civil money penalty, including the gravity of the offense, any history of prior offenses, the ability to pay the penalty, the injury to the public, any benefits received by the violator, the extent of potential benefit to other persons, deterrence of future violations, the degree of the violator's culpability, any injury to tenants, and such other matters as justice may require.

***Gravity of the offense.*** The Respondents' violation of the trust imposed in them as beneficiaries of HUD-insured funds is a grave matter. The Respondents' assertion that they were ignorant of the strictures of the insurance program does not decrease the gravity of the offense. The Respondents' argument that HUD's failure to act ratified some of the payments at issue is unavailing.

The Secretary alleges that the payments at issue in this case constitute grave violations of 12 U.S.C. § 1735f-15(c)(1)(B)(ii) because of the risk the unauthorized use of project funds poses to the insurance fund, because the expenditures did not benefit the residents, and because "the

[20] *See also*, *United States v. Summerlin*, 310 U.S. 414, 416-17 (1940) (holding that the United States "is not . . . subject to the defense of laches in enforcing its rights"); *Pan-American Petroleum & Transport Co. v. United States*, 273 U.S. 456, 506 (1927) (declining to apply equitable doctrines to "frustrate the purpose of [United States'] laws or to thwart public policy"); *Lee v. Spellings*, 447 F.3d 1087, 1090 (8th Cir. 2006) ("a laches defense may not be asserted against the government"); *E.E.O.C. v. Recruit U.S.A., Inc*., 939 F.2d 746, 753 (9th Cir. 1991) ("the [un]clean hands doctrine should not be strictly enforced when to do so would frustrate a substantial public interest"); *United States v. Weintraub*, 613 F.2d 612, 619 (6th Cir. 1979) (affirming that "the government is exempt from the consequences of its laches"); *United States. v. American Electric Power Service Corp*., 218 F. Supp. 2d 931, 938 (S.D. Ohio 2002) ("the defense of unclean hands may not be used against the United States to prevent it from enforcing its laws to protect the public interest"); *Securities and Exchange Commission v. Gulf & Western Industries, Inc*., 502 F.Supp. 343, 348 (D.D.C. 1980) ("the doctrine of unclean hands . . . may not be invoked against a governmental agency which is attempting to enforce a congressional mandate in the public interest.").

repetitiveness of the 22 diversions reflected a serious disregard for the [Regulatory] [A]greement." (GPB 20.) The Respondents assert that the repetitiveness of the violations is "irrelevant" to the gravity of each violation, and further allege that the gravity of the violations is mitigated by HUD's own inaction. (RRB 9.) The Respondents allege that HUD "knew the Project was in an operating deficit and that Ms. Wong was investing her own money in the project" and "had notice of possible unauthorized expenditures, such as the Bank of America [c]redit [line]," but "never advised Respondents that repayments were limited to surplus funds" prior to bringing this case. (RPB 9 and 20.)

The Respondents further claim that "HUD's own negligence and misconduct" should mitigate the gravity of the alleged violations. (RRB 9.) But, the cases cited by the Respondents to support this argument are distinguishable on their facts.[21] (*See* RPB 20 *and* RRB 3 and 9.) Furthermore, when HUD refused to insure the $1.1 million operating loss loan sought by the Respondents, they ceased making payments on the mortgage, and used project revenues to repay funds advanced by relatives. The Respondents' payments constitute grave violations of the restrictions set forth at 12 U.S.C. § 1735f-15(c)(1)(B)(ii) because they are indicative of the carelessness with which the Respondents treated the trust they received as beneficiaries of a HUD-insured mortgage. The mortgage was in default when most of the improper payments were made out of project funds. (HT 430:8-15 and 431:4-10.) HUD suffered a loss of $3.6 million when the note on the property was sold in 2005. (GX 16.)

***History of Prior Offenses.*** The Respondents' lack of prior offenses suggests that the maximum penalty should not be imposed in this case.[22] Nonetheless, an appropriate penalty should be imposed so that the Respondents—and others similarly situated—are put on notice that they must read and abide by their Regulatory Agreement, the governing statutes, and the implementing regulations.

***Ability to Pay.*** The Respondents protest that they do not have the means to pay the penalty sought by the Secretary. (RPB 21-22; RRB 9-10.) However, evidence was presented showing that the Respondents have an interest in land, the value of which may still exceed the penalty sought by the Secretary. (HT 456:5-457:17, 479:20-481:14, 483:1-19.) Although this asset's market value may currently be less than its assessed value, it must be taken into consideration in determining the Respondents' ability to pay.

***Injury to the Public.*** The Secretary alleges there was monetary injury to the public stemming from the payments at issue; damage to the integrity of HUD's insurance

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[21] The penalty sought by HUD in *Matter of Blumenfeld et al*, HUDALJ 90-1550-DB (August 28, 1992) was mitigated because the ALJ found that Respondents clearly stated their intent to repay owner advances, that HUD waited for three years to inform the respondents that such payments violated the HUD regulatory agreement, and that the respondents' reliance on HUD silence "was not unreasonable" in light of a specific ambiguity in the HUD Handbook. In *Crestwood Terrace Partnership*, HUDALJ 00-002-CMP (January 30, 2001), the gravity of the offense—failure to timely file audited financial statements—was mitigated by HUD's more than 20-year history of accepting unaudited statements. Neither *Blumenfeld* nor *Crestwood Terrace Partnership* stand for the general proposition that silence following a HUD inquiry, without more, mitigates the gravity of an offense.

[22] Upon full consideration of the regulatory penalty factors, however, there is no impediment to imposing the maximum penalty for some or all violations, even in the absence of prior offenses.

program; and increased monitoring and enforcement costs. (*See* GPB 21.)[23] The Respondents argue that "[t]he alleged 'loss' to the public was no greater than the loss the public would have sustained had the Respondents defaulted on the loan" before making the payments at issue here. (RPB 20.) However, the Respondents' breach of their duty to pay the HUD-insured loan before paying other creditors materially contributed to a public injury.

***Benefits Received by the Violator and others.*** The Respondents and the recipients of the payments at issue in this case benefited from the return of funds they would have otherwise lost. However, the evidence does not suggest that the Respondents sought unjust enrichment at the expense of the project. Although the benefits received by the Respondents and others warrant the imposition of a civil money penalty, the maximum penalty is not warranted for all counts.

***Deterrence of Future Violations.*** Deterrence is a permissible and socially useful goal. Any penalty will theoretically provide deterrence. *See In Matter of Associate Trust Financial Services*, HUDALJ 96-008-CMP (November 20, 1997) (Initial Decision on Second Remand). Deterrence is most effective, however, when those to be deterred are aware of all the relevant facts in a case, so they can assess the relative severity of the imposed penalty. Despite the Respondents claim that "[Ms. Wong] is not a future violator" because she "has learned HUD's view of 'reasonable operating expenses,'" the penalty imposed should reinforce—for the Respondents and others—the significance of the duty to learn and comply with the strictures of any undertaken HUD project.

***Degree of Violators' Culpability.*** Ms. Wong (and Sundial, her failed corporation) were solely responsible for the violations at issue here. To the extent that Ms. Wong lacked full appreciation of her violations, it was due to her own failure to inform herself of the commitments to which she agreed.

The Respondents argue that "the Government's own negligence and failure to oversee Sundial militates in the Respondents' favor," and claim that HUD must bear some responsibility for choosing to fund a business that could not succeed. (RRB 10.) (*See also* RPB 20-21.) The Respondents conclude: "If HUD seeks to prevent fraud abuse and waste of taxpayer dollars . . . then it should look no further than itself. . . . To blame Respondents for the entire loss to the public is to ignore the fact that HUD entered into a business transaction with Ms. Wong [and] to ignore HUD's role in this transaction." (RPB 20-21.) However, the Respondents' attempt to blame their violation of 12 U.S.C. § 1735f-15(c)(1)(B)(ii) on the Secretary fails to account for the Respondents' own recklessness in the unauthorized repayment of loans out of project revenues.

The Respondents' argument that HUD should share culpability for the statutory violations casts doubt on the Respondents' willingness to fully accept that responsibility, and ignores the fact that the Regulatory Agreement itself was an effort by HUD to ensure that the Respondents were aware of the regulatory and statutory restrictions on the project.

[23] The Secretary states: "HUD does not claim that the expenditures at issue were the sole or even primary cause for Sundial's default on the mortgage and the resulting loss to HUD. However, this injury may have been attributable in part to these illegal expenditures . . . ."

***Injury to the tenants or others.*** There was no injury to third parties as a result of these violations. This is not an aggravating factor in determining the penalty.

***Other matters.*** The Respondents assert that this Court should consider the loss suffered by Ms. Wong in this case. Counsel for HUD correctly points out that Ms. Wong's personal losses are the result of her own business decisions and cannot serve as a penalty for the violations. Nonetheless, Ms. Wong's losses are part of the circumstances that may be considered by the Court in assessing civil money penalties that will have a deterrent impact upon others who are aware of all the facts.

## PROPOSED CIVIL MONEY PENALTIES

The Acting Director of the HUD Departmental Enforcement Center, considering the factors relevant to the appropriateness and amount of civil money penalties (24 C.F.R. § 30.80), evaluated the prehearing matters presented in the Complaint and in the Response to the Pre-Penalty Notice. These include the gravity of the offenses, injury to the public, and degree of the violator's culpability. (GPB 19.) Deterrence of future violations is also relevant to consider in determining penalty amount in any case. The Complaint proposed imposing a penalty totaling $245,000, comprised of the following individual penalties for each of the counts:

Count 1: $30,000 for the payout of $10,000 to VNCC on July 27, 2003.
Count 2: $32,500 for the payout of $50,000 to VNCC on April 12, 2004.
Count 3: $32,500 for the payout of $25,000 to VNCC on May 18, 2004.
Count 4: $32,500 for the payout of $18,000 to VNCC on June 14, 2004.
Count 5: $15,000 for the payout of $5,000 to VNCC on July 7, 2004.
Count 6: $32,500 for the payout of $18,000 to VNCC on September 13, 2004.
Count 7: $32,500 for the payout of $12,000 to SFCC on October 15, 2004.
Count 8: $1,500 for the payout of $373.73 to cover interest on Nick and Alice Wong's Bank of America line of credit on October 9, 2003.
Count 9: $1,500 for the payout of $387.04 to cover interest on Nick and Alice Wong's Bank of America line of credit on November 10, 2003.
Count 10: $1,500 for the payout of $373.74 to cover interest on Nick and Alice Wong's Bank of America line of credit on December 9, 2003.
Count 11: $1,500 for the payout of $383.35 to cover interest on Nick and Alice Wong's Bank of America line of credit on January 9, 2004.
Count 12: $1,500 for the payout of $387.38 to cover interest on Nick and Alice Wong's Bank of America line of credit on February 9, 2004
Count 13: $1,500 for the payout of $358.71 to cover interest on Nick and Alice Wong's Bank of America line of credit on March 9, 2004.
Count 14: $1,500 for the payout of $382.62 to cover interest on Nick and Alice Wong's Bank of America line of credit on April 9, 2004.
Count 15: $3,000 for the payout of $369.45 to cover interest on Nick and Alice Wong's Bank of America line of credit on May 10, 2004.
Count 16: $3,000 for the payout of $382.60 to cover interest on Nick and Alice Wong's Bank of America line of credit on June 9, 2004.

Count 17: $3,000 for the payout of $371.08 to cover interest on Nick and Alice Wong's Bank of America line of credit on July 9, 2004.
Count 18: $3,000 for the payout of $392.73 to cover interest on Nick and Alice Wong's Bank of America line of credit on August 9, 2004.
Count 19: $3,000 for the payout of $404.52 to cover interest on Nick and Alice Wong's Bank of America line of credit on September 9, 2004.
Count 20: $3,000 for the payout of $408.60 to cover interest on Nick and Alice Wong's Bank of America line of credit on October 12, 2004.
Count 21: $3,000 for the payout of $434.37 to cover interest on Nick and Alice Wong's Bank of America line of credit on November 9, 2004.
Count 22: $6,000 for the payout of $932.78 to cover interest on Nick and Alice Wong's Bank of America line of credit on February 21, 2005.
The total amount sought by the Secretary for these counts is $245,000.[24]

The Respondents' assert that the Secretary failed to account for mitigating factors in assessing penalties in this case. However, at the times here relevant, 24 C.F.R. § 30.45(g) (2004) provided for a maximum penalty of $32,500 to be imposed for each violation of 12 U.S.C. § 1735f-15. HUD sought less than the authorized penalty for all but 5 of the 22 counts pursued at the hearing. For most counts, the penalty sought was considerably less than the maximum, and indicated careful consideration of the then-available facts applicable to each relevant penalty factor.

## CONCLUSIONS and ORDER

Consistent with the foregoing findings and discussion, the Court concludes as follows:

In Count 1, the $10,000 deposited in Sundial's account on July 18, 2003 constituted a mistaken transfer, not a short-term loan. The funds never belonged to Sundial and were never intentionally loaned to or entrusted to Sundial. Although the funds were deposited in a program account, they were not program funds. Their return to their proper owner on July 27, 2003 may not serve as the basis for the imposition of a civil money penalty under 12 U.S.C. § 1735f-15(c)(1)(B)(ii). Consequently, Count 1 of the Complaint is **DISMISSED**.

Likewise, Counts 23, 24 and 25, not prosecuted at the hearing, are **DISMISSED**.

As to the remaining Counts, 2 through 22, the evidence establishes that the Respondents knowingly committed material violations of the National Housing Act [12 U.S.C. § 1735f-15(c)(1)(B)(ii)] by paying out project revenues without statutory authorization and without prior written approval of the Secretary. Accordingly, Counts 2 through 22 are **SUSTAINED**.

As to the penalties sought for the foregoing sustained violations, the Court has considered all of the circumstances presented in the record, including the facts of each of the 21 proven violations and the fact that 13 of the violating expenditures occurred while the project mortgage

[24] Respondents assert that the penalty sought in this case must be reduced because, Respondents allege, the Secretary has not shown "that as to each individual count, the penalty is appropriate." (RRB 9.) However, because the payments at issue in this case are similar, individual recitation of the applicability of each factor of 24 C.F.R. § 30.80 would be unnecessarily repetitive.

was in default. As to Counts 2 and 3, the Government proposes, and the Court imposes, the maximum civil money penalties of $32,500 each.

As for the remaining counts, considering all of the circumstances presented in the record, including the facts of each of the 21 proven violations (and the fact that 13 of the violating expenditures occurred while the project mortgage was in default), the Court has determined that lesser penalties are appropriate, as follows:

In Count 4, the Court approves penalties in the amount of $25,000;
In Count 5, the Court approves a penalty in the amount of $10,000;
In Count 6, the Court approves penalties in the amount of $25,000;
In Count 7, the Court approves a penalty in the amount of $15,000;
In Counts 8 through 21, the Court approves penalties in the amount of $500 each;
In Count 22, the Court approves a penalty in the amount of $1,000.

In sum, the Court approves civil money penalties for the sustained violations in Counts 2 through 22 in the total amount of $148,000. Accordingly, the Respondents shall, jointly and severally, pay to the Secretary of HUD a civil money penalty of $148,000, which is immediately due and payable without further proceedings.

So **ORDERED**.

[signed]

J. Jeremiah Mahoney
Chief Administrative Law Judge (Acting)

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**Notice of Appeal Rights**. The appeal procedure is set forth in detail in 24 C.F.R. § 26.52. (2009). 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 90 days of its service, this decision becomes final.

**Service of Appeal.** Any appeal 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
1250 Maryland Ave, S.W., Portals Bldg., Suite 200
Washington, DC 20024
Facsimile: (202) 401-5153
Scanned electronic document: secretarialreview@hud.gov