U.S. DEPARTMENT OF
HOUSING AND URBAN DEVELOPMENT
OFFICE OF INSPECTOR GENERAL

MEMORANDUM NO: 2012-LA-1801

September 26, 2012

TO: Charles S. Coulter, Deputy Assistant Secretary for Singly Family Housing, HU

Dane M. Narode, Associate General Counsel for Program Enforcement, CACC

FROM: Tanya E. Schulze, Regional Inspector General for Audit, Los Angeles Region 9, 9DGA

SUBJECT: Shea Mortgage, Inc., Aliso Viejo, CA, Allowed the Recording of Prohibited Restrictive Covenants

INTRODUCTION

The U.S. Department of Housing and Urban Development (HUD), Office of Inspector General (OIG), conducted a limited review of loans underwritten by Shea Mortgage, Inc.[1] We selected the lender based on the results of an auditability survey, which determined that Shea Mortgage allowed prohibited restrictive covenants to be filed against Federal Housing Administration (FHA)-insured properties. The objective of our review was to determine the extent to which Shea Mortgage failed to prevent the recording of prohibited restrictive covenants or potential liens in connection with FHA-insured loans closed between January 1, 2008, and December 31, 2011.

HUD Handbook 2000.06, REV-4, provides specific timeframes for management decisions on recommended corrective actions. For each recommendation without a management decision, please respond and provide status reports in accordance with the HUD Handbook. Please furnish us copies of any correspondence or directives issued because of the review.

The Inspector General Act, Title 5 United States Code, section 8L, requires that OIG post its publicly available reports on the OIG Web site. Accordingly, this report will be posted at http://www.hudoig.gov.

[1] FHA identification number 78404

SCOPE AND METHODOLOGY

We reviewed 115[2] loans underwritten by Shea Mortgage with closing dates between January 1, 2008, and December 31, 2011. We conducted the audit work from the HUD OIG Phoenix, AZ, Office of Audit between April and August 2012. To accomplish our objective, we:

- Reviewed prior HUD OIG audit reports with findings that included lenders allowing prohibited restrictive covenants;[3]
- Reviewed relevant FHA requirements set forth in 24 CFR (Code of Federal Regulations) Part 203;
- Reviewed a HUD OIG legal opinion pertaining to restrictive covenants;
- Reviewed a HUD management decision discussing prohibited restrictive covenants;
- Reviewed prior reviews conducted by HUD Quality Assurance Division (QAD);
- Discussed the prohibited restrictive covenants with Shea Mortgage officials, and
- Obtained and reviewed FHA loan data downloaded from HUD's Single Family Data Warehouse[4] and Neighborhood Watch systems.[5]

We analyzed the Single Family Data Warehouse data as of May 31, 2012, and separated the data into two categories: (1) loans that went into claim status and (2) loans that were still active. We selected a 100 percent review of the claim loans, 48 loans total, and elected to conduct a highly stratified attribute statistical sample of the 1,498 active loans. The stratified sample of the 67 loan samples was randomly selected and weighted by means of a computer program in SAS® using a seed value of 7. To meet the audit objective, we also:

- Requested and received copies of the lender's FHA lender files for the loans selected for review;
- Conducted Internet research, identified and queried applicable county recorder offices, and searched Accurint[6] to obtain and review recorded documents related to the sampled FHA-insured mortgages; and

[2] 48 claim loans and 67 statistically selected active loans
[3] Audit report numbers 2009-LA-1018, 2010-LA-1009, and 2011-LA-1017
[4] HUD's Single Family Data Warehouse is a collection of database tables structured to provide HUD users easy and efficient access to single-family housing case-level data on properties and associated loans, insurance, claims, defaults, and demographics.
[5] Neighborhood Watch is a Web-based software application that displays loan performance data for lenders and appraisers by loan types and geographic areas, using FHA-insured single-family loan information.
[6] Accurint LE Plus accesses databases built from public records, commercial data sets, and data provided by various government agencies.

- Compiled and summarized the loan data with corresponding prohibited restrictive covenants.

For the audit sample, the percentage and number of loans with unallowable restrictive covenants were computed based on the weighted sampling results and extended to the population using the "surveyfreq" procedure provided by SAS®. We used a six-strata sample design to control for potential bias that might arise from varying rates of price escalation and varying resale demand based on population density. Of the selected samples, 31 had disallowed covenants, which projects to 47.8 percent, or 715.45 loans. To account for the statistical margin of error, we subtracted the standard error (86.12) times a t-score of 1.67. As a result, we can be 95 percent confident that at least 571.6 of the 1,498 loans had similar problems with unallowable restrictive covenants.

We relied in part on and used HUD computer-processed data to select the claim and active loans reviewed for prohibited restrictive covenants. Although we did not perform a detailed assessment of the reliability of data, we performed a minimal level of testing and determined that the data were sufficiently reliable for our purposes.

We conducted our work in accordance with generally accepted government auditing standards, except that we did not consider the internal controls or information systems controls of Shea Mortgage. We did not follow standards in these areas because our objective was to identify the extent to which Shea Mortgage allowed prohibited restrictive covenants and how that affected the FHA single-family insurance program risk. To meet our objective, it was not necessary to fully comply with the standards, nor did our approach negatively affect our review results.

BACKGROUND

Shea Mortgage is a nonsupervised direct endorsement lender[7] headquartered in Aliso Viejo, CA. It was approved to participate in HUD's FHA mortgage insurance program in April 2002. Its affiliate builder, Shea Homes, was the seller of the properties discussed in this review memorandum.

FHA, created by Congress in 1934, is the largest mortgage insurer in the world aimed at helping low- and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. FHA mortgage insurance also encourages lenders to approve mortgages for otherwise creditworthy borrowers that might not be able to meet conventional underwriting requirements by protecting the lender against default. Lenders are responsible for complying with all applicable HUD regulations and are protected against default by FHA's Mutual Mortgage Insurance Fund, which is sustained by borrower premiums. The insurance fund pays claims to lenders in the event of homeowner default.

[7] A nonsupervised lender is a HUD-FHA-approved lending institution that has as its principal activity the lending or investment of funds in real estate mortgages and is not a supervised lender, a loan correspondent, a governmental institution, a government-sponsored enterprise, or a public or State housing agency and has not applied for approval for the limited purpose of being an investment lender.

We reviewed a legal opinion[8] from the OIG's Office of Legal Counsel (OLC) regarding the seller's restriction on conveyance of FHA properties. Counsel opined that the recorded agreements, between the seller and borrowers, would constitute a violation of HUD statutes, regulations or handbook requirements. In its opinion, OIG OLC specifically stated that 24 CFR 203.41(b)(iv), pertaining to a consent by a third party, violates HUD's regulations. In this case, the seller is considered a third party.

We also obtained a HUD management decision on the recommendations of a prior OIG audit,[9] not related to Shea Mortgage. In the decision, HUD agreed that the execution of the prohibited restrictive covenants is a violation of Federal regulations and FHA requirements and considered the violation a serious deficiency, stating that the loans with the prohibited restrictive covenants are ineligible for FHA insurance.

Additionally, we reviewed HUD's QAD finding letters to Shea Mortgage concerning two FHA loans, which violated 24 CFR 203.41(b) with regards to restrictions on conveyance.[10] In the HUD letters to Shea Mortgage, HUD stated that the restrictions on conveyance were found to be unallowable material Federal statute violations. HUD determined that Shea Mortgage failed to ensure that the subject property met eligibility requirements for FHA mortgage insurance. HUD also noted that FHA will not accept legal restrictions on conveyance.

RESULTS

Shea Mortgage did not follow HUD requirements when it underwrote loans that had executed and recorded agreements between Shea Homes and the FHA borrower, containing prohibited restrictive covenants in connection with FHA-insured properties. This noncompliance occurred because Shea Mortgage did not exercise due diligence and was unaware that the restrictive covenants recorded between Shea Homes and the borrowers violated HUD-FHA requirements. As a result, we found 600 FHA-insured loans (29 claim loans and 571 active loans) with a corresponding prohibited restrictive covenant recorded with the applicable county recording office, and Shea Mortgage placed the FHA insurance fund at unnecessary risk for potential losses.

Claim Loan Review Results

We identified and reviewed all 48 claim loans underwritten by Shea Mortgage,[11] limited to loans closed between January 1, 2008, and December 31, 2011. In our review of the applicable county recorders' documents, we identified unallowable restrictive covenants corresponding to 29 of the 48 claim loans with properties in Arizona and California. Of the 29 loans, 11 resulted in actual losses to HUD totaling $1.47 million (see appendix C, table 1), and 18 resulted in claims paid totaling $2.43 million, but the properties had not been sold by HUD (see table 2, appendix C).

Active Loan Sample Results

[8] The legal opinion was previously obtained during the review of separate lender (2011-LA-1017) for an equivalent restriction contained in the FHA purchase agreement.
[9] Audit report 2011-LA-1017
[10] HUD post endorsement technical review results on FHA loans 048-6246440 and 048-5912514.
[11] Based on HUD's Single Family Data Warehouse as of May 31, 2012

Additionally, we completed a random attribute statistical sample and selected 67 of 1,498 active loans within our audit period. In our review of the applicable county recorders' documents of the sampled active FHA loans, we identified an unallowable restrictive covenant corresponding to 31 of the 67 sampled active loans with properties in Arizona and California. Of the 31 loans, 27[12] were still active with an unpaid principal balance of $7.7 million (see table 3, appendix C), and 1[13] loan was a preforeclosure sale with a $135,699 claim paid by HUD (see table 2, appendix C).

Based on a highly stratified sample, designed to minimize error and to accommodate varying rates of price escalation and varying demand based on population density, 47.8 percent of the 67 weighted loan samples contained restrictive covenants, which are not allowed by HUD rules. Further, we can be 95 percent confident that at least 571 of the 1,498 active loans in our audit period had similar problems with unallowable restrictive covenants (see Scope and Methodology).

Restriction on Conveyance

For each FHA loan, the lender certifies on the uniform residential loan applications that the mortgage was eligible for HUD mortgage insurance under the direct endorsement program. The FHA insurance requirements, set forth in 24 CFR 203.41(b), state that to be eligible for insurance, the property must not be subject to legal restrictions on conveyance. Further, 24 CFR 203.41(a)(3) defines legal restrictions on conveyance as "any provision in any legal instrument, law or regulation applicable to the mortgagor or the mortgaged property, including but not limited to a lease, deed, sales contract, declaration of covenants, declaration of condominium, option, right of first refusal, will, or trust agreement, that attempts to cause a conveyance (including a lease) made by the mortgagor to:

(i) Be void or voidable by a third party;
(ii) Be the basis of contractual liability of the mortgagor for breach of an agreement not to convey, including rights of first refusal, pre-emptive rights or options related to mortgagor efforts to convey;
(iii) Terminate or subject to termination all or a part of the interest held by the mortgagor in the mortgaged property if a conveyance is attempted;
(iv) Be subject to the consent of a third party;
(v) Be subject to limits on the amount of sales proceeds retainable by the seller; or
(vi) Be grounds for acceleration of the insured mortgage or increase in the interest rate."

Additionally, HUD Handbooks 4000.2 paragraph 5-1(B) and 4155.2 paragraph 6.A.1.h both state that it is the lender's responsibility at loan closing to ensure that any conditions of title to the property are acceptable to FHA. In essence, it is the duty of the lender to ensure FHA loans approved for mortgage insurance are eligible and acceptable per FHA rules and regulations. The

[12] FHA loan numbers 043-7500663 (refinance), 048-4852796 (paid in full), and 048-5798344 (netting refinance) were active at the time of our review but the FHA insurance status was later terminated due to the stated actions. Therefore, indemnification is not warranted, and these loans were not included in appendix C.
[13] 023-3417172

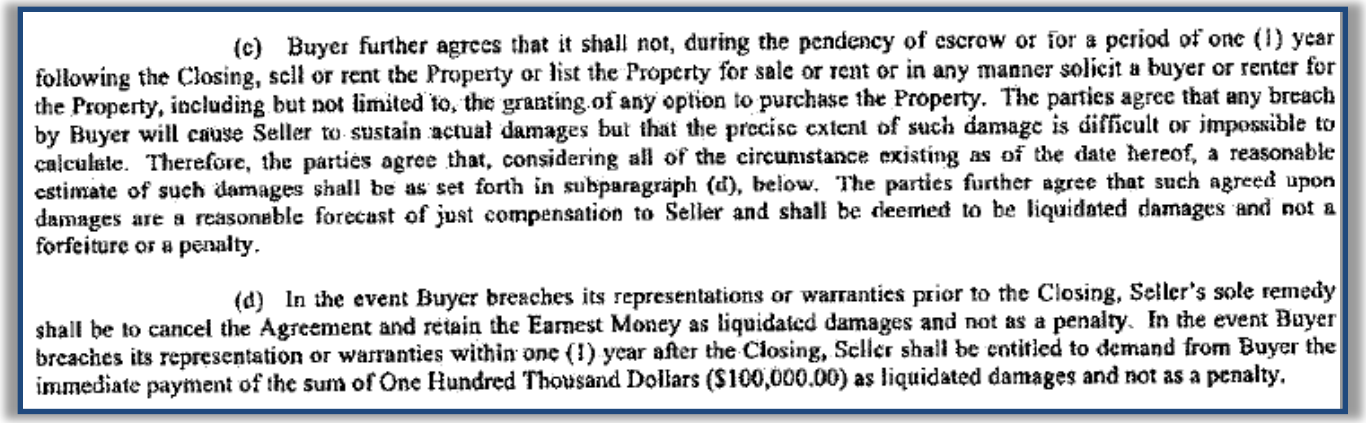
restrictive covenants identified placed a prohibited restriction on the conveyance, by a third party, of the FHA properties, conflicting with the lender's certification that the loans met HUD-FHA insurance requirements set forth in 24 CFR 203.41 (a)(3). Although HUD's Handbook 4155.1 paragraph 4.B.2.b states, "FHA security instruments require a borrower to establish bona fide occupancy in a home as the borrower's principal residence within 60 days of signing the security instrument, with continued occupancy for at least one year," these security instruments would be between the lender and borrower, not a third party like the seller. Extra emphasis must be placed on the fact that the conveyance of the property, during the occupancy period, was at the consent of the seller, which violated HUD-FHA requirements at 24 CFR 203.41(a)(3)(iv). During the exit conference, Shea Mortgage officials confirmed that the seller's consent was required for conveyance during this period. The following are excerpts from two versions of the recorded restrictive covenants found between the seller, a third party to the FHA loans, and borrowers.

> 2. In order to induce Seller to enter into the Agreement, Buyer represented to Seller that Buyer intended to personally occupy the Property as a residence and that Buyer was not purchasing the Property for investment purposes. Buyer further agreed that Buyer would occupy the Property upon close of escrow and would not for a term of twelve (12) months from the date of close of escrow of the Property sell, lease, rent, list, or grant an Option to Purchase, lease or rent the Property (the "Restriction").

> 2. In order to induce Seller to enter into the Agreement, Buyer represented to Seller that it intended to personally occupy the Property as a primary residence and that it was not purchasing the Property for investment purposes. Buyer further agreed that it would not sell, rent, list the Property for rent, or grant an Option to Purchase or rent the Property for a term of one (1) year from the date of close of escrow of the Property (the "Restriction").

We also identified examples of language found in the purchase agreements, contained within the lender's loan files, which stipulate monetary damages to the seller in the event of a breach in the contract. A breach of the contract would include the borrower selling, leasing, or renting the property during the occupancy period. In the example of the purchase contract language pertaining to the agreed occupancy period provided below, the monetary damage payable to the seller was listed as $100,000.[14]

[14] The example was from the lender case file for FHA loan number 023-2611543.



(c) Buyer further agrees that it shall not, during the pendency of escrow or for a period of one (1) year following the Closing, sell or rent the Property or list the Property for sale or rent or in any manner solicit a buyer or renter for the Property, including but not limited to, the granting of any option to purchase the Property. The parties agree that any breach by Buyer will cause Seller to sustain actual damages but that the precise extent of such damage is difficult or impossible to calculate. Therefore, the parties agree that, considering all of the circumstance existing as of the date hereof, a reasonable estimate of such damages shall be as set forth in subparagraph (d), below. The parties further agree that such agreed upon damages are a reasonable forecast of just compensation to Seller and shall be deemed to be liquidated damages and not a forfeiture or a penalty.

(d) In the event Buyer breaches its representations or warranties prior to the Closing, Seller's sole remedy shall be to cancel the Agreement and retain the Earnest Money as liquidated damages and not as a penalty. In the event Buyer breaches its representation or warranties within one (1) year after the Closing, Seller shall be entitled to demand from Buyer the immediate payment of the sum of One Hundred Thousand Dollars ($100,000.00) as liquidated damages and not as a penalty.

During a conference call, Shea Mortgage officials stated they were unaware that the restrictive covenants recorded between Shea Homes and the borrowers violated HUD-FHA requirements. However, it appeared that Shea Mortgage was notified by HUD QAD, based on a post endorsement review, that legal restrictions on conveyance violate 24 CFR 203.41(b), are material loan deficiencies, and render a property ineligible for FHA insurance. In the review, HUD stated Shea Mortgage failed to ensure that the subject property met eligibility requirements for FHA mortgage insurance. Shea Mortgage did not exercise due diligence by failing to ensure that language included in its loans was appropriate and followed HUD rules and regulations. We informed Shea Mortgage officials that the requirements pertaining to legal restrictions on conveyance are contained in 24 CFR Part 203, Single Family Mortgage Insurance.

Impact and Risk for Losses

We identified 600 loans (29 claim loans and 571 active loans) within our audit period that had unallowable restrictive covenants on the FHA-insured properties. The third party agreements, which contained the prohibited restrictive covenants, between the seller and borrowers, violated HUD-FHA requirements set forth in 24 CFR 203.41 (a)(3)(iv), thereby materially impacting the insurability of the questioned loans, making the loans ineligible for FHA insurance. Additionally, the borrowers in the restrictive covenant agreements were restricted in their ability to rent, lease, sell, or otherwise convey the FHA properties. By allowing the restrictive conveyance agreements on FHA properties, Shea Mortgage may have forced borrowers with decreasing financial capability to remain in their property longer than they would have otherwise. As a result, Shea Mortgage's failure to exercise due diligence placed the FHA insurance fund at unnecessary risk for potential losses by approving ineligible properties for FHA insurance and by restricting borrower's' in their ability to rent, lease, sell, or otherwise convey the FHA properties. For the 600 loans identified, HUD would not otherwise see a loss on the uninsurable FHA loans as they would not have been approved for FHA insurance and would not be the responsibility of the FHA insurance fund. For the 29 claim loans identified as ineligible for FHA insurance, HUD did in fact suffer a loss it should not have suffered.

Corrective Actions Taken

Between HUD's prior QAD notifications[15] and our review results, Shea Mortgage was notified that legal restrictions on conveyance are statute violations of 24 CFR 203.41(b), are material loan deficiencies, and render a property ineligible for FHA insurance. As a result, Shea Mortgage has taken nonmonetary action to correct the material deficiency.[16] These actions include:

- Notifying FHA borrowers, with active restrictive covenants, that the restrictive covenants are no longer binding;
- Including an automatic condition on its approval letters and closing instructions that the restrictive covenant limiting the sale or lease of the subject property is not allowed;
- Requiring a revision to the Shea Homes purchase contract; and
- Providing training to its employees.

Conclusion

Shea Mortgage did not follow HUD requirements when it underwrote loans that had executed and recorded agreements between Shea Homes and the FHA borrower, containing prohibited restrictive covenants in connection with FHA-insured properties. We identified 600 loans (29 claim loans and 571 active loans) within our audit period that did not meet the requirements for FHA insurance. Shea Mortgage's failure to exercise due diligence allowed prohibited restrictive covenants on the FHA-insured properties, which rendered them uninsurable. These uninsurable loans placed the FHA insurance fund at unnecessary risk for potential losses because HUD would not otherwise see a loss on loans not insured by the FHA insurance fund. Of the 115 (48 claim loans and 67 sampled active loans) loans, 11 resulted in an actual loss to HUD of more than $1.4 million. Another 19 of these loans had claims paid totaling more than $2.5 million. The remaining 27 loans found with prohibited restrictive covenants had a total unpaid mortgage balance of more than $7.7 million with an estimated loss to HUD of more than $5 million (see appendix C).

RECOMMENDATIONS

We recommend that HUD's Deputy Assistant Secretary for Single Family Housing require Shea Mortgage to:

1A. Reimburse the FHA insurance fund for the $1,467,611 in actual losses resulting from the amount of claims and associated expenses paid on 11 loans that contained prohibited restrictive covenants (see table 1, appendix C).

[15] Based on two post endorsement technical reviews.

[16] In a response letter dated September 12, 2012, Shea Mortgage only provided examples of the corrective actions; therefore, the OIG was not able to review or determine that the actions taken were applicable to all loans. Any corrective actions taken by Shea Mortgage must be fully supported and verified by HUD during audit resolution.

1B. Support the eligibility of $2,566,837 in claims paid or execute an indemnification agreement requiring any unsupported amounts to be repaid for claims paid on 19 loans, for which HUD has paid claims but has not sold the properties (see table 2, appendix C).

1C. Remove prohibited restrictive language or execute an indemnification agreement that prohibits it from submitting claims on 27 active loans with prohibited restrictive covenants in the amount of $7,715,456, thereby putting $5,092,201 to better use (see table 3, appendix C).

1D. Analyze all FHA loans originated or underwritten beginning January 1, 2008 and nullify all active restrictive covenants or execute an indemnification agreement that prohibits it from submitting claims on those loans identified.

1E. Adhere to 24 CFR 203.41 by excluding restrictive language for all new FHA-insured loan originations and ensure policies and procedures reflect FHA requirements.

We recommend that HUD's Associate General Counsel for Program Enforcement:

1F. Determine legal sufficiency and if legally sufficient, pursue civil remedies (31 U.S.C. (United States Code) Sections 3801-3812, 3729, or both), civil money penalties (24 CFR 30.35), or other administrative action against Shea Mortgage, its principals, or both for incorrectly certifying to the integrity of the data or that due diligence was exercised during the origination of FHA-insured mortgages.

Appendix A

SCHEDULE OF QUESTIONED COSTS AND FUNDS TO BE PUT TO BETTER USE

Recommendation number	Ineligible 1/	Unsupported 2/	Funds to be put to better use 3/
1A	$1,467,611		
1B		$2,566,837	
1C			$5,092,201
Total	$1,467,611	$2,566,837	$5,092,201

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.

2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.

3/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an OIG recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. If HUD implements our recommendations to indemnify loans not originated in accordance with HUD-FHA requirements, it will reduce FHA's risk of loss to the insurance fund. See appendix C for a breakdown, by FHA loan number, of the funds to be put to better use.

Appendix B

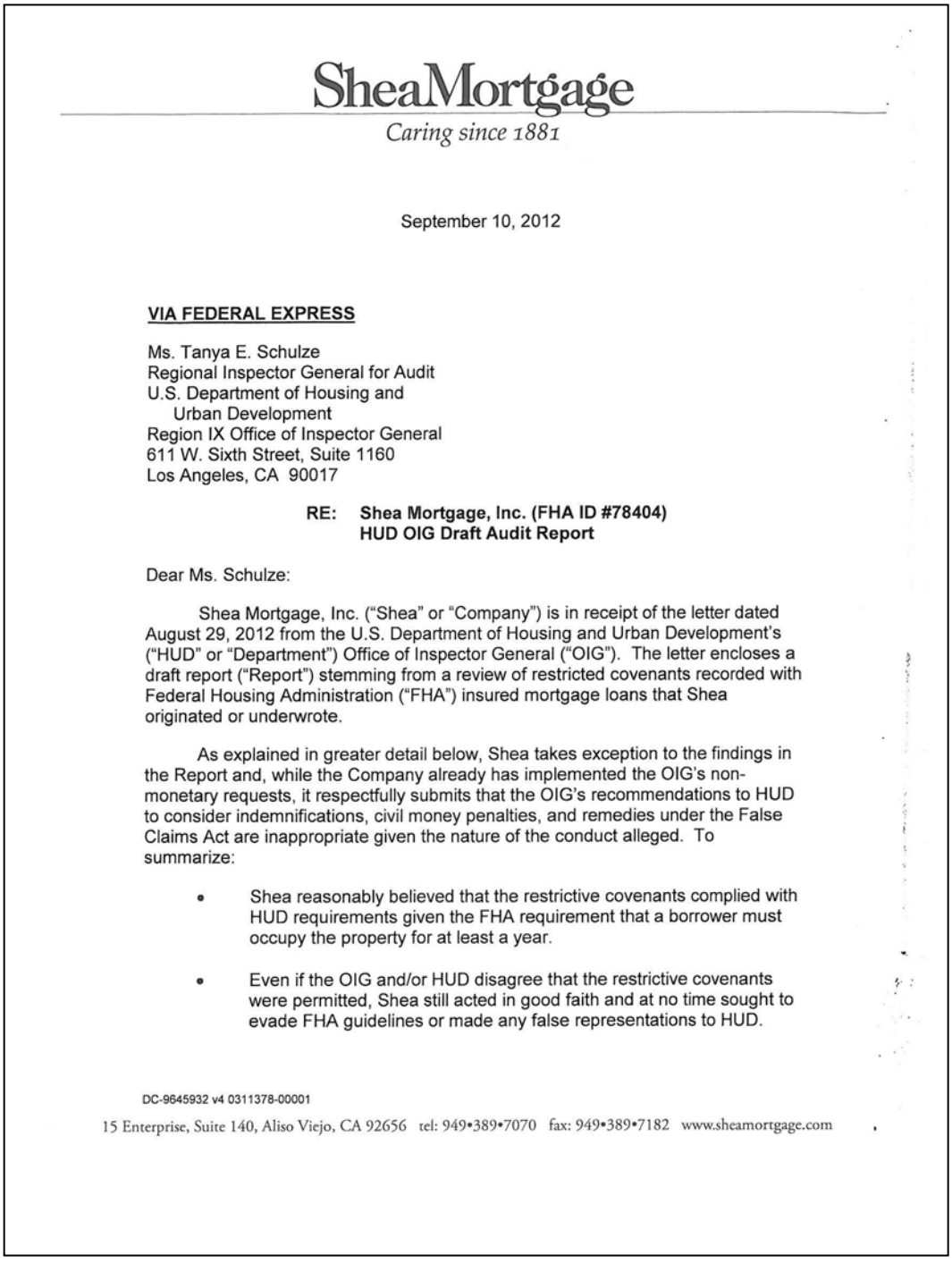
AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation **Auditee Comments**

Comment 1

Comment 2

Comment 3



Shea Mortgage

Caring since 1881

September 10, 2012

VIA FEDERAL EXPRESS

Ms. Tanya E. Schulze
Regional Inspector General for Audit
U.S. Department of Housing and
Urban Development
Region IX Office of Inspector General
611 W. Sixth Street, Suite 1160
Los Angeles, CA 90017

RE: Shea Mortgage, Inc. (FHA ID #78404)
HUD OIG Draft Audit Report

Dear Ms. Schulze:

Shea Mortgage, Inc. ("Shea" or "Company") is in receipt of the letter dated August 29, 2012 from the U.S. Department of Housing and Urban Development's ("HUD" or "Department") Office of Inspector General ("OIG"). The letter encloses a draft report ("Report") stemming from a review of restricted covenants recorded with Federal Housing Administration ("FHA") insured mortgage loans that Shea originated or underwrote.

As explained in greater detail below, Shea takes exception to the findings in the Report and, while the Company already has implemented the OIG's non-monetary requests, it respectfully submits that the OIG's recommendations to HUD to consider indemnifications, civil money penalties, and remedies under the False Claims Act are inappropriate given the nature of the conduct alleged. To summarize:

- Shea reasonably believed that the restrictive covenants complied with HUD requirements given the FHA requirement that a borrower must occupy the property for at least a year.
- Even if the OIG and/or HUD disagree that the restrictive covenants were permitted, Shea still acted in good faith and at no time sought to evade FHA guidelines or made any false representations to HUD.

DC-9645932 v4 0311378-00001

15 Enterprise, Suite 140, Aliso Viejo, CA 92656 tel: 949•389•7070 fax: 949•389•7182 www.sheamortgage.com

Comment 4

- While the Report suggests that Shea's approval of loans with the restrictive covenants increased the risk to the FHA insurance fund because the loans technically were ineligible for insurance and because the covenants may have forced borrowers to remain in their houses longer than they wished by restricting their ability to convey the properties,
  - there were no deficiencies in the loans themselves,
  - there were numerous exceptions to the restrictive covenants, including broad exceptions for borrowers facing financial difficulties rendering them unable to make their mortgage payments,
  - there is no allegation, evidence, or reason to believe that any borrower was forced to remain in his or her home when he or she otherwise would have opted to convey the property, and
  - there is no connection between the restrictive covenants and the reason for any borrower defaults.

Comment 5

- The restrictive covenants were consistent with HUD's own stated policy objectives to discourage investors, ensure owner-occupancy, and prevent property flipping.

Comment 6

- Shea has taken appropriate corrective measures, which included:
  - sending letters to the 219 borrowers whose loans still contained active restrictive covenants to explain that the covenants have been withdrawn and will not be enforced,
  - ensuring that the affiliated builder modified its sales contract to exempt FHA loans from the restrictive covenants, and
  - creating heightened awareness among Company personnel to ensure employees understand and appreciate HUD/FHA rules and guidelines pertaining to legal restrictions on conveyance.

Comment 7

For these reasons, and as detailed below, monetary sanctions are inappropriate in this instance and the suggestion in the Report that Shea may have misrepresented information to HUD, and that HUD therefore should consider remedies under the False Claims Act, should be removed from the final report. The suggestion that borrowers may have been forced to remain in their homes likewise should be removed given that there are no allegations, evidence, or reason to believe that even a single Shea borrower was put in such a position.

Comment 4

I. BACKGROUND – SHEA AND THE DRAFT REPORT

Shea, a non-supervised direct endorsement lender, opened for business in 1995 and is headquartered in Aliso Viejo, California. It first received approval to participate in HUD's FHA mortgage insurance programs in April 2002, and it currently maintains 10 offices registered with HUD/FHA. Shea sells the loans it originates into the secondary market on a servicing-released basis, and its primary investors include Fannie Mae, Freddie Mac and Wells Fargo. The Company acts as a principal for five authorized agents and is an authorized agent for one principal. The Company enjoys excellent relationships with both consumers and its investors, and Shea's employees consistently strive to produce high quality loans in compliance with HUD/FHA standards. FHA lending constitutes approximately 21% of Shea's current loan production. As FHA-insured loans comprise a significant portion of its loan origination business, the Company takes its relationship with the Department and its responsibilities under the FHA program seriously. Moreover, the company enjoys a favorable FHA compare ratio with regard to its origination and underwriting activities. It strives to comply with applicable rules and regulations and is committed to educating and training its employees on issues regarding FHA compliance.

Comment 8

The Report states that its primary objective was to determine the extent to which Shea underwrote loans with, and did not prevent the recording of, agreements between Shea Homes, the Company's affiliated builder, and borrowers containing prohibited restrictive covenants (the "Covenant" or "Covenants") in connection with FHA-insured loans that closed between January 1, 2008 and December 31, 2011. The OIG reviewed 115 loans that Shea underwrote and closed during that time period, including 48 claim loans and 67 statistically selected active loans (out of a total of 1,498 active loans). The OIG determined that 29 of the 48 claim loans and 32 of the 67 active loans, for a total of 61 loans, contained prohibited restrictive covenants limiting the borrower's ability to sell or lease the property for a year after closing in violation of FHA regulations at 24 CFR 203.41(b), which provide that, to be eligible for FHA insurance, a property must not be subject to legal restrictions on conveyance. The Report suggests that Shea failed to meet its responsibility at closing to ensure conditions of title to the property are acceptable to FHA, citing HUD Handbooks 4000.2, ¶ 5-1(B) and 4155.2 5.A.1.h, and incorrectly certified that the properties met HUD-FHA requirements. While the OIG identified only 61 loans with Covenants (29 claim loans and 32 active loans with properties in Arizona and California), it states that there are 600 based on its extrapolation of the 32 active loans with Covenants identified to the entire universe of 1,498 active loans, which yielded 571 active loans. The Report concludes that Shea placed the FHA insurance fund at unnecessary risk by underwriting these loans both because the loans were not eligible for FHA insurance and because its allowance of the

Covenants "may have forced borrowers with decreasing financial capability to remain in their property longer than they would have otherwise."

Based on these assertions and extrapolation, the Report recommends that HUD require Shea: (1) to indemnify HUD for actual losses totaling $1,467,611 sustained in connection with claims made on 11 of the 61 loans; (2) to demonstrate the eligibility of $2,566,837 in claims paid or execute an indemnification agreement requiring unsupported amounts to be repaid for claims paid on 19 of the 61 loans where HUD has paid the claims but not yet sold the properties; (3) to remove the prohibited restrictive language or execute an indemnification agreement for 27 active loans with prohibited restrictive covenants; (4) for all FHA loans that Shea originated or underwrote since January 1, 2008, either nullify all restrictive covenants or execute an indemnification agreement; and (5) to exclude restrictive language for all new FHA loan originations and ensure the Company's policies and procedures reflect FHA requirements. The Report further recommends that HUD consider pursuing civil remedies under the False Claims Act, 31 U.S.C. §§ 3729, 3801-3812, civil money penalties, or other administrative action against Shea and/or its principals.

II. RESPONSE TO THE FINDINGS

Comment 7

After receiving the draft Report, Shea conducted a thorough review of the matters raised and the circumstances surrounding them. Based on this stringent review, the Company respectfully submits that neither indemnifications nor civil money penalties are warranted. In fact, Shea already has complied with a number of the OIG's requests. A False Claims Act action likewise would be inappropriate as Shea at no time knowingly made a false representation to the Department.

Comment 6
Comment 7

Comment 2

First and foremost, Shea did not believe that the Covenant was contrary to HUD/FHA requirements. Shea believed, and one reasonably could determine, that the Covenant did not violate HUD/FHA requirements, and the Company at all times acted in good faith in an effort to comply with applicable guidelines. In addition, contrary to the suggestions in the Report, there is no evidence, or any reason to believe, that the Covenant increased the risk to the FHA insurance fund. The Report suggests an increased risk for two reasons: (1) approval of loans that technically were ineligible for FHA insurance; and (2) restrictions on borrowers' ability to sell or lease their properties. Shea disagrees, however, that the mere existence of the Covenant increased the risk. Not only can one reasonably determine that the Covenant complied with FHA requirements, but the Covenant was in no way tied to the reason for any borrower default.

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Nevertheless, even if one takes the position that the loans were technically uninsurable and therefore increased the risk to the FHA insurance fund because they should not have been insured at all, the statements suggesting that the

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Covenant also increased the risk to the FHA insurance fund because it restricted borrowers' ability to convey their properties, and may have forced borrowers to remain in their homes when they otherwise would not have done so, should be removed from the Report. There is no evidence or any reason to believe that any borrower was forced to remain in his or her home longer than he or she otherwise would have remained in the absence of the Covenant. Moreover, the Covenant was consistent with HUD/FHA policy objectives and lending guidelines. What's more, Shea identified all FHA loans that it originated or underwrote since January 1, 2008 and nullified any active Covenants, as well as implemented other corrective measures to ensure no such Covenants are recorded in Shea's FHA loans going forward. There are no existing Covenants in any of Shea's active FHA loans and no borrower with a FHA loan from Shea currently is restricted in any way in the lease or sale of his or her property. For these reasons, the financial penalties proposed in the Report are unwarranted and Shea already has implemented the OIG's non-monetary requests.

Comment 9

Comment 10

Shea further notes that the Report's suggestion that 571 active loans should be deemed to contain prohibited Covenants based on an extrapolation of 32 active loans to the Company's entire FHA portfolio is inequitable, as is the estimate of potential losses on the active loans contained in the sample reviewed. Shea would not object to the Report's mention of the Department's actual or potential losses in connection with loans for which Covenants actually were recorded and for which claims have been made; however, administrative actions and penalties should be based on actual findings in the loan files reviewed and actual claims to HUD in those cases, not conjecture or speculation. References to loan files not reviewed and potential losses on active loans should those loans ever go into default and result in claims to HUD are inflammatory and do not reflect any actual financial losses to HUD. Any amounts due to HUD in connection with any indemnifications will be determined based on actual losses to HUD if and when they occur upon resolution of the claims made to the Department, rather than the estimates included in the Report.

A. Shea Did Not Intentionally Circumvent HUD/FHA Requirements or Improperly Certify Compliance

Comment 2

The Report suggests that Shea did not exercise due diligence because it failed to ensure that language included in its loans was appropriate and followed HUD rules and regulations. To this end, the Report also suggests that Shea made false certifications as to the loans' compliance with FHA standards.

At no time did Shea fail to exercise due diligence or make a false certification. As explained below, Shea reasonably believed that the Covenant – the use of which has been common throughout the building industry in recent years – was permissible under HUD/FHA guidelines. While we appreciate that the OIG and/or

Comment 2

HUD may take a different view, Shea certainly did not intend to disregard HUD/FHA guidance and acted with the good faith belief that its practices were in compliance with applicable requirements at all times.

The applicable HUD regulation provides that a mortgage is not eligible for FHA insurance if the property is subject to legal restrictions on conveyance, except as permitted by the regulation. See 24 CFR § 203.41(b). The regulation further provides that certain delineated legal restrictions are allowable if they are part of an eligible governmental program, including a requirement that the mortgagor be required to continue to be an owner-occupant, as long as the restrictions automatically terminate if title to the property is transferred by foreclosure or deed-in-lieu of foreclosure or the mortgage is assigned to HUD, and a violation of the restriction is not grounds for, among other things, contractual liability. See id. § 203.41(c), (d). As recognized in the Report, FHA guidelines require a borrower to occupy the property as his or her principal residence for at least one year and expressly prohibit FHA insurance on properties purchased by investors. See HUD Handbook 4155.1 4.B.2.

Comment 2

Comment 11

Comment 2

Based on the FHA requirement that a borrower must be an owner-occupant for a year, the regulation's exception for such governmental requirements from the prohibition against legal restrictions on conveyance, and the exception in the sales contracts for transfers resulting from foreclosures, Shea reasonably believed that the builder's Covenant requiring a year of occupancy was permissible. A Shea employee also spoke with a HUD official in mid-2009, after which conversation the employee believed she had confirmed the Company's understanding that the Covenant was permissible. Shea had no reason to question its employee's understanding. Given that HUD itself requires a year of owner-occupancy, it seemed disingenuous that a lender simultaneously would be prohibited from ensuring that requirement is met. The Report dismisses the significance of the Handbook provision indicating that FHA security instruments require continued occupancy for at least a year because such instruments are between the lender and the borrower, not a third party like the seller. The regulation, however, does not limit the exception for governmental programs requiring continued occupancy to agreements between the lender and borrower; rather, the exception in Section 203.41(c), (d)(5) applies to the general prohibition against legal restrictions on conveyance in Section 203.41(b), as defined in Section 203.41(a)(3) to include agreements with third parties. Thus, as HUD/FHA requires owner occupancy for at least a year, it was reasonable to believe that a seller could require a buyer to occupy the property for a year and that a lender could underwrite a loan with a sales contract requiring the borrower's adherence to FHA requirements.

That being said, in late 2011, when HUD clarified its position to Shea that the governmental loan exception does not apply to sales contracts, the Company acted

Comment 12

quickly to address HUD's concerns. In March 2011, HUD conducted a Post Endorsement Technical Review ("PETR") that yielded an unacceptable rating based on the restrictive covenant issue. Shea responded to the PETR rating in May 2011, at which time the Company explained its understanding based on its earlier communication with HUD. Shea did not receive a reply from HUD until December 2011, which took the form of another PETR based on the same issue. Shea replied to HUD, again reiterating its belief that the seller's restriction was permissible based on prior communications with a HUD official, but also indicating that, in an effort to resolve any outstanding concerns, it had directed the builder's legal counsel to prepare a contract addendum excluding FHA loans from the Covenant. The builder in fact modified its contract shortly thereafter in January 2012, and it appears that the last Covenant in any FHA loan was filed in February 2012.

B. The Restrictive Covenant Did Not Increase the Risk to the FHA Insurance Fund

The Report suggests that Shea's approval of the loans with Covenants placed the FHA insurance fund at unnecessary risk for losses because the loans were ineligible for FHA insurance and because it "may have forced borrowers with decreasing financial capability to remain in their property longer than they would have otherwise." These statements, however, are wholly unsupported by any factual evidence.

There is no evidence, or any reason to believe, that the Covenant increased the risk to the FHA insurance fund in any case. While Shea has taken action to eliminate any Covenants in FHA sales contracts and ensure their absence in the future, the temporary Covenants in some cases in the past did not adversely affect the FHA insurance fund.

Comment 4

First, there is no allegation of any deficiencies in the loans themselves. Shea originated, processed, underwrote, and approved the borrowers for FHA financing in accordance with FHA guidelines and each borrower qualified for the FHA loan. The Covenant in the builder's sales contract did not impact the underwriting of the files in any way and has no bearing on a borrower's creditworthiness or the likelihood that he or she will make mortgage payments. There are no loan-level deficiencies in the files, and Shea made quality loans to eligible borrowers.

Second, there is no evidence, or any reason to believe, that even a single borrower was forced to remain in his or her home longer than he or she otherwise would have remained in the absence of the Covenant. The Report does not identify a single individual who claimed that to be the case, and Shea is unaware of any such instance. In fact, as discussed in greater detail below, any

borrower defaults in the cases cited in the Report were wholly unrelated to the existence of the Covenant.

Comment 4

To that end, please note that the builder's sales contracts contained numerous exceptions to the legal restrictions on conveyance to ensure borrowers were able to sell or lease their properties without restrictions when faced with exigent circumstances. For example, the limitations on the sale or lease of the property did not apply in the following situations:

- death of a buyer or co-buyer;
- dissolution of marriage or legal separation of married buyers, entry into a property settlement agreement incident to such dissolution or separation;
- mandatory job transfer;
- sudden and unexpected medical or financial emergency of such serious nature that makes it impossible for buyer to occupy the residence;
- transfer between spouses or between parent and child;
- transfer into a revocable trust in which the buyer is the beneficiary;
- transfer, conveyance, pledge, or assignment of the property to secure the performance of an obligation that will be released or reconveyed upon completion of the performance; and
- transfer resulting from a foreclosure by the beneficiary of a first mortgage or a transfer in lien thereof.

Significantly, the restrictions also were subject to a catchall exception for any serious hardship creating such a significant burden on the buyer that it would make it impossible for the buyer to comply with the restrictions on conveyance.

Comment 13

Moreover, the Covenant was not a restriction on the property, but a restriction to ensure owner-occupancy by the FHA borrower. In each case where the sales contract contained a Covenant, we understand that no sale or lease restriction was recorded on the property until after the first mortgage or Deed of Trust was recorded and the restriction was subordinate to HUD's interest. In other words, the Covenant did not prevent conveyance of a property to HUD or to a third-party investor through foreclosure, short sale, modification, or otherwise. It merely required that, absent such circumstances or the broad exceptions for various life events, the borrower remain an owner-occupant for a year in compliance with HUD/FHA requirements.

Comment 14

Comment 2

In sum, the foregoing exceptions effectively permitted a buyer to convey the property under any circumstance that would have rendered him or her unable to make mortgage payments. Given that FHA borrowers must be owner-occupants to qualify for FHA financing under HUD rules, and given that owner-occupants

generally do not sell their residences within one year of purchasing them absent unexpected life events, the foregoing hardship exceptions appeared sufficient to allow a buyer to convey the property when the circumstances necessitated as much. There is no proof the restrictions actually inhibited any borrower from conveying a property at any time.

Comment 15

Third, the Covenant self-terminated after a year and Shea has released the Covenant in all cases where it had not expired already. The Covenant in every contract terminated automatically after the expiration of 12 months. In 1,279 of the 1,498 active FHA loans that Shea originated or underwrote during the applicable time period, the one-year period already has expired and it is clear that the covenant has not caused any harm to the FHA insurance fund. In these cases, the Covenants expired, there are no existing restrictions on conveyance, and the loans remain active with no claims to HUD. In the remaining 219 cases, Shea has sent letters to the borrowers releasing them from their obligations under the Covenant and vowing not to enforce it. Thus, there are no longer any enforceable Covenants on any of the 1,498 active FHA loans and the Covenants could not have had any adverse impact on HUD/FHA.

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Finally, there is no reason to tie the restrictive covenant to any loan default. Only six of the 61 loans cited in the Report became delinquent within the first 12 months when the Covenant was still in force, including one of the 11 with actual losses to HUD as identified by the OIG (i.e., FHA Case No. 023-2735251) and five additional loans (i.e., FHA Case Nos. 048-4815787, 023-3360032, 042-8458483, 023-3680699, and 048-6011949). In all six cases, the delinquency was the result of bankruptcy or curtailment of income and had nothing to do with the Covenant. In addition, either one of those situations would have qualified for an exception to the restriction on conveyance (i.e., the exception for a financial emergency or the catchall exception for any hardship making compliance impossible). If the borrowers could not afford to remain in the properties, they could have demonstrated financial hardship to qualify for an exception to the restriction on conveyance and sold or leased the property. The Covenant neither caused these borrowers' bankruptcy/curtailment of income nor applied to them after they found themselves in financial straits. The Covenant and the borrower delinquencies were wholly unrelated.

C. The Covenant Was Consistent with HUD/FHA's Policy Objectives

Comment 4
Comment 17

The OIG's suggestion that Shea somehow increased the risk to the FHA insurance fund by closing loans with sales contracts requiring borrowers to occupy the properties for at least a year is incongruous given that HUD explicitly has voiced the same goals as those underlying the Covenant. The purpose of the Covenant was two-fold: (1) to discourage investors and ensure owner-occupancy; and (2) to prevent property flipping, which in turn compromised the integrity of communities by

Comment 5

lowering property values. The Covenant was established at a time when investors were perpetrating mortgage fraud by posing as legitimate homebuyers to obtain maximum financing and then flipping or leasing the properties shortly after closing on their purchase. While mortgage lenders, including Shea, endeavored to identify these types of issues during the underwriting process, many builders sought to discourage investors earlier in the process. The Covenant was not intended to restrict alienability for consumers purchasing properties as residences, which is why there were numerous exceptions to the conveyance restrictions as discussed above.

Comment 2

Notably, the foregoing goals were consistent with HUD/FHA's own policy objectives. HUD prohibits FHA loans to investors and property flipping. Specifically, FHA loans generally are limited to owner-occupied principal residences; the borrower must occupy the property for the majority of the calendar year and have continued occupancy for at least one year. See HUD Handbook 4155.1 4.B.1.a, 4.B.2.a, b. HUD went so far as to prohibit multiple FHA loans to the same borrower in order to prevent circumvention of its ban on loans to private investors. See id. 4.B.2.c, d. The Covenant in this case was intended to serve the same purpose by ensuring owner-occupancy for at least a year barring exigent circumstances that rendered continued occupancy impossible. HUD likewise promulgated a property flipping rule to prevent the resale of recently acquired properties at artificially inflated values for considerable profit. The rule prohibited resales within 90 days and imposed additional requirements on properties sold between 90 days and one year. See, e.g., 24 C.F.R. § 203.37a; Mortgagee Letters 2003-07, 2005-05, 2006-14; HUD handbook 4155.2 4.7.[1] The Covenant in this case was intended to serve the same purpose by deterring investors and discouraging property flipping.

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Given that the Covenant in this case was consistent with HUD's policy objectives, it did not add risk or unnecessarily harm the FHA insurance fund. Just the opposite – it furthered HUD's goals to prohibit loans to investors and prevent property flipping and served to protect and enhance the FHA insurance fund.

D. Shea Has Implemented Corrective Measures

Comment 2

As noted above, the Covenant likely was permissible and certainly was consistent with HUD's own objectives. Nevertheless, Shea quickly took a number of

[1] A temporary waiver of the property flipping rule is in effect due to high foreclosure rates and a need to stabilize "real estate prices and neighborhoods that have been heavily impacted by foreclosures," and to "facilitate the sale and occupancy of foreclosed homes that have been rehabilitated by making the mortgages of such homes eligible for FHA mortgage insurance." 77. Fed. Reg. 49, 14819. The Department, however, has made clear that property flipping generally is prohibited and the seller's contracts in this case included exceptions for borrowers facing exigent circumstances.

steps to ensure no restrictions are currently in place and that none will be recorded on FHA loans in the future.

Comment 6

Specifically, Shea:

- reviewed the active FHA loans that it has originated or underwritten and determined that there are 219 files with Covenants yet to expire (i.e., that are still within the first 12 months), and sent letters to all 219 borrowers releasing them from their obligations under the Covenant and vowing not to enforce it.
- ensured that its affiliated builder modified its sales contract to exempt FHA loans from any legal restrictions on conveyance; and
- raised a heightened awareness of the issue with Company staff to ensure they understand and appreciate HUD/FHA rules and guidelines pertaining to legal restrictions on conveyance.

Shea's management is confident that these measures have addressed the issue. There are no existing Covenants in force, and none will be placed on FHA loans going forward.

E. Indemnification and Civil Penalties are Unwarranted

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Shea strongly disagrees with the recommendations in the Report. As explained above: there is no allegation of any loan-level deficiencies in any of the files; there is no evidence that any borrower remained in a property longer than he or she would have but for the Covenant; the Covenant self-terminated after a year; there is no connection between the Covenant any borrowers' reasons for default; borrowers in financial straits could have sought to convey their properties unfettered under the exceptions to the Covenant in the sales contract; and, the Covenant was consistent with HUD policy objectives insofar as it was intended to ensure owner-occupancy and prevent property flipping. In addition, Shea already has analyzed the loans it originated or underwrote since January 1, 2008, nullified all active Covenants, and ensured the builder's exclusion of FHA-insured loans from all Covenants in its sales contracts going forward. For these reasons, indemnification of any of the files would be inappropriate. The borrowers qualified for FHA financing and there are no deficiencies in the loans themselves.

Comment 2

Furthermore, Shea strongly opposes the recommendation that HUD consider either civil money penalties or remedies under the False Claims Act. The imposition of a civil money penalty requires a lender's commission of a knowing and material violation. See 24 C.F.R. § 30.35. Similarly, to trigger liability under the False Claims Act, a person must make a claim to the government that is false or fraudulent,

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knowing of its falsity and seeking payment from the federal treasury. See 31 U.S.C. § 3729. In this case, however, Shea did not intentionally circumvent FHA requirements, the Covenant did not affect the borrowers' eligibility for FHA financing or ability to repay their mortgages, the Covenant was not the proximate cause of any claims to the Department, and Shea did not knowingly make any false statements to HUD. Shea reasonably believed that the Covenant complied with HUD/FHA requirements at all relevant times, and the Report does not allege that Shea or its underwriters intentionally provided false information in any case. The OIG's suggestion that Shea may have certified falsely to the loans' compliance with FHA requirements is erroneous. Civil money penalties are inappropriate, and a recommendation that HUD consider a False Claims Act action is inflammatory.

Comment 18

We also note that, rather than cite new allegations, the recommendation to consider a False Claims Act case appears to be an attempt to pile on the allegations made against Shea. HUD examination reports typically allege certain deficiencies in a company's FHA operations, and the company is given an opportunity to address the materiality and accuracy of the allegations. By including an allegation of potentially false certifications, the OIG has created a situation where every misunderstanding of FHA requirements could give rise to allegations of a false certification, which will serve only to discourage FHA lending. Enforcement actions are meant to reinforce HUD's rules and regulations, rather than discourage broad participation in FHA lending.

F. The Report Contains Recommendations to HUD but Does Not Constitute a Final Action

Comment 19

As noted above, the Report merely recommends that the Department pursue indemnification and/or penalties in the cited cases. Upon receiving the final report, the Department will have an opportunity to independently examine the OIG's findings and Shea's response and make an independent determination as to whether indemnification or penalties would be appropriate in this instance. As discussed at length earlier in this response, Shea disagrees with the OIG's characterization of the Company's actions and the assertion that the loan files warrant indemnification and/or penalties. HUD likewise may disagree with the Report's assertions and decide not to pursue indemnification or penalties in this instance, which we believe should be the outcome after HUD considers all of the relevant facts.

Comment 20

In addition, while the review process is still ongoing at the time the OIG issues its "final" report, the Report and the OIG's recommendations typically are made public on the OIG website. As a result, a lender's investors and peers are able to access the preliminary recommendations of the OIG before a final assessment as to their merit can be made by the Department. These entities often misinterpret the OIG's recommendations to be final actions by the Department. Under these

circumstances, making these preliminary recommendations public and suggesting that HUD pursue indemnification or other remedies in connection with the referenced files may have a material, adverse effect on the Company's business, which is especially egregious given the inaccuracies we articulated above.

Comment 20

If the OIG's goal is to present the reader with a full and accurate disclosure of this review and its implications to the Company, the Report should include the following disclosure on the first page in bold, capitalized lettering:

THE REPORT FINDINGS REFLECT THE VIEWS OF THE OFFICE OF INSPECTOR GENERAL AND DO NOT CONSTITUTE A FINAL DETERMINATION OF THE MATTERS RAISED HEREIN BY THE U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT. THE FINAL DETERMINATION IN THIS MATTER WILL BE MADE BY THE REPORT'S ADDRESSEE, THE HUD ASSISTANT SECRETARY FOR HOUSING – FEDERAL HOUSING COMMISSIONER, WHO WILL ULTIMATELY DECIDE WHETHER TO ACCEPT THE REPORT'S RECOMMENDATIONS IN WHOLE OR IN PART OR REJECT THEM.

Such a disclosure would more accurately convey the status of the OIG's "final" report to the Company's investors, customers, and the public.

III. CONCLUSION

Comment 4

Shea takes the matters raised in the Report seriously. Shea believes that, through this response and supporting documentation, it has demonstrated Shea's good faith effort to comply with HUD/FHA requirements (and likely compliance with the specific terms of the applicable regulation), the lack of any evidence or connection between the Covenant and any borrower defaults, and the Company's prompt initiation of corrective measures similar to those that the Department has deemed sufficient to resolve these types of matters in the past. Shea appreciates this opportunity to respond to the matters raised in the Report.

We trust that this correspondence adequately addresses the OIG's concerns, and we hope that you will consider this response and supporting documentation when reviewing the pending matter and compiling a final report. Should you have any questions or need additional information, please call our Washington counsel, Phillip L. Schulman, at (202) 778-9027.

Thank you for your kind consideration.

Sincerely,

Joel VanRyckeghen
President

cc: Phillip L. Schulman, Esq.

OIG Evaluation of Auditee Comments

Comment 1 The recommendations presented in the audit memorandum are based on the elements of the finding and the fact that the presence of a prohibited restrictive covenant impacts the insurability of an FHA loan and are a violation of Federal statute.

Comment 2 Generally, Shea Mortgage stated that it believed and could reasonably have determined that the restrictive covenants complied with HUD-FHA requirements, given the FHA requirements that a borrower must occupy the property for at least one year. Shea Mortgage is incorrect to focus on the one year owner occupancy requirement as this is not an element of the OIG finding. We disagree with Shea Mortgage's attempts to connect any legal restriction on conveyance with the one year owner occupancy requirement. The deficiency identified was when a lender, Shea Mortgage, allows a seller, Shea Homes, to impose a restriction on conveyance that list restrictions beyond simply requiring one year occupancy. The exceptions identified by Shea Mortgage do not apply.

While we agree that the FHA requirements do emphasize a one year occupancy period, the same regulations, under 24 CFR 203.41(a)(3)(iv), for free assumability of the property, emphasize the prohibition of a restriction where the conveyance of a property be subject to the consent of a third party, in this case the seller. As stated in the memorandum, "[t]he FHA insurance requirements, set forth in 24 CFR 203.41(b), state that to be eligible for insurance, the property must not be subject to legal restrictions on conveyance. Further, 24 CFR 203.41(a)(3) defines legal restrictions on conveyance as 'any provision in any legal instrument, law or regulation applicable to the mortgagor or the mortgaged property, including but not limited to a lease, deed, sales contract, declaration of covenants…that attempts to cause a conveyance (including a lease) made by the mortgagor to…(iv) Be subject to the consent of a third party."

The audit memorandum does not allege that Shea Mortgage knowingly made a false representation to HUD and the OIG acknowledges that Shea Mortgage may not be the only lender allowing the recording of unallowable restrictive covenants. To clarify, the memorandum finding was based on the restriction on conveyance, preventing free assumability. As stated in the memorandum, "for each FHA loan, the lender certifies on the uniform residential loan applications that the mortgage was eligible for HUD mortgage insurance under the direct endorsement program." The burden is on Shea Mortgage, as with any lender participating in the FHA insurance program, to become knowledgeable and adhere to FHA rules and regulations. As stated in the memorandum, HUD Handbooks 4000.2 paragraph 5-1(B) and 4155.2 paragraph 6.A.1.h both state that it is the lender's responsibility at loan closing to ensure that any conditions of title to the property are acceptable to FHA. Had Shea Mortgage exercised due diligence, it would not have approved loans for FHA insurance that were ineligible due to the presence of prohibited restrictive covenants on the associated FHA-insured properties.

Comment 3 We acknowledge Shea Mortgage's statement regarding its intentions when approving the questioned loans for FHA insurance. The findings and recommendations are based on the numerous documents reviewed and discussions held with Shea Mortgage. We note that Shea Mortgage was cooperative and forthcoming throughout the review.

Comment 4 We disagree with Shea Mortgage that the memorandum suggested that the restrictive covenants increased the risk to the FHA insurance fund. Specifically, the memorandum states that the unallowable restrictive covenants put the FHA insurance fund at unnecessary risk for losses.

As stated in the "Scope and Methodology" section of the memorandum, the scope of the review focused solely on the presence of prohibited restrictive covenants. Therefore, we cannot say the reviewed loans did or did not contain additional underwriting loan deficiencies. However, despite whether there were no other deficiencies in the loans; exceptions to the restrictive covenants; no borrowers forced to remain in the property when they may have otherwise conveyed the property; or no tie between the restrictive covenant and the reason for the loan default on these loans is irrelevant because the FHA loans identified in this memorandum were determined to have violated Federal statute and were not eligible for FHA insurance. As with any underwriting review, deficiencies identified, such as overstated income and understated liabilities, do not have to be the reason an FHA loan went into default or claim for HUD to seek indemnification. Rather, the deficiencies are used as evidence that the FHA loan should not have been FHA-insured. In the same regard, the audit memorandum identifies a material deficiency that deemed the identified loans ineligible for FHA insurance. Therefore, any loss or claim tied to the loan presents an unnecessary loss to HUD's FHA insurance fund.

To add additional clarification, we revised the language in the "Impact and Risk for Losses" and "Conclusion" sections of the memorandum to state that the restrictive covenant on the FHA-insured property materially impacted the insurability of the questions loans, rendered the FHA loans uninsurable and therefore, put the FHA insurance fund at an unnecessary risk for losses because HUD would not otherwise see a loss on loans not insured by the FHA insurance fund.

Comment 5 The findings presented in the memorandum were based on the comparison between the HUD-FHA requirements and Shea Mortgage's actions. In this instance, we found that the restrictive covenants allowed by Shea Mortgage were contrary to 24 CFR 203.41(a)(3), for free assumability of the property. In this regard, the prohibited restrictive covenants are not consistent with HUD's policies.

Comment 6 We acknowledge that Shea Mortgage has taken corrective actions to remedy the problem identified and have included these actions in the audit memorandum

under section "Corrective Action Taken". However, each recommendation addressed to HUD in the audit memorandum, both monetary and nonmonetary, was created with the intention to remedy deficiencies identified. HUD will review the adequacy and implementation of Shea Mortgage's corrective actions during the audit resolution process to determine if they were sufficient in response to the OIG recommendations.

Comment 7 As with any review, we are tasked with promoting the effectiveness and efficiency of government operations by ensuring HUD rules and regulations are followed. Our findings are a direct result of identifying a violation of HUD-FHA requirements for FHA insurance. Based on our conclusions, it was our duty and obligation to HUD and other stakeholders to recommend HUD take necessary, appropriate action. We believe the recommendations contained in the audit memorandum are fair and appropriate given the materiality of the OIG finding. As stated in comment 4, the recorded prohibited restrictive covenants impacted the insurability of the reviewed loans. Shea Mortgage had a duty to ensure loans it approved for FHA insurance were in accordance with all HUD rules and regulations.

The Inspector General Act of 1978 gives the OIG the authority to conduct and supervise audits and investigations relating to the programs and operations of HUD. As such, the OIG has the responsibility to recommend corrective action, including civil or administrative actions based on the facts identified in its audit reports. Any recommendations or referral for civil or administrative actions are addressed to HUD for review and final determination. Therefore, the recommendations remain unchanged.

In addition, the FHA Reform Act of 2010 states, if the Secretary determines that a mortgage executed by a mortgagee approved by the Secretary under the direct endorsement program or insured by a mortgagee pursuant to the delegation of authority under section 256 was not originated or underwritten in accordance with the requirements established by the Secretary, and the Secretary pays an insurance claim with respect to the mortgage within a reasonable period specified by the Secretary, the Secretary may require the mortgagee to indemnify the Secretary for the loss.

Comment 8 To clarify, the OIG determined that 31, not 32, active loans contained prohibited restrictive covenants on the FHA property. Additionally, the total claim and active loans found with prohibited restrictive covenants on the FHA property was 60, not 61.

Comment 9 We disagree with Shea Mortgage's assertions that the active loan sample projection of 571 active loans with unallowable restrictive covenants was inequitable and inflammatory. As stated in the New York Law Journal's article The Use of Statistical Sampling as Evidence, by George Bundy Smith and Thomas J. Hall,

Statistical sampling is a scientific methodology by which one draws conclusions about a large population of data by measuring and analyzing a smaller, representative sample of the population. When the sample is randomly selected and of sufficient size so as to achieve statistical significance, statisticians may confidently make inferences about the larger population by reviewing the sample. As such, statistical sampling can provide an efficient way to estimate accurately larger populations of data, and has been utilized across many spectrums outside of the courtroom, including election polling, television ratings, unemployment surveys and analyses of public health issues.

Additionally, we disagree that the potential losses on the active loans contained in the sample reviewed were inequitable. The potential losses noted in the memorandum for the active loans reviewed are based solely on those FHA cases reviewed, not including loans identified through the sample projection, and determined to contain the prohibited restrictive covenant and are not projection based on the attribute sample.

Comment 10 We agree with Shea Mortgage's assessment that amounts due to HUD in connection with any indemnification should be determined based on actual losses to HUD if and when they occur upon resolution of the claim made to HUD. We believe our recommendations have made this distinction, separating loans that have gone into claim and loans that are active. The estimated losses, as stated in the memorandum, were estimated based on HUD's 66 percent loss severity rate, multiplied by the unpaid mortgage balance. The 66 percent loss rate was the average loss on FHA-insured foreclosed-upon properties based on HUD's Single Family Acquired Asset Management System's "case management profit and loss by acquisition" computation ending December 2011.

Comment 11 Shea Mortgage stated that it discussed the restrictive covenant with a HUD employee in 2009 and believed that the employee confirmed that the restrictive covenant was permissible. However, Shea Mortgage was unable to provide any supporting documentation or information, such as the name of the employee or correspondence, so the matter could be researched further. Aside from the OIG's analysis and determinations, we determined, based on documentation reviewed, that HUD came to the same conclusion that the presence of a restrictive covenant is a material deficiency and renders a loan uninsurable under the FHA insurance program. In this regard, the prohibited restrictive covenants are not consistent with HUD's policies.

Comment 12 In the HUD reviews identified by Shea Mortgage, restrictive covenants were found to be unallowable material Federal statute violations. HUD determined that Shea Mortgage failed to ensure that the subject property met eligibility requirements for FHA mortgage insurance. HUD also noted that FHA will not accept legal restrictions on conveyance. The loans reviewed were active loans in

which HUD required Shea Mortgage to provide the required documentation or sign an indemnification agreement. Again, indicating the material nature of the deficiencies and how it does not adhere to HUD's policies.

Comment 13 We disagree with Shea Mortgage's assessment that the restrictive covenant was not a restriction on the property. The memorandum contains excerpts from the restrictive covenant executed and recorded between the borrower and seller, which, in part stated, "Buyer further agreed that Buyer would occupy the Property upon close of escrow and would not for a term of twelve (12) months from the date of close of escrow of the Property sell, lease, rent, list, or grant an Option to Purchase, lease or rent the Property (the 'Restriction')."

Additionally, we would like to clarify that the memorandum finding was based on the restriction on conveyance, preventing free assumability, not the owner-occupancy requirement. For clarity, we added the following language to the report section "Restriction on Conveyance": Extra emphasis must be placed on the fact that the conveyance of the property, during the occupancy period, was at the consent of the seller, which violated HUD-FHA requirements at 24 CFR 203.41(a)(3)(iv). During the exit conference, Shea Mortgage officials confirmed that the seller's consent was required for conveyance during this period.

Comment 14 Shea Mortgage states that there was no impediment to the conveyance in events such as foreclosure, short sale, or modification, but otherwise would have "required that absent such circumstances or the broad exceptions for various life events, the borrower remain an owner-occupant for a year in compliance with HUD/FHA requirements." Again, we would like to clarify that the memorandum finding was based on the restriction on conveyance, preventing free assumability, not the owner-occupancy requirement. Furthermore, discussions with Shea Mortgage officials verified that in order for the borrower to use one of the exceptions for various life events they would have needed the seller's consent, which, as stated in the OIG memorandum, violated 24 CFR 203.41(a)(3)(iv).

Comment 15 In a letter dated September 12, 2012, Shea Mortgage provided a sample letter it mailed out to 217 FHA loan holders with active unallowable restrictive covenants. While we recognize the corrective action, the recommendations remain unchanged since Shea Mortgage only provided one example. Shea Mortgage, during audit resolution, should provide HUD evidence for each loan indicating that the unallowable legal restriction on conveyance has been released.

Comment 16 Shea Mortgage stated that the borrowers could have demonstrated financial hardship to qualify for an exception to the restriction on conveyance and sold or leased the property. We would like to emphasize that conveyance of the property subject to the consent of the seller violates CFR 203.41(a)(3)(iv). See comment 4.

Comment 17 To clarify, the memorandum refers to the restrictive covenant documents between the seller and borrower that were filed with the applicable county recorders'

office, not specifically the purchase contract. The restrictive covenant documents had various names including

- Memorandum of Limitation on Sale or Lease;
- Memorandum of Limitation on Sale, Lease or Rental; and
- Memorandum of Agreement Regarding Limitation on Sale/Lease/Rental.

Comment 18 We disagree with Shea Mortgage's assessment that the audit memorandum contains allegations of false certifications. The memorandum presents facts as discovered and reviewed by the OIG and recommendations to remedy associated findings. Recommendation 1F is appropriate in that it calls for a review of the facts presented and a determination of legal sufficiency with regards to civil or administrative actions. As stated in comment 7, our findings and recommendations adhere to the goal and mission of the OIG, to promote the effectiveness and efficiency of government operations by ensuring HUD rules and regulations are followed.

Comment 19 Shea Mortgage is correct in that the memorandum and associated recommendations are addressed to HUD. As with any OIG review, we work closely with HUD throughout the review process to ensure a fair and appropriate audit resolution is reached.

Comment 20 We disagree with Shea Mortgage's characterization of the OIG reporting process. The OIG conducts a review and reporting process that is both fair and balanced. Shea Mortgage was informed throughout the review process to ensure awareness, communication, and cooperation by all involved parties, including HUD. A preliminary finding outline was presented to Shea Mortgage on August 7, 2012 and we held an exit conference, attended by Shea Mortgage and HUD, on September 10, 2012. Lastly, Shea Mortgage was given the opportunity to present its formal response to the memorandum on September 12, 2012, a copy of which is included in appendix B of this memorandum. Therefore, we do not agree that a qualifying statement, as presented by Shea Mortgage, is necessary as the report is considered a final presentation of the OIG review, findings, recommendations, and comment.

Appendix C

SUMMARY OF FHA LOANS REVIEWED

Table 1 - Actual loss to HUD
Claim loan review results

FHA loan number	Recommendation 1A – actual loss to HUD[17]
023-2611543	$ 87,713
023-2623121	103,920
023-2625332	89,954
023-2653067	92,082
023-2665246	92,767
023-2690995	112,258
023-2704782	123,689
023-2735251	134,764
042-8062258	175,641
045-6569558	172,325
048-4598743	282,498
Total	**$ 1,467,611**

[17] The actual loss to HUD was obtained from HUD's Single Family Data Warehouse.

Table 2 - Claims paid, loss unknown
Claim loan review results – including one active sample loan

FHA loan number	Claim (C) or active sample loan (A) review	Recommendation 1B – claims paid, but no actual loss known[18]
023-2596452	C	$ 99,626
023-2626610	C	129,068
023-2641624	C	98,358
023-2898853	C	118,232
023-2901453	C	97,237
023-3310027	C	73,372
023-3326637	C	260,816
023-3360032	C	195,205
023-3417172	A	135,699
023-3675102	C	57,661
042-8458484	C	76,229
045-6578291	C	160,077
048-4815787	C	379,290
048-4832625	C	160,873
048-5045815	C	141,212
048-5156819	C	60,839
048-5414443	C	77,681
048-6011949	C	100,060
197-3943960	C	145,302
Total		**$ 2,566,837**

[18] The claims paid values were obtained from HUD's Neighborhood Watch system, refreshed on July13, 2012.

Table 3 - Potential loss to HUD
Active loan sample results

FHA loan number	Unpaid mortgage balance[19]	Recommendation 1C – potential loss on active loans[20]
023-2917158	$ 109,828	$ 72,486
023-3033897	229,444	151,433
023-3680699	218,635	144,299
023-3807711	181,297	119,656
023-3924257	124,924	82,450
023-3939455	252,234	166,474
023-4004766	273,895	180,771
023-4174672	172,649	113,949
023-4286251	225,358	148,736
023-4457438	339,107	223,810
042-8097552	470,156	310,303
042-8489458	402,165	265,429
043-7996426	345,364	227,940
043-8601716	335,501	221,431
048-5067748	302,623	199,731
048-5265726	260,582	171,984
048-5366739	228,718	150,954
048-5472134	289,590	191,130
048-5600922	283,753	187,277
048-5705273	288,922	190,689
048-6256999	271,598	179,254
048-6504370	332,099	219,185
197-4021464	394,395	260,301
197-4387122	331,225	218,609
197-4678911	284,563	187,812
197-4966271	508,311	335,485
197-5314302	258,520	170,623
Total	**$ 7,715,456**	**$ 5,092,201**

[19] The unpaid mortgage balance for each loan was obtained from HUD's Neighborhood Watch.
[20] The potential loss was estimated based on HUD's 66 percent loss severity rate, multiplied by the unpaid mortgage balance. The 66 percent loss rate was the average loss on FHA-insured foreclosed-upon properties based on HUD's Single Family Acquired Asset Management System's "case management profit and loss by acquisition" computation ending December 2011.