

TO: Gary T. Le Vine, Director, Single Family Housing Division, 1EHS

FROM: William D. Hartnett, District Inspector General, Office of Audit, 1AGA

SUBJECT: Processing of 48 Defaulted
Single Family Mortgages
New Hill Homes
New Haven, Connecticut

We performed a review of the Connecticut State Office's (CSO) processing of 48-single family defaulted FHA insured mortgages collectively known as New Hill Homes. Our objective was to determine what actions are needed to minimize HUD's potential loss on these properties.

This report contains a finding documenting the delays in foreclosing and identifying specific actions to be taken to limit the Department's potential loss.

Within 60 days, please provide us, for each recommendation cited in the report, a status report on: (1) the corrective action taken; (2) the proposed corrective action and the date to be completed; or (3) why action is considered unnecessary. Also, please furnish us copies of any correspondence or directives issued related to this audit.

Should you have any questions, please contact our office at (617) 565-5259.

Executive Summary

We performed a review of the Connecticut State Office's (CSO), processing of 48-single family defaulted FHA insured mortgages collectively known as New Hill Homes. Our objective was to ascertain what actions are needed to minimize the potential losses to the insurance fund. We also wanted to determine if the actions necessary to finalize the foreclosure and initiate legal actions for deficiency judgments were being taken.

HUD's primary protection in cases of failure to pay single-family insured mortgages is foreclosure and, as appropriate, deficiency judgments against mortgagors. This process follows very specific legal steps including court proceedings. As a result, it could take several years to complete the process. Therefore, HUD should assure that the foreclosure process is not delayed.

Delays occurred

We found that the Mortgagee and the CSO contributed to delays in the foreclosure process. The Mortgagee attempted to obtain waivers of regulations and the CSO did not respond promptly to the Mortgagee's requests. In addition, the Mortgagor delayed foreclosure action by trying to refinance the mortgages. Because of those delays, the unpaid mortgages totalling \$2.7 million remained in default for over three years while owners collected subsidized rents in excess of \$2.4 million and made no mortgage payments. Unless deficiency judgments are obtained and collected, HUD could sustain a loss of more than \$2 million dollars.

Recommendations We are recommending that the foreclosures be finalized without any further extensions.

We are also recommending that once the properties are transferred to HUD, you request the Office of General Counsel in conjunction with the Department of Justice pursue deficiency judgments against the Mortgagor.

We provided the draft report to the Director, Single Family Housing Division on February 26, 1997 and received his response on March 7, 1997. The Director agreed with our recommendations. In addition, the Director stated that while avoidable delays occurred early in the foreclosure process, recent actions have been timely. The Director also stated that there was much opposition to HUD's decision to foreclose rather than accept blanket assignment.

We have evaluated and included the Director's comments in the finding as we

considered appropriate. We have included a copy of the Director's comments in Appendix A of this report.

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Abbreviations	
CFR	Code of Federal Regulations
CSO	Connecticut State Office
FHA	Federal Housing Administration
HUD	Department of Housing and Urban Development
OIG	Office of Inspector General

Introduction

HUD insured 48 single-family homes located in New Haven, Connecticut under a pilot 203k program in 1984. Collectively, these 48 individual mortgages are referred to as New Hill Homes. The properties, which contain 139 dwelling units, were developed by Michael C. Kantrow who is also the guarantor of the mortgages. In 1984, Mr. Kantrow executed notes and granted mortgages of his interest in the properties to Community Development Corporation who subsequently endorsed the notes and assigned its interest in the mortgages to the Connecticut National Bank now known as Fleet National Bank. In 1984, Mr. Kantrow transferred his interest in the premises to New Hill Homes Associates Limited Partnership but remained as guarantor of the mortgages. The mortgages were financed by tax exempt bonds issued by the State of Connecticut.

HUD, through the State of Connecticut's Department of Economic and Community Development, subsidized 92 of the 139 units under the Moderate Rehabilitation Section 8 program. The annual budget authority for these units amounted to \$1,184,383.

The Connecticut State Office's (CSO), Single Family Housing Division is responsible for the processing of single family defaulted FHA insured mortgages. HUD's servicing policies are directed toward protecting the Department's interest in insured mortgages by minimizing HUD's losses where claims cannot be avoided.

Processing of defaulted mortgages are carried out by mortgagees. HUD generally does not get involved in the foreclosure process unless requested to do so by the mortgagee and/or the mortgagor. In the case of New Hill Homes, the mortgagee (Fleet National Bank) requested HUD to waive certain regulations and accept assignment of the 48 defaulted mortgages.

During 1996, Mr. Kantrow attempted to form a non-profit organization to buy back the mortgages at a substantial discount under a HUD program. The CSO was considering Mr. Kantrow's proposal until a September 30, 1996 HUD imposed suspension removed Mr. Kantrow from any further dealings with the Department.

Audit scope and methodology

The objective of our review was to determine if adequate and timely actions were taken to protect HUD's interests and to minimize HUD's losses.

To accomplish our objective, we:

- o Obtained an understanding of the relationships of all parties involved with the mortgages.
- o Reviewed regulations and HUD Handbooks.
- o Reviewed CSO and mortgagee files/correspondence.
- o Obtained assistance on legal matters relating to the ownership and other legal transactions from the Assistant General Counsel's staff and OIG's legal staff.
- o Reviewed selected income and expense data maintained by an identity-of-interest Management Agent for these properties.
- o Interviewed Headquarters, CSO, General Counsel and mortgagee staff.

Review period

Our review work was performed from December 1996 to February 1997. The audit covered the period February 1994 through February 1997. When appropriate, the review was extended to include other periods.

We conducted the review in accordance with generally accepted government auditing standards.

Need to Foreclose and Initiate Legal Action for Deficiency Judgments

The CSO's Single Family Housing Division has delayed foreclosure action on 48 single-family defaulted mortgages, with unpaid principal balances totalling approximately \$2.7 million. The defaults on the 48 single family mortgages, which contained 139 dwelling units, began February 1994 and the process has yet to be finalized. The delays in processing these defaults to foreclosure has allowed the mortgage guarantor to collect in excess of \$2.4 million in subsidized rents while not making any mortgage payments. It is estimated HUD's loss could exceed \$2 million. Legal action needs to be initiated to file and collect deficiency judgments against the guarantor of the mortgages.

HUD's protection is foreclosure

The mortgagee is the primary party responsible for servicing the FHA insured mortgages. When a default occurs, mortgagees must take appropriate actions which generate the smallest financial loss to the insurance fund. HUD's primary protection for non-payment of single-family mortgages is foreclosure and as appropriate, a deficiency judgment. Therefore, it is necessary for HUD to respond promptly to mortgagee inquiries to keep the process moving as expeditiously as possible.

Mortgagee may initiate foreclosure without delay

The regulations (24 CFR 203.606) provide that the mortgagee may initiate foreclosure without delay, if the mortgaged property is not the mortgagor's principal residence and it is occupied by tenants who are paying rent, but the rental income is not being applied to the mortgage debt or the property is owned by a corporation or partnership. The 48 properties in default met all these criteria.

Mortgagee requested assignment

Although clearly allowed by the regulations, the mortgagee did not commence foreclosure, but rather chose to request HUD accept assignment of the mortgages in order to avoid foreclosure. This request was made even though 24 CFR 203.650 states that a mortgage will not be eligible for assignment in any case where the mortgagor owns two or more properties occupied by tenants who are paying rent and the rental income from the property is not being applied to the mortgage.

Rental income not used to pay mortgage

Since January 1994, the owner/guarantor of mortgages received rental income of at least \$2.4 million with at least \$1.9 million funded by Section 8 subsidies. However, during this same time, the owner/mortgage guarantor did not make any mortgage payments.

Possible loss of \$2 million

The decision by the mortgagee to pursue assignment and the lack of responsiveness by the CSO delayed the foreclosure process and could contribute to substantial losses to the FHA insurance fund. At the time of the default, the unpaid principal balance of the 48 mortgages totalled \$2.7 million. Based on the mortgagee's calculation, accrued interest through March 31, 1997 is approximately \$1,148,000 and unpaid taxes another \$300,000 for a total outstanding debt of \$4,148,000. A January, 1996 appraisal valued the properties at \$2,110,000, therefore, there is a potential loss to the insurance fund of \$2,038,000 if deficiency judgments are not collectable.

Detailed below is a chronology of events detailing the delays to foreclose on these mortgages.

Mortgagor defaults

The mortgagor failed to make the February 1994 mortgage payments on the 48 insured mortgages, placing all 48 mortgages in default. The mortgagee notified HUD of the defaults on May 2, 1994.

HUD does not respond

On August 29, 1994, October 11, 1994, and January 10, 1995 the mortgagee requested the CSO to consider assignment of the insured mortgages. Despite an increasing level of concern expressed by the mortgagee, the CSO did not respond to any of these letters. This contributed to the delay in initiating foreclosure proceedings by at least five months.

Mortgagee expresses frustration with CSO

On April 11, 1995, 14 months after the mortgage defaults, the mortgagee wrote to the CSO again referencing the three previous unanswered letters and expressing their frustration at not receiving a response to their requests for assignment. This letter stated that the mortgagee had completed the preparation of foreclosures and intended to commence foreclosure if a formal extension of the date to initiate foreclosure was not forthcoming.

CSOs first written response

On April 21, 1995, the CSO in their first response to the mortgagee, advised that 37 of the mortgages were ineligible for assignment and Headquarters is unwilling to grant waivers. The remaining 11 mortgage assignment requests are under review by Headquarters. The letter indicated the CSO would consider extending the date to initiate foreclosures on all 48 properties to September 30, 1995.

Unsupported CSO extension

On May 22, 1995, the CSO formally approved the extension of the date for initiation of foreclosure for all 48 properties to September 30, 1995, ". . . in order to provide adequate time for refinancing of the mortgages to prevent foreclosure." Neither the CSO nor the mortgagee were able to furnish documentation that a refinancing plan was under consideration and was being actively pursued.

Undocumented basis for approving extension

The basis for the CSO's decision to extend the foreclosure dates for the 48 mortgages to September 30, 1995 was not documented. The mortgages for 37 of the properties were clearly ineligible for assignment or waivers and should have been foreclosed. Further, there is no evidence that a decision was obtained from Headquarters on the remaining 11 mortgages. The CSO was unable to furnish any evidence of the request to Headquarters or any follow up on the request.

CSO was still unresponsive

On September 8, 1995 the mortgagee wrote the CSO that since they had not received a written response concerning HUD's willingness to accept assignment of the remaining 11 mortgages, they were left with no choice but to assume that assignment had been denied. The letter stated that foreclosure would commence on all 48 mortgages and requested the CSO to notify them immediately if this was not correct. The CSO files contain no evidence of a response to this letter.

Mortgagee initiates
foreclosure 19 months
after default

On September 14, 1995, nineteen months after default, the mortgagee finally initiated the foreclosure process on the 48 mortgages by filing complaints in court for each property. The foreclosure actions were contested by the owner, the guarantor of the mortgages, and the tenants. Negotiations continued among the parties through August 1996 when Stipulated Judgments acknowledged that the defendants had withdrawn all defenses to the foreclosures, with the exception that the owner and the guarantor of the mortgages retained their rights to challenge the amount of the debt at any future deficiency judgment hearing.

Law days

Part of the foreclosure process is to establish a "law day" which is the last day an owner can retain title to the properties by paying off all monies due under the mortgage.

Two properties foreclosed
- Possible loss \$137,282

Two of the properties had "law days" established of September 30, 1996 and the mortgagee obtained title to the properties which were subsequently deeded to HUD on November 13, 1996. The mortgagee is currently pursuing deficiency judgments on the two properties amounting to \$137,282.

CSO extends law days to
3/31/97

Thirty eight of the remaining 46 mortgages initially had "law days" established of October 31, 1996. On October 29, 1996, the CSO requested the mortgagee to extend the "law days" to March 31, 1997 to allow time to pursue an alternative procedure to foreclosure. This procedure would allow a nonprofit company to purchase the properties without the properties being conveyed to HUD. At HUD's request, the mortgagee obtained from the court, extensions of the "law days" to March 31, 1997. For this procedure to succeed the owner/guarantor of the mortgages would be required to approve each sale to the nonprofit, if it was to occur prior to the "law day" as planned.

Agreement to sell properties failed

Although, the CSO thought that they had an agreement from the owner/guarantor of mortgages for this procedure, the agreement failed to materialize when the guarantor of the mortgages attempted to obtain additional monies through the sales to pay off loans. As a result, the CSO now plans to allow the "law days" to pass allowing the foreclosure process to be completed.

The mortgagee was able to negotiate "law days" of March 31, 1997 on the remaining 8 mortgages. Therefore, the foreclosure process can be completed for all 46 remaining mortgages on March 31, 1997.

Single Family Director responds

The Director, Single Family Housing Division, CSO concurred in our recommendations and advised that appropriate instructions have already been issued to the Mortgagee. The Director stated that the CSO will vigorously pursue deficiency judgments once conveyance has been completed. The Director further commented that while avoidable delays did occur early in the foreclosure process current actions have been timely and appropriate. He believes that actions currently being taken will maximize recovery, provide homeownership opportunities for low and moderate-income families, avoid further neighborhood blight and prevent negative media coverage of HUD. He also stated that HUD's decision to foreclose was very unpopular and not well received.

Recommendations We recommend that you:

- 1A. Instruct the Mortgagee to foreclose on the remaining 46 properties on March 31, 1997.
- 1B. Assure that the mortgagee obtains title to the properties, and deeds them to HUD.
- 1C. Assure that the Motions for Deficiency Judgment are filed on each property no later than April 30, 1997.
- 1D. Request the Assistant General Counsel to pursue the Deficiency Judgments in conjunction with the Department of Justice.

Appendix A

Auditee Comments

Appendix B

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