RD/RHS Homeownership Programs: Owners' and Purchasers' Rights

NATIONAL HOUSING LAW PROJECT

advancing housing justice

RD/RHS

HOMEOWNERSHIP PROGRAMS:

OWNERS' and PURCHASERS' RIGHTS

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This Manual was produced to provide accurate and authoritative information about the housing programs of the United States Department of Agriculture and the laws that affect them. While it was written by attorneys, it is not intended as a substitute for the advice of an attorney who is familiar with your case and circumstances. If you need legal advice, contact an attorney or other professional where you live.

August 1, 2010

FOREWORD

The National Housing Law Project (NHLP) is very pleased to publish *Rural Development and the Rural Housing Services: Single Family Housing Programs*. We offer this manual as a practical, and hopefully, valuable resource to our colleagues in the legal services and housing advocacy communities who stand alongside low-income tenants and homeowners of rural America and work tirelessly to deliver a greater measure of housing justice to their clients.

This manual is also dedicated to Arthur M. Collings, Jr., who devoted his life to improving housing conditions in rural areas and as a steadfast ally of our country's rural poor, worked continuously to ensure that the Rural Development/Rural Housing Service's housing programs effectively serve their constituencies. Mr. Collings served as a mentor and teacher to Gideon Anders, the manual's primary author, during their tenure together at the Housing Assistance Council. Without Mr. Collings' leadership and wise guidance, this manual would have never been written.

Special thanks to Gideon Anders, a Senior Staff Attorney at NHLP and its former Executive Director. *The Single Family Housing Programs* manual is a labor of love for Gideon, reflective of his encyclopedic knowledge and a lifelong commitment to alleviating the housing problems of the rural poor. Significant contributions to this manual were made also by David Rammler, Todd Espinosa and James Scruggs. We thank them all for their valuable contributions. We also thank Francis Antonio and Hailey Magsig for their meticulous formatting and typesetting assistance and Christian Kurpiewski, a student at UCLA School of Law and an NHLP summer intern, for his fastidious proofreading and cite checking.

Generous support for writing this manual came from The Ford Foundation. Our heartfelt thanks to the Foundation, which, among other goals, seeks to protect the hard-earned assets of low income families. The opinions expressed in this manual are those of the authors and NHLP, and should not be construed as representing the opinions or policy of The Ford Foundation or any other NHLP funders.

We hope that *Rural Development and the Rural Housing Services: Single Family Housing Programs* will serve as a valuable tool for practitioners and we welcome your feedback, suggestions, or corrections.

Marcia Rosen
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TABLE OF CONTENTS

CHAPTER 1
INTRODUCTION

CHAPTER 2
APPLYING FOR SECTION 502 LOANS AND SECTION 504 LOANS AND GRANTS

TABLE OF CONTENTS

CHAPTER 3
THE INTEREST SUBSIDY AND DEFERRED MORTGAGE PAYMENT PROGRAMS

CHAPTER 4
CONSTRUCTION DEFECTS

TABLE OF CONTENTS

CHAPTER 5
MORATORIUM RELIEF PROGRAM AND OTHER LOAN SERVICING TOOLS

CHAPTER 6
FORECLOSURES AND RECONVEYANCES

TABLE OF CONTENTS

CHAPTER 7
REFINANCING RD/RHS LOANS WITH PRIVATE FINANCING AND RECAPTURE OF INTEREST SUBSIDY

CHAPTER 8
DISPOSITION OF RD/RHS-OWNED SINGLE FAMILY PROPERTIES

CHAPTER 9
APPEALS

TABLE OF CONTENTS

Table of Cases

E

F

G

H

I

J

K

L

M

N

O

P

R

S

T

U

V

W

Y

INTRODUCTION TO THE MANUAL, RURAL DEVELOPMENT AND THE RURAL HOUSING SERVICE SINGLE FAMILY HOUSING PROGRAMS

CHAPTER 1
INTRODUCTION

1.1 ABOUT THIS MANUAL

1.1.1 REFERENCES TO RHS, RD and FmHA.

Since 1994, the Department of Agriculture has reorganized several times and, in the process, moved responsibility for the department's housing programs between various divisions and agencies. Prior to 1994, all of the department's rural housing programs were administered by the Farmers Home Administration (FmHA), which had a national office, state offices and sub-state field offices. In 1994, FmHA was eliminated and a new division created called the Rural Housing and Community Development Service (RHCDS). It administered the USDA housing programs at the national level but not at the state and local levels. There, the programs were handled by the Rural Economic and Community Development (RECD) division of the department.

RHCDS was renamed as the Rural Housing Services (RHS) one or two years after it was formed. Under both RHCDS and RHS, administration of the programs at the national level was handled by RHS staff, but field administration of the programs was shifted to the Rural Development (RD) division of the department. The RD structure and its administration of the USDA housing programs are described below.[1]

For a number of years now, USDA has sought to eliminate the RHS by referring to the national office staff as RD staff and calling the RHS housing programs the RD Housing and Community Facilities Programs.[2] However, for reasons that are not entirely clear, the department has not taken certain steps that remove legal responsibility for the housing programs from the RHS.[3] As a consequence, there are a number of instances where the department is forced to refer to RHS as the agency administering the USDA housing program. For example, the Administrator of the RD Housing and Community Development Programs is formally referred to as the Administrator for the Rural Housing Service and she testifies before Congress under that name.[4] Similarly, all rural housing regulations published in the Federal Register continue to be published under the RHS name.[5]

Because USDA has not fully abandoned the RHS moniker, this manual refers to the rural housing programs and the agency administering them as the Rural Development/Rural Housing Service (RD/RHS). While agency regulations are published in the Federal Register as RHS regulations this manual will also refer to them as RD/RHS regulations. References to agency publications, such as guidelines and handbook, will also be referenced as RD/RHS guidelines and handbooks.

In some instances references are made in this manual to FmHA or even RHCDS. This is done in historical references and because some of the agency's regulations, guidelines and forms have not been updated and continue to name FmHA or RHCDS as the agency administering the rural housing program. You should, however, be aware that these agencies are no longer in existence and reference to them is made simply because some current document continues to refer to them. You can and should substitute RHS or RD as the agency responsible for the duties, obligations, or services that are attributable to FmHA or RHCDS.

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[1] *See* § 1.3, *infra*.

[2] *See*, *e.g.* http://www.rurdev.usda.gov/rhs/ (last visited Oct. 5, 2009).

[3] It appears that the administration of the USDA housing program is statutorily delegated to RHS and that USDA has not requested Congress to redelegate the programs to RD.

[4] *See*, http://www.rurdev.usda.gov/rhs/Admin/administrator.htm (last visited Oct. 1, 2009).

[5] *See e.g.* 74 Fed. Reg. 19505 (April 29, 2009).

1.1.2 HOW THIS MANUAL IS ORGANIZED

This manual was written by the staff of the National Housing Law Project (NHLP) and provides the basic information necessary to represent applicants for, or borrowers under, the RD/RHS single family housing programs. This includes the single family direct and guaranteed loan programs, authorized under Section 502 of the Housing Act of 1949,[6] and the home repair loan and grant programs authorized under Section 504 of that act.[7] In writing this manual, we have assumed that the reader knows little, if anything, about these programs and their operation.

This manual does not discuss the RD/RHS multi-family housing programs. Regrettably, NHLP has not had funding to update that portion of the 1994 manual on the RD/RHS housing programs.

Chapter 1 provides instructions on its use; a brief history and description of the RD/RHS, its authorizing legislation, issuance system, and bureaucracy; a general description of each of the programs covered by this manual; and a description of recurring themes in the federal and RD/RHS housing programs. The program description section should be helpful if you are confused by the RD/RHS programs and terminology and their interrelated and overlapping parts. The section on recurring themes is designed to provide background information for placing particular housing problems in a larger context.

Chapters 2 through 9 are devoted to the operations of the RD/RHS single-family home loan and grant programs. These chapters cover common issues that applicants for RD/RHS loans or RD/RHS borrowers may encounter when dealing with the RD staff, RHS, or private lenders whose loans are guaranteed by the agency. Separate chapters cover the application process, defects in construction, appeals, foreclosures, and other issues. Again, many issues faced by applicants or borrowers do not fit neatly into the categories we have selected but have aspects that overlap two or more chapters. Whenever issues relate to a discussion in another chapter, we have attempted to insert appropriate cross-references. Nonetheless, check for related chapters or sections to which cross-references have not been made. The discussion in chapters 2 through 9 applies equally to all of the single-family loan and grant programs unless it is specifically limited to one program.

We are not including in this manual a chapter on some common substantive law questions and procedural issues that arise in litigation concerning the federal housing programs. The material in the 1994 version of this manual was taken in large part from our *HUD Housing Programs: Tenants' Rights* (1994) manual. We refer you to Chapter 16 of the current edition of that manual, which was published in 2004 and was recently updated by the *2010 Supplement.*

We have included a detailed table of contents to help you find the relevant text for your client's problems. The table of cases also includes references to the sections of the text where the cases are discussed or cited.

In preparing the manual, we have researched relevant statutes, RD/RHS regulations, RD/RHS Handbooks, RHS/RD Administrative Notices and Unnumbered Letters, forms, reported and unreported judicial decisions. We have also reviewed posted National Appeals Division opinions, although the citations to these opinions are not exhaustive because of the voluminous number of appeals decisions. With a few noted exceptions, the research has been carried through July of 2009, so you should check for subsequent developments. For unreported cases, we have included available references that should enable you to secure opinions and pleadings directly from the referenced source. Unfortunately, some of those sources may no longer have copies of older opinions or pleadings. We have nonetheless maintained the references for significant decisions of which you should be aware.[8] Where appropriate,

[6] 42 U.S.C. § 1472 (West 2003).
[7] *Id.* § 1474.

[8] For example, we understand that the Sergeant Shriver Center on Poverty Law, which publishes the National Clearinghouse, does not have ready access to many older pleadings and decisions that have been sent to it and are catalogued in the older issues of the National Clearinghouse. To determine whether a cited opinion is still available, you will have to contact the Shriver Center. The Shriver Center website is accessible at http://www.povertylaw.org/. The Shriver Center can also be contacted at 50 East Washington Street, Suite 500, Chicago, Illinois 60602; (312) 263-3830 (voice); (312) 263-3846 (fax).

we have also included the Westlaw or LEXIS case number for other unreported opinions.

To the best of our knowledge, other than the earlier editions of this manual, there has been no previous attempt to write about the operations of the RD/RHS housing programs from the applicant's and borrower's perspectives. The relatively small number of cases and materials available on the operations of the programs has forced us to rely frequently on our own experiences and observations. Because RD is a highly decentralized agency, its programs operate somewhat differently in different states or localities.

1.2 HISTORY AND DEVELOPMENT OF FmHA AND ITS SUCCESSORS, RHCDS AND RD/RHS

1.2.1 FARMERS HOME ADMINISTRATION

Until 1994, FmHA[9] was an agency of the United States Department of Agriculture (USDA) that administered over 28 housing, rural development, and farm programs through a system of 1,900 county, 260 district, and 46 state offices located in rural areas nationwide. Although FmHA was established in 1949, its origins may be traced back to the Resettlement Administration, a rural rehabilitation agency created by President Roosevelt in 1935. During its two years of existence, the Resettlement Administration made hundreds of thousands of short-term loans, often supplemented by grants, to low-income families to help them become self-supporting. These borrowers also received supervision and technical counseling to assure that the purposes of the loans would be achieved.

The apparent success of the Resettlement Administration's short-term loan program prompted Congress to pass the Bankhead-Jones Farm Tenant Act,[10] which authorized 40-year farm ownership loans to farmers who lacked other sources of credit for buying land and for making improvements to their farms and homes. Although administration of this program was placed in the hands of the Resettlement Administration, in 1938 the agency was transferred from the Office of the President to the Department of Agriculture and renamed the Farm Securities Administration (FSA). During the next nine years, the FSA administered credit programs enabling thousands of farmers to become farmowners. Farm and home counseling was part of the FSA's service to borrowers.

In addition to administering the Farm Tenant Act, the FSA carried on resettlement-oriented projects to establish new farms and communities, group medical care services, agricultural cooperatives, migratory labor camps,[11] and other social and economic programs. These activities of the FSA came to be viewed as socialistic, impractical, and leading to the regimentation of clients and to the destruction of their individualism, initiative, and self-respect.[12] Substantial political opposition forced the elimination of many of the resettlement programs and reorganization of the FSA into the FmHA in 1946. Various programs previously administered by other agencies within the USDA were consolidated into the FmHA, along with several new farm programs.

FmHA's entry into the rural housing field began with the Housing Act of 1949.[13] Under Section 502 of the Act, the agency was granted authority to make housing loans to farmers in need of decent, safe, and sanitary housing for themselves and for their laborers. Section 504 of that act created the home repair loan and grant program for those farm-

[9] Until 1974, FmHA was officially and commonly referred to as the FHA. Because references to FHA often led to confusion with the programs of the Federal Housing Administration, also known as the FHA, FmHA officially changed its initials. 39 Fed. Reg. 14,499 (Apr. 24, 1974).

[10] Ch. 517, 50 Stat. 522 (1937) (codified at 7 U.S.C.A. §§ 1010-1012 (West, WESTLAW, Current through P.L. 111-69 (excluding P.L. 111-67 and 111-68) approved 10-1-09).

[11] This was the only housing program undertaken by the Resettlement Administration and later operated by the FSA. Ninety-two small but well-planned camps were constructed under the program. Most were permanent units but a few included tents and other temporary shelters. Rents were minimal, ranging from nothing to $3.25 per week. When the FSA was reorganized in 1947, responsibility for these projects was transferred to the United States Public Housing Authority, which was directed to sell them. When sale proved impossible, the remaining camps were given to county public housing authorities on the condition that they be operated for the benefit of farmworkers or other low-income families. Some of these camps are still in use. Reno, Roisman, and Schapiro, *Legal Services and the Rural Poor: A Discussion of Housing and Other Neglected Issues* (Legal Services Corp. 1977).

[12] A. Aaron, SHELTER AND SUBSIDIES, 147-48 (1972).

[13] Pub. L. No. 81-171, 63 Stat. 413 (1949).

ers who were in need of decent shelter, but who were too poor to pay back a Section 502 loan.

Between 1949 and 1961, the FmHA housing programs remained exclusively for the benefit of farmers and their tenants. The Housing Act of 1961 changed that by extending Section 502 and Section 504 loans to non-farm rural residents living in towns with populations up to 2,500 people.[14] In 1965, the service area for FmHA was expanded from towns with a population of 2,500 or less to those with populations below 5,500.[15]

From the standpoint of low-income persons, the first significant change in the FmHA programs came in 1968 when the Interest Credit program was created. It authorized FmHA to subsidize Section 502 loans and lower the interest rates charged to a minimum of one percent.[16] The agency's ability to serve lower income families was expanded substantially through this program. The 1968 amendments to the 1949 Housing Act also institutionalized a self-help homeownership construction and ownership program, which previously had been operated primarily under the auspices of the American Friends Service Committee.[17]

Changes in the FmHA programs continued throughout the 1970s and 1980s. In 1970, the agency's service area was increased to towns of up to 10,000 in population,[18] and in 1974, to towns outside Metropolitan Statistical Areas (MSA) with populations up to 20,000.[19] An FmHA appeals procedure was mandated in 1979,[20] while a new Housing Preservation Grant Program, providing for grants to nonprofit and public agencies for the rehabilitation of single-family homes and multifamily rental housing, was authorized in 1983.[21]

Several other significant changes were made to the FmHA programs in the early 1990s. At the urging of the first Bush administration, which was hoping to phase out the direct Section 502 loan program, a single-family guaranteed loan program was permanently authorized,[22] and, for the first year of the program, a number of these loans were subsidized by Interest Assistance.[23] At the same time, some FmHA loan assistance was targeted to areas and persons with the greatest need for housing assistance.[24] A deferred mortgage demonstration program was authorized and funded to enable FmHA to serve families that otherwise would not qualify for Section 502 loans by deferring up to 25 percent of their monthly payment.[25]

Until 1990, FmHA's authority expanded in many other areas in addition to housing. Community development loan and grant programs and farm loan programs were added to the agency's authorities by various acts, including the Rural Development Act of 1972[26] and the Agricultural Credit Acts of 1978[27] and 1987.[28] That expansion, however, halted in 1990 when Congress created the Rural Development Administration (RDA) within the Department of Agriculture and authorized the transfer of FmHA's community development programs to the new agency.[29]

1.2.2 THE RURAL HOUSING AND COMMUNITY DEVELOPMENT SERVICE

Prior to the 1960s, when FmHA's housing role was expanded substantially to include rental and subsidized housing for low-income rural residents, FmHA's mission was focused almost exclusively on agriculture and agricultural support activities. The agency's primary functions were loans to farmers for the purchase and operation of farms. Its housing activities were viewed as incidental to the main agricultural activity and were directed at providing housing to farmers and persons working on farms or in other agricultural activities.

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[14] Pub. L. No. 87-709, §§ 801(a), 803, 75 Stat. 186 (1961).
[15] Pub. L. No. 89-117, § 1007, 79 Stat. 451 (1965).
[16] *See* 42 U.S.C.A. § 1490a(a)(1) (West 2003).
[17] *See* Margolis, SOMETHING TO BUILD ON (1967) (a history of self-help housing published by International Self Help Housing Associates, Washington, D.C. (out of print).
[18] Pub. L. No. 91-609, § 803(e), 84 Stat. 1807 (1970).
[19] Pub. L. No. 93-383, § 511, 88 Stat. 695 (1974).
[20] Pub. L. No. 95-557, § 503, 92 Stat. 2112 (1978).
[21] Pub. L. No. 98-181, § 522, 97 Stat. 1250 (1983).
[22] Pub. L. No. 101-625, § 706(a), 104 Stat. 4284 (1990).
[23] *See* § 6.11.1, *infra*.
[24] Pub. L. No. 101-625, §§ 704(a), 706(b), 709(b), 104 Stat. 4283, 4284-86, 4288 (1990).
[25] *Id*. § 706(b). *See* § 2.4.2.2.1, *infra*.
[26] Pub. L. No. 92-419, 86 Stat. 657 (1972).
[27] Pub. L. No. 95-334, 92 Stat. 420 (1978).
[28] Pub. L. No. 100-233, 101 Stat. 1568 (1988).
[29] Funding for the RDA did not actually become available until 1992. Moreover, FmHA continued to operate many of the RDA programs under a separate memorandum of understanding because the RDA was never fully staffed. The 1994 reorganization of the Department of Agriculture also eliminated the RDA.

The expansion of the agency's mission to include the provision of housing, particularly subsidized housing, to low-income rural residents created an uneasy tension in the agency between its agricultural support role and its housing and, later, community development role. Agency staff, who were required to have an agricultural background, often identified with farmers and viewed housing applicants and borrowers as undeserving poor people. Indeed, some FmHA employees, supported by farmer-dominated county committees, which at the time made loan decisions, viewed the housing programs as conflicting with the agency's farm support role. They viewed the housing programs as providing program beneficiaries with security and independence that undermined farmers' ability to recruit and retain a cheap and subservient labor force.

This tension manifested itself in a number of ways, including rejection of applicants who were not viewed as deserving or of high moral character. In many instances, greater assistance and services were being provided to farmers than to homeowners and renters because farmers were considered as deserving and the latter groups were not. Homeowners were not given foreclosure relief because they had been given their chance when their loans were made and FmHA staff felt that that was all they were entitled to receive. When agricultural emergencies arose, in the form of droughts, freezes or floods, rural housing loan processing often came to a halt.

While attitudes changed with time and with FmHA hiring of staff whose time was dedicated exclusively to housing, the tensions continued to persist into the 1980s and even into the 1990s. Notwithstanding this tension, rural housing and community development advocates were reluctant to separate the agency's farm and housing and community development functions for fear of losing broad rural support for program funding. Thus, when some of FmHA's community development programs were shifted to the Rural Development Administration (RDA) in 1990, rural housing advocates resisted a similar transfer of the housing programs by securing legislation prohibiting such a transfer.[30] What finally brought about the separation of the rural housing and farm programs was the Clinton Administration's effort to streamline and reduce staffing at the Department of Agriculture. Pursuant to legislation authorizing the Department's reorganization,[31] all of its housing, utility, community, business and cooperative development were consolidated under the umbrella of a division called Rural Economic and Community Development (RECD). Within RECD, the housing and community development programs of FmHA and RDA were placed in the Rural Housing and Community Development Service (RHCDS). The FmHA farm programs, together with conservation reserve and agricultural conservation programs, which were formerly administered by the Agricultural Stabilization and Conservation Service, were placed in the Consolidated Farm Service Agency.[32] Thus, for the first time in nearly 30 years, the FmHA housing and farm programs were separated.

1.2.3 RURAL DEVELOPMENT

Within a couple of years of their formation, the RECD and RHCDS were reorganized and renamed as the Rural Development (RD) and Rural Housing Service (RHS). In the process, all the FmHA field offices were renamed and reorganized as RD offices and the RHCDS was effectively reduced to a Washington, DC, based division of RD responsible for the national administration of what were formerly the FmHA housing programs.

RD and, in particular, the RHS housing programs did not fare well during the George W. Bush administration, which despite its promotion of homeownership did not have much empathy for homeownership programs that served low-income households. Throughout its eight year term, the Bush administration sought to eliminate the single-family direct loan program by proposing to eliminate funding for the program and shifting ever greater funding to the guaranteed loan program, which serves a higher income clientele. When Congress refused to defund the direct loan program, the administration accelerated the closing and consolidation of RD local offices, making it more difficult for individuals to reach RD offices and apply for

[30] 42 U.S.C.A. § 1471(j) (West 2003).

[31] Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994, Pub. L. No. 103-354, 108 Stat. 3178 (Oct. 13, 1994), *reprinted in* 1994 U.S.C.C.A.N. (108 Stat.) 3178.

[32] USDA, Secretary's Memorandum 1010-1 (Oct. 20, 1994).

direct loans. Indeed, the practice became so prevalent that Congress attempted to stem it by using appropriations acts to preclude RD from closing any further offices without first notifying Congress and determining that the closing is cost effective.[33] Nonetheless, the consolidation has had an impact on many local and area offices, which either do not have sufficient staff to process new direct loan applications or have other demands placed on the limited staff.

While it is generally too early to judge how the Barack Obama administration plans to treat the single family homeownership programs, it is of note that over $1 billion in additional funding was made available for the programs under the American Recovery and Reinvestment Act and that six months after the program was funded, USDA announced that over 50,000 new homeowners were assisted by the funding.[34] It is yet to be seen whether RD will shift some emphasis away from the guarantee program to the direct loan program, provide more subsidies to the direct program and devote more staff to loan processing and servicing.

1.2.4 FUNDING LEVELS

While the FmHA housing programs were among a handful of federal new construction programs to survive the 1970s, their expansion was halted by budget cuts instituted by the Reagan and first Bush administrations. The Clinton administration attempted to revive the FmHA programs in the early years of the administration, however, opposition by a Republican controlled Congress continued to eliminate funding for the programs. The second Bush administration repeatedly tried to kill most of the agency's programs that served low income households but Congress opposed that move, leaving the direct loan programs alive but without substantial funding.

Appropriations for all the FmHA housing programs reached an all-time high of $4.533 billion in Fiscal Year (FY) 1981.[35] By FY 1992, the FmHA housing appropriations dropped to $2.618 billion. In 2008, the overall RHS funding was $8.622 billion, however, nearly $ 6.224 of that amount was for the guaranteed single and multifamily housing programs, which serve a higher income clientele. Effectively, this left $2.397 for all other RD/RHS programs, including the Rental Assistance program, which required more the $900 million. Moreover, because of inflation, the impact on the number of units financed was even more dramatic. In FY 1981, FmHA loans financed 118,600 units of new, existing and rehabilitated housing.[36] By Fiscal Year 1992, the number of units financed by FmHA had dropped to 46,905.[37] In 2008, the total number of new units financed was 106,684; however, 85,568 of these units were financed by the Section 502 single family guaranteed loan program and the Section 538 guaranteed rural rental housing loan program. This means that only 21,116 single and multi-family housing units that serve low income households were produced in 2008.

The single family direct home loan program was dramatically affected by the repeated budget cuts that stretched from 1985 to 2008. In 1976, the program produced an all-time high of 132,771 units. By 1991, it dropped to 11,403 units, and by 2008, it dropped to the lowest level since 1961, by producing only 9,831 units.

It is currently too early to tell what the Obama administration will do with the single family direct loan program. Generally, it professes support for the program and expresses a need to serve low income households; however, larger budget constraints are likely to inhibit the administration's expression of support. Moreover, early signals appear to suggest that the administration is unwilling to shift the resources for the guaranteed loan program to the direct program because it sees a need to continue the guaranteed program and views its cost as being quite moderate.

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[33] Omnibus Appropriations Act, 2009, Pub. L. 111-8, § 714 (Mar. 11, 2009).

[34] AGRICULTURE DEPUTY SECRETARY MERRIGAN ANNOUNCES USDA HAS HELPED 50,000 AMERICANS BECOME HOMEOWNERS (USDA Press Release 0367.09, AUG. 5, 2009) (available at http://www.usda.gov/wps/portal/!ut/p/_s.7_0_A/7_0_1OB?contentidonly=true&contentid=2009/08/0367.xml) (last visited 10.1.09).

[35] *See* Agriculture, Rural Development and Related Agencies Program for Fiscal Year 1981, Pub. L. No. 96-528, 1980 U.S.C.C.A.N. (94 Stat.) 3095, 3105-3108.

[36] Housing Assistance Council, Inc., *HAC News* (Washington, D.C., Jan. 6, 1982).

[37] Housing Assistance Council, Inc., *The FmHA Housing Program in Fiscal Year 1992: "A Reasonable Year"* (Washington, D.C., Jan. 1993) (hereinafter HAC, *"A Reasonable Year"*).

1.2.4.1 Direct Loan Program Funding Mechanism

Although FmHA funding was reduced as part of Congress' efforts to control the budget, until 1994 comparatively little attention had been paid to FmHA's administration of its housing programs or its role in setting or meeting federal housing policies and objectives. One probable reason for this is the unique way in which FmHA housing programs have been funded. Originally, all FmHA housing loans were made directly to the borrower using appropriated federal funds. This was a unique method of financing the construction and purchase of housing since the federal government had previously encouraged private lending institutions to undertake the loan-making function by providing them with loan guarantees. FmHA was given authority to make direct rural housing loans because Congress recognized that traditional mortgage-lending institutions that provided urban dwellers with home financing did not exist in rural areas, and that housing programs could succeed only by making direct loans to borrowers using federally appropriated funds.

In 1965, as FmHA loan activity increased, Congress changed the method of funding most of the agency's loan programs. It did this by creating a revolving loan fund, known as the Rural Housing Insurance Fund (RHIF),[38] and authorizing FmHA to use it to make its housing loans. The RHIF was capitalized by special appropriations and by funds still in the previously appropriated direct loan accounts. From the borrowers' perspective, creation of the RHIF did not change the operations of the FmHA loan programs. It did, however, relieve FmHA from having to seek appropriations for most of its loan programs. The legislation authorized FmHA to replenish the fund through the sale of notes, known as Certificates of Beneficial Ownership (CBOs), to the Federal Financing Bank, which, in turn, sells them to the United States Treasury. The CBOs are secured by the assets of the RHIF, namely, borrowers' notes and mortgage instruments. Since the RHIF incurs losses due to defaults, the payment of subsidies, and administrative expenses, there continued to be a need for annual appropriations. Nevertheless, the need was so substantially reduced that, until the early 1980s, little attention was paid to the program's substantial expansion.

From a fiscal perspective, attention to the FmHA housing programs increased substantially throughout the 1980s and early 1990s because the Reagan and first Bush administrations were seeking to eliminate many federal housing programs in general, and the FmHA programs in particular, as a means of cutting federal spending. And while repeated efforts to eliminate the FmHA programs altogether failed, the two administrations were successful in substantially reducing appropriations for the direct loan programs.

In 1987, in a much criticized and fiscally questionable move, the Reagan administration also used the existing FmHA Section 502 loan inventory to reduce the federal deficit by selling in excess of $3 billion in loans to a privately created Delaware Trust, called the Rural Housing Trust 1987-1.[39]

More importantly, until 1992, the FmHA housing programs had enjoyed many supporters and few detractors, and, with some exceptions, have not been subject to the extensive abuses of the HUD/FHA programs. As a result, they did not draw the same degree of attention or congressional and press scrutiny as did the HUD/FHA programs. Indeed, up to that time, FmHA programs had received steadfast support from the building industry, rural constituents and advocates of rural development. Even the agency's critics have consistently supported the agency's objectives and sought increased funding for its staff and activities.

Increased budget scrutiny by practically all the recent administrations and Congress has precluded the growth of the direct rural housing programs. It has simply become too difficult to increase funding for subsidized loan programs that serve low income persons. This has become particularly true when the various administrations have been promoting the relatively inexpensive guaranteed loan program, which benefits lenders and moderate-income households.

Unfortunately, FmHA never received substantial scrutiny from tenants and purchaser beneficiaries. In part, this is due to the fact that, unlike their urban counterparts, low-income persons resid-

[38] *See* 42 U.S.C.A. § 1487(e) (West 2003).

[39] *See* § 6.10, *infra* for a discussion of RHT loans.

ing in rural areas are seldom organized and have no national organization that solely represents their interests. The National Rural Housing Coalition, the only national organization that represents consumers on rural housing issues, is dominated by nonprofit owners and developers whose primary concerns are levels of appropriations and program eligibility rules. Rural residents also lack local representation because they are constrained by various social, political and economic forces from asserting their rights and views. Moreover, because they are dispersed, they lack the critical mass necessary to influence decisions that affect their lives and benefits.

The expansion of legal services into rural areas has increased scrutiny of FmHA's, and now RD/RHS' practices somewhat, but not significantly. Rural legal services attorneys seldom have housing as their exclusive specialty; they carry a significant and varied case load, and as a consequence, are usually unable to represent clients in a manner that results in reforming the agency's practices. The restrictions placed on Legal Services Corporation funded programs and consolidation of these program have also virtually precluded them from bringing pressure on the agency in everything except individual cases.

1.2.5 TYPES OF LOANS AND BORROWERS

There are four classes of RD/RHS borrowers: those who have obtained "insured" loans, which are often also called direct loans; those who have RD/RHS-guaranteed loans; those who have insured loans and private "leveraged loans;" and a special class whose loans were at one-time insured, but have been sold to a private entity called the Rural Housing Trust 1987-1.

Persons who have obtained what the statute refers to as "insured loans" are a significant portion of outstanding RD/RHS borrowers. These individuals are in a unique position because their loan, even though referred to as an insured loan, comes directly from the federal government. It is for this reason that these loans are often also referred to as direct loans. All of the insured loan borrower's dealings are with RD/RHS or private subcontractors and not with any of the persons or institutions that invest their funds in the RHIF. This differs from the HUD/FHA and Veterans Administration (VA) practice, in which borrowers obtain their loans from a private mortgage lender, such as a bank, and the HUD/FHA or VA insures the credit institution against default by the borrower.

In its capacity as a direct lender, RD/RHS is potentially in competition with private lending institutions. Congress has therefore mandated that it operate as a lender of last resort. As such, it may make loans only to persons unable to obtain assistance from private mortgagees[40] and then only for as long as they are unable to obtain private financing.[41] In practice, these requirements are known as the "credit elsewhere test" and the "graduation requirement." The former requires RD/RHS to serve only applicants who are not eligible for commercial loans. The latter enables RD/RHS to require borrowers whose financial situation improves to refinance their RD/RHS loan with a private loan.

The second class of RD/RHS borrowers consists of recipients of guaranteed loans, also authorized by Section 502 of the Housing Act of 1949.[42] These loans are modeled after the HUD/FHA and VA loan programs in that the borrower obtains the loan from a private lender whom RD/RHS protects against the borrower's default. Except for a small number of loans made in Fiscal Year 1990, guaranteed loans are unsubsidized and, as a consequence, almost exclusively serve moderate-income persons. As discussed elsewhere in this manual, RD/RHS has not extended to guaranteed borrowers the servicing protections to which they are entitled by statute and which are designed to lessen the likelihood of foreclosure should they encounter circumstances that are beyond their control that make it difficult to continue making mortgage payments.[43]

During the George W. Bush administration, RD/RHS sought to increase the number of Section 502 loans made without increasing the fiscal budget for the program. It did so by encouraging private lenders to work with the agency by making private home loans in conjunction with the Section 502 loans. These private loans, known as "leveraged

[40] 42 U.S.C.A. § 1471 (c) (West 2003).
[41] *Id.* § 1472 (b) (3).
[42] *Id.* § 1472 (h).
[43] *See* § 6.11, *infra*.

loans," would have an interest rate that could not exceed 3%.

The fourth and final group of borrowers is composed of persons who originally had Section 502 loans, but whose loan instruments were sold to a private entity called the Rural Housing Trust 1987-1 (RHT). RHT was organized under Delaware law in 1987 for the sole purpose of purchasing approximately $3.2 billion in what were then FmHA Section 502 loan instruments after Congress directed that FmHA sell them in an effort to balance the Fiscal Year 1987 budget. FmHA received the discounted value of the loans, or approximately $2.7 billion, which was treated as income for the government in 1987.

By virtue of the loan instruments and special FmHA regulations, RHT loans continue to be subject to all RD/RHS regulations as if they were Section 502 loans.[44] However, the loans are now serviced by Chase Residential Mortgage Inc. Thus, borrowers whose loans have been sold to the RHT have no further dealings with the agency except in three cases. First, if the RHT borrower is the recipient of Interest Credit assistance, RD/RHS pays the assistance to the RHT on behalf of the borrower. Second, borrowers who have appealed hearing decisions of the RHT staff are entitled to seek review from the USDA's National Appeals Division. Third, to the extent that the loan is subject to recapture, RD/RHS is the entity to whom the recapture is remitted.

Due to the passage of time and the reduction in commercial interest rates, the current number of RHT borrowers is quite small.

1.3 ADMINISTRATION

The Housing Act of 1949 vests administration of the RD/RHS housing programs in the Secretary of Agriculture.[45] Until 1994, the Secretary of Agriculture delegated authority to administer the programs to the FmHA Administrator by way of the Undersecretary for Small Community and Rural Development. After the 1994 reorganization of the Department of Agriculture administration of the housing programs was delegated to the Administrator of the Rural Housing and Community Development Service (RHCDS) by way of the Undersecretary for Rural Economic and Community Development.[46] In the subsequent renaming of the division and agency, most of the RECD functions were transferred to the Rural Development division of the department and the housing programs were delegated to the Rural Housing Service, which was headed by the RHS Administrator. Officially, the USDA housing programs are still run by the RHS Administrator, although that person is internally referred to as the Rural Development Housing and Community Development Programs Administrator.

1.3.1 RD/RHS NATIONAL OFFICE

Rural Development (RD) is a division of USDA whose mission is to increase economic opportunity and improve the quality of life for all rural Americans. RD, which operates under the direction of an Undersecretary, operates in ten program areas including: utilities, renewable energy, housing, business and community development and facilities programs. RD has forty-seven state offices, each headed by a state director who is a political appointee and who, technically, reports to the Undersecretary for Rural Development. Several state directors are responsible for more than one state or territory.

RHS is an agency within the RD division. As before the various reorganizations, the RHS Administrator has a small staff of specialists located primarily in Washington, D.C., who assist the Administrator in carrying out the agency's housing programs' responsibilities. Collectively, it is referred to as the National Office. Directly under the Administrator is a Program Support Staff Director whose primary functions are to assist the RHS Administrator. The day-to-day operation of the single-family housing programs is carried out under the direction of the Deputy Administrator Single Family Housing Programs.

The RHS Administrator is a political appointee. However, unlike her FmHA predecessors, she is no longer subject to Senate confirmation. All RD/RHS persons of lower rank are career civil service employees.

[44] *See*, 7 C.F.R. § 1957.1 (2009).
[45] *See, e.g.*, 42 U.S.C.A. §§ 1471, 1480 (West 2003).
[46] USDA, Secretary's Memorandum 1010-1 (Oct. 20, 1994).

1.3.2 RURAL DEVELOPMENT FIELD STAFF

The similarities between the FmHA and RD/RHS administrative structure end at the National Office. In fact, unlike the FmHA before it, RHS has no field staff whatsoever. The housing programs are administered in the field by Rural Development employees. These employees also administer other RD programs such as utility programs and business and cooperative programs.

RD has a state office responsible for each state and territory. Forty-six states and the Commonwealth of Puerto Rico have their own state office; the remaining states and territories share five state offices.[47] Each RD state office is headed by a State Director who is a political appointee of the Secretary of Agriculture and, therefore, subject to political pressures and influences. State Directors are directly responsible to the Undersecretary for Rural Development and not the Administrator of Housing. Thus, the working relationship between RHS' national office and RD State Directors, and, ultimately, RD field staff, is heavily dependent on the relationship between the RHS Administrator and the Undersecretary for Rural Development.

Typically, each state office maintains a small staff of program and technical specialists who advise the State Director and other state staff on specific agency program operations and technical requirements. Although state office organization is left to the State Director, most states have a Chief of Rural Housing who is responsible for the housing programs in the state. Other staff members in the state office may report to that individual with responsibility split between the single-family and multi-family programs.

In each state RD is organized either on a two or three level basis. In a two level state, RD operates all of its services from area offices. In a three level state, the agency has one or more area and local offices. RD offices can be located through the agency's website at http://www.rurdev. In total, RD has approximately 400 area and local offices, substantially fewer than the approximately 1800 offices that were operated by FmHA. As a consequence, it is not as convenient to file an application for an agency loan or grant or to secure personal support when facing a hardship or defaulting on a loan.

RD area and local office staff are responsible for administering all of the RD programs, including the housing programs. In most cases a staff member will specialize in the single-family home loan programs. Generally, with respect to the single-family loan program the local RD staff is primarily focused on loan making as the loan servicing functions of the agency have been transferred to the Centralized Servicing Center (CSC), located in St. Louis, Missouri. In some instances, however, CSC will call on local RD staff to assist in servicing loans that are in default.

1.3.3 CENTRALIZED SERVICING CENTER

As part of the FmHA reorganization, RD/RHS created a St. Louis, Missouri, based Centralized Servicing Center (CSC), which is responsible for handling all borrower accounts and payments, maintaining all borrower records and undertaking loan servicing. The office was set up as a way to streamline the loan servicing functions of the agency and to reduce the cost of loan administration. Unfortunately, it also dismantled an extremely personal and effective loan servicing system which had been in place for nearly 50 years.

While RD field staff is still called in to service loans under special circumstances, all routine loan servicing is handled by mail or phone from St. Louis. Borrowers and their representatives have complained that access to CSC staff is restricted by the fact that CSC is only open between 7 a.m. and 5 p.m. Central Standard Time, making it difficult for persons from other time zones to contact CSC staff by telephone. Phone lines are reported to be busy frequently, requiring borrowers to leave messages, which may not be returned promptly. Additionally, persons who have difficulty reading or have limited English speaking capacity are disadvantaged in their dealings with CSC staff.

[47] The California State Office is also responsible for Nevada; the Delaware office is also responsible for Maryland; the Hawaii State Office is also responsible for Samoa and the Pacific Trust Territories; Massachusetts' office is also responsible for Connecticut and Rhode Island; and the Vermont office is responsible for New Hampshire and the Virgin Islands.

1.4 NATIONAL APPEALS DIVISION

A major, and welcome, change in the administration of the FmHA housing programs came as a result of legislation authorizing the reorganization of the Department of Agriculture. That legislation removed the National Appeals Staff from the FmHA and replaced it with an independent USDA National Appeals Division (NAD) responsible directly to the Secretary of Agriculture. The change stemmed the practice of former FmHA Administrators influencing and reversing decisions of the former National Appeals Staff. A more complete discussion of the NAD can be found in Chapter 9, *infra.*

1.5 LEGAL STAFF

RD/RHS does not have an in-house legal staff. Attorneys responsible for handling housing issues work in the Rural Development Division of the Office of General Counsel (OGC) of the Department of Agriculture. These attorneys answer to the USDA General Counsel, who is directly responsible to the Secretary.[48] The OGC has a National Office in Washington, D.C. and regional offices throughout the United States. The OGC National Office advises primarily the RD/RHS national office staff and provides advice and direction to the regional OGC staff. The OGC regional offices advise the agency's state and substate offices.

The OGC does not represent RD/RHS in court proceedings, although it is authorized to represent the agency in single-family litigation.[49] RD/RHS also engages private attorneys to conduct single-family litigation.[50] It uses only private attorneys to conduct foreclosures. Other litigation authority is vested exclusively in the Department of Justice and its local representatives, the United States Attorneys' offices.[51] In most cases not involving foreclosure, an Assistant United States Attorney will handle the litigation with the advice and assistance of a representative of the OGC.

The dispersal of authority among RD/RHS, OGC, and the Justice Department may frustrate attempts to negotiate settlements of litigation with RD/RHS. Communications between the United States Attorneys and RHCDS usually are handled through OGC. The United States Attorney may refuse to deal with you until hearing from his or her client, who may be either the agency or OGC. The OGC may not deal with you either because it does not represent RD/RHS in court or because it has not heard from the client. In addition, the OGC discourages attempts to deal directly with agency staff, based on its belief that such communication violates the code of professional responsibility for an attorney to meet with an opposing party without the presence of counsel.[52]

If you are unable to obtain responses from any of the parties regarding potential settlement of a case, you may want to raise the issue at the pretrial conference. Local federal court rules generally require that each party be represented at pretrial conference by counsel having authority to settle the case.[53]

1.6 STATUTES AND REGULATIONS

1.6.1 STATUTES

The statutory authorities for all RD/RHS housing programs are contained in Title V of the Housing Act of 1949, as amended.[54] Several statutory provisions dealing with the obligations of RD/RHS and the powers of the Secretary of Agriculture, who is ultimately responsible for the administration of the housing programs, are codified in other places. The most important of these are several congressional declarations regarding national housing policy, which are commonly known as the national housing goals.[55] These mandatory policies required RD/RHS to exercise its authority consist-

[48] 7 C.F.R. § 2.31 (2009).
[49] 42 U.S.C.A. § 1480(d) (West 2003).
[50] *Id.*
[51] *See id.*; 7 C.F.R. §§ 2.31(i) and (k) (2003).
[52] In fact, several states' bar codes of professional responsibility permit such meetings when the opposing party is a government official. *See e.g.* California Rules of Professional Conduct, Rule 2-100 (2009).
[53] *E.g.*, the United States District Court for the Northern District of California, ADR Local Rules, § 7-4 (b) (Dec. 2008).
[54] 42 U.S.C.A. §§ 1471-1490t (West 2003 and Supp. 2009).
[55] *Id.* §§ 1441 and 1441a; 12 U.S.C.A. § 1701t (West 2001).

ently with the 1949 declaration of national housing policy.[56]

1.6.2 RD/RHS REGULATIONS, INSTRUCTIONS AND HANDBOOKS

RD/RHS has mostly, but not completely, revised the FmHA regulations to refer to the agency as it has been reorganized since the late 1990s. Thus, while some of the regulations still refer to FmHA, the discussion that follows will refer to RD/RHS regulations, instructions, handbooks and other issuances as if they have all been recodified.

All RD/RHS housing program regulations are codified in volume seven of the Code of Federal Regulations (C.F.R.).[57] Substantive regulations governing the housing programs are either codified at 7 C.F.R. Part 1900 or Parts 3550 (single-family) and 3560 (multi-family). Administrative regulations dealing with the internal functions of the agency are codified separately in Part 2000.[58]

For the most part, RD/RHS regulations published in the C.F.R. are very concise and in a minimalist fashion, lacking specificity with respect to program operations. Thus, the entire body of the RD/RHS regulations dealing with the RD/RHS single family loan program, including loan making, servicing, and foreclosure are codified in only 42 pages of the C.F.R. In the 1990s, regulations covering these programs were several hundred pages long.

This abbreviated use of the C.F.R. reflects agency policy, first announced in 1989, that the agency would discontinue the practice of publishing identical regulations in the *Federal Register* and in FmHA Instructions in order to save *Federal Register* publication costs, to diminish the need for subsequent modifications and changes, and to curtail the material that is subject to review by the Office of Management and Budget.[59] Under this policy, RD/RHS publishes regulations in highly abbreviated versions in the *Federal Register*, "differentiating between information which confers a right or obligation on the public from material that is instructional and administrative in nature."[60]

Since that time, RD/RHS has even abandoned the use of its Instructions, going instead to Handbooks which detail the eligibility for loans, loan application processing, borrower obligations, loan servicing, appeals, and foreclosures and transfers of secured properties. The RD/RHS Handbooks are published on line and are accessible at http://www.rurdev.usda.gov/Handbooks.html.

Unfortunately, the policy change, as manifested in the RD/RHS handbooks, has three significant impacts on the public. First, it impairs the public's ability to follow RD/RHS loan making and servicing procedures. Not everyone has access to computers, particularly at high speeds necessary to readily access volumes of information, and no one is advised by RD/RHS that they can learn about their rights and obligations through the Internet. Second, information that is excluded from the published regulations and is included only in the Handbooks often clearly affects the substantive rights and obligations of the public and makes it all but impossible for an ordinary individual to determine whether the agency is violating its obligations to borrowers and applicants. Third, by omitting what in effect are substantive regulations from the C.F.R., RD/RHS is depriving the public from learning about and commenting on changes that it routinely makes to its handbooks, which frequently affect the rights and obligations of the public. In essence, borrowers and the public are deprived of their rights to notice and comment under the Administrative Procedure Act.

Aside from judicially challenging the RD/RHS publication policy, advocates may overcome some of the problems they face in fully understanding agency program policy by reviewing the RD/RHS handbooks as they are published on line. As noted earlier, they are accessible at

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[56] *United States v. Garner*, 767 F.2d 104, 110-111 (5th Cir. 1985); *United States v. Shields*, 733 F. Supp. 776, 785 (D. Vt. 1989); *United States v. White*, 429 F. Supp. 1245 (N.D. Miss. 1977); *Rocky Ford Hous. Auth. v. USDA*, 427 F. Supp. 118 (D.D.C. 1977); *Pealo v. FmHA*, 361 F. Supp. 1320 (D.D.C. 1973). *See United States v. Winthrop Towers*, 628 F.2d 1028 (7th Cir. 1980); *Pennsylvania v. Lynn*, 501 F.2d 848 (D.C. Cir. 1974); *Lee v. Kemp*, 731 F. Supp. 1101, 1105-1107 (D.D.C. 1989); *Techer v. Roberts-Harris*, 83 F.R.D. 124, 129 (D. Conn. 1979); *Brown v. Lynn*, 385 F. Supp. 986 (N.D. Ill. 1974). *But see Perry v. Housing Auth. of Charleston*, 664 F.2d 1210 (4th Cir. 1981).

[57] 7 C.F.R. §§ 1800-1999 and 2000-3560 (2009).

[58] *Id.* §§ 2000-2054.

[59] Memorandum of Neal Sox Johnson, Acting FmHA Administrator, to FmHA National Office Officials (Oct. 11, 1989).

[60] *Id.*

http://www.rurdev.usda.gov/Handbooks.html. Please note, however, that the RD handbooks that are available online are current handbooks. The agency does not maintain on its website older versions of its handbooks, ones that may have been in effect when your client's loan was considered or serviced.

It is also important to note that RD/RHS Handbooks do not have the force and effect of law. Indeed, the USDA National Appeals Division makes it clear that RD/RHS decisions must be based on its regulations and not on Handbooks. Unfortunately, this is not always followed.

While RD/RHS regulations may not have the force and effect of law, you may be able to enforce the handbooks against the agency itself because the handbooks set out agency policy.

When publishing regulations, RD/RHS' compliance with the Administrative Procedure Act (APA) has been less than exemplary. FmHA and now RHS are known to have published regulations for immediate implementation without citing any justification for its actions, citing such broad justification that any regulation could be published using the same rationale, or citing a rationale that does not withstand scrutiny.[61] The agency has also published final regulations without adequately explaining their basis or purpose[62] and in contravention of its statutory authority.[63] Recently, it even published what should be regulations by simply publishing a notice in the Federal Register[64] and by publishing an Unnumbered Letter.[65]

Until 1983, FmHA was technically exempt from the APA's requirement that rules be published for public comment prior to their adoption.[66] By notice published in the *Federal Register*, however, USDA had agreed to abide by the APA's publication requirements, beginning in 1971.[67] It was therefore bound to comply with the procedural demands of the APA.[68]

In 1983, Congress amended the Housing Act of 1949, prohibiting FmHA from adopting rules or regulations pursuant to that act without first publishing the rules for public comment in the *Federal Register* for at least 60 days and publishing them in final form for at least 30 days.[69] Moreover, the statute exempts from its coverage only regulations that FmHA certifies are issued on an emergency basis.[70] The only court to have considered the statute has concluded that the exception is not coextensive with the "good cause" exception to the APA publication requirement and that FmHA must certify the existence of an emergency before it can rely on the exception.[71] Notwithstanding this judicial admonition, FmHA's conformance with the statute and the APA has been wanting.[72]

Not infrequently, RD/RHS also violates the APA by incorporating substantive policy changes in unpublished materials such as Administrative Notices (ANs) or Unnumbered Letters. Sometimes this practice operates to the detriment of applicants and borrowers for RD/RHS services.[73] Legal services advocates should therefore carefully determine whether agency regulations or other directives that

[61] *See, e.g.*, 43 Fed. Reg. 51,385 (Nov. 3, 1978) (amendments to implement Subsidy Recapture program required to comply with Housing and Community Development Amendments of 1978); 54 Fed. Reg. 47,958 (Nov. 20, 1989) (amendment to regulations governing appeals for borrowers whose loans were sold to the Rural Housing Trust 1987-1 justified by the fact that servicing of the loans was being transferred from FmHA to an agent of RHT. FmHA had known for more than two years that the loan servicing would be transferred before the actual transfer took place. Moreover, there is no reason FmHA could not have continued to use the same appeals process pending the orderly publication of new regulations in accordance with the APA.).

[62] *See, e.g.*, *United States v. Garner*, *supra* note 56.

[63] *See id.*; *United States v. Shields*, *supra* note 56, at 782-85. *See also* 70 Fed. Reg. 8503 (Feb. 22, 2005) (postponing implementation of citizenship requirements because it does not conform to the law).

[64] 71 Fed. Reg. 14,084 (March 20, 2006).

[65] Clarification of Issues for Rural Development Voucher Demonstration Program, RD Unnumbered Letter (April 27, 2007).

[66] 5 U.S.C.A. § 553(a)(2) (WEST, WESTLAW, Current through P.L. 111-69 (excluding P.L. 111-67 and 111-68) approved 10-1-09).

[67] 36 Fed. Reg. 13,804 (July 24, 1971).

[68] *Rodway v. USDA*, 514 F.2d 809 (D.C. Cir. 1975).

[69] 42 U.S.C.A. § 1490n(a) (West 2003).

[70] *Id.* § 1480(c).

[71] *Arteaga v. Lyng*, 660 F. Supp. 1142 (M.D. Fla. 1987).

[72] *See, e.g.*, 54 Fed. Reg. 47,958 (Nov. 20, 1989). *See supra* note 56 (*Garner* and *Shields*).

[73] *See*, *RHS Makes Dramatic Changes to Rural Voucher Program*, 38 Hous. L. Bull. 92 (April/May 2008).

limit or deny assistance to their clients were properly implemented.

1.6.3 ADMINISTRATIVE NOTICES

RD/RHS publishes a series of interpretative memoranda and field instructions known as Administrative Notices (ANs). These are not published in the *Federal Register* or codified in the C.F.R. However, they are accessible, typically for one year, at http://www.rurdev.usda.gov/rd-an_list.html. ANs are usually relatively short and contain policy directives, interpretative rulings, or notices of fund allocations. ANs are sent electronically to RD field offices on a regular basis and are filed in binders containing RD/RHS Instructions or handbooks, immediately preceding the instructions they affect. An AN's expiration date appears on the document itself and may not be later than one year after date of publication. RD offices will usually remove ANs from their handbooks upon expiration. Both unexpired and expired ANs are important to legal services clients because they contain official directives and interpretations of regulations. Expired ANs may be useful in supporting a particular interpretation of a regulation or in showing that a particular agency policy was in effect during a given period of time.

Unfortunately, unlike HUD, RD/RHS does not maintain access to expired ANs on its website. Expired ANs must be requested from the agency under the Freedom of Information Act. Moreover, with respect to the single-family home loan and grant programs, RD no longer publishes very many ANs. This is because it is just as simple for it to change the RD/RHS Handbook as to publish a new AN.

To the extent that ANs affect program operations and client eligibility, they may violate the APA's requirement that agency rules and regulations be published for public comment.[74]

1.6.4 UNNUMBERED LETTERS

The RD/RHS Administrator communicates to agency and RD staff on matters of agency-wide concern by way of Unnumbered Letters. Most often these letters are communicated to RD state offices as well as to others by electronic mail, with a hard copy produced and maintained at the National Office. RHCDS publishes a list of Unnumbered Letters issued during any given month at the end of each month. These are currently available, again on a one-year basis, at http://www.rurdev.usda.gov/RD_UnnumberedList.html.

Most Unnumbered Letters deal with administrative issues that are of little concern or relevance to borrowers or applicants. However, some announce new policies, give interpretations of agency regulations, or answer questions about how particular programs are to be administered in the field. Like ANs, Unnumbered Letters may violate the APA.

1.6.5 SUPPLEMENTAL STATE INSTRUCTIONS

State RD offices often supplement handbooks or agency instructions and ANs to deal with problems, such as those involving real property, that are unique to the state.[75] These supplemental instructions are usually identified by the same number as the RD/RHS national handbook or instruction on the same subject matter, except that the state's identifying initials will either proceed or follow the instruction number.[76] State instructions may be available on the state RD website or obtained from local or state RD offices.

State instructions may not modify national policies or procedures[77] and must be approved by RD/RHS' National Office.[78] Depending on the content of the state instruction, the approval may be obtained before or after the state instruction is issued.[79]

Arguably, the mere fact that any state instruction was not published in the *Federal Register* and was not promulgated in accordance with Sec-

[74] *See Anderson v. Butz*, 428 F. Supp. 245 (E.D. Cal. 1975), *aff'd*, 550 F.2d 459 (9th Cir. 1977).

[75] Such instructions are authorized by RD Instruction 2006.51 (11-07-07).

[76] *See, e.g.* California Supplement 3550 (12.28.06). Available at http://www.rurdev.usda.gov/ca/sfh/main%20index.htm (last visited 10.2.09).

[77] RD Instruction 2006.51 (10-08-03).

[78] *Id.* § 2006.55. The approval may be sought before or after publication depending on the type of publication.

[79] *Id.*

tion 553 of the APA[80] also makes it invalid. RD/RHS may argue that when an existing and validly promulgated regulation authorizes a state instruction, the APA's requirements have been met. It is questionable whether such an argument would prevail[81] and, in any case, few published RD/RHS regulations in fact authorize supplemental state instructions. To the extent that state instructions arbitrarily treat applicants or borrowers in different states differently, the regulations may also be subject to attack on substantive APA grounds or on Fifth Amendment due process or equal protection grounds.[82]

1.6.6 RD/RHS FORMS

RD/RHS uses several hundred standard forms in the administration of its programs. None are published in the Federal Register. Most are, however, available on the RD website at http://www.rurdev.usda.gov/regs/formstoc.html. On occasion, RD/RHS forms may be useful in determining the type of information the agency collects, the covenants and agreements an applicant or borrower has executed, or the way in which the agency makes certain calculations. To guide its employees on the completion of its forms, RD/RHS publishes a Forms Manual Insert (FMI) for most of its standard forms. The FMI duplicates the form and contains detailed instructions on completing it. Copies of FMIs are available from the same RD website under the form number.

Some state RD offices modify the RD National Office forms to conform to state or local laws. Frequently, those forms are also available from the state RD website.

Various RD/RHS forms that are used as agreements between borrowers and RD/RHS contain clauses and covenants that are not authorized by statute or regulations. If RD/RHS attempts to enforce these unauthorized provisions, you should consider challenging their validity on the grounds that they have not been published in accordance with the APA.[83]

1.7 PROGRAM DESCRIPTIONS

This section describes each of the RD/RHS single-family homeownership programs. For the single-family loan and grant programs, the descriptions include the legislation creating the programs, the types of housing that may be constructed, purchased, or repaired; the available subsidies; the programs' intended beneficiaries; and how the programs operate.

These program descriptions are not intended to answer all questions about the programs' operation or applicants' or borrowers' rights in every situation. They are intended only to provide a general overview of the programs for persons unfamiliar with them. Later chapters will address some of these issues in detail.

1.7.1 SECTION 502: HOME OWNERSHIP LOANS

Historically, the Section 502 loan program, authorized by the Housing Act of 1949,[84] has been the largest, and by far, the most popular of the FmHA loan programs. Nearly 2.5 million loans, totaling over $100 billion, have been made under the program since its inception. The number of Section 502 direct loans made by FmHA in a single year peaked in the mid-1970s at about 132,000. Budget cuts and efforts to terminate the program have reduced that number to fewer than 15,000 units per year in recent years.[85] Guaranteed loan activity has been growing in recent years, to the point where over 58,000 loans were made in Fiscal Year 2008.

Well over $1 billion was made available to RD/RHS under the American Recovery and Reinvestment Act of 2009. The agency has recently announced that the funds have assisted over 50,000 households achieve homeownership.[86] It is not yet

[80] 5 U.S.C.A. § 553 (WEST, WESTLAW, Current through P.L. 111-69 (excluding P.L. 111-67 and 111-68) approved 10-1-09).
[81] *See Anderson v. Butz*, *supra* note 74.
[82] *See Johnson v. USDA*, 734 F.2d 774, 784-87 (11th Cir. 1984).
[83] *See United States v. Marshall*, 431 F. Supp. 888 (N.D. Ill. 1977).
[84] 42 U.S.C.A. § 1472 (West 2003).
[85] *See* HAC, *"A Reasonable Year"*, *supra* note 37, App. A.
[86] Agriculture Deputy Secretary Merrigan Announces USDA Has Helped 50,000 Americans Become Homeowners. USDA CA Press release 10.09.

clear what the distribution of these loans is by programs.

There are three types of Section 502 loans: Insured Section 502 loans[87] made directly by RD/RHS to low- or moderate-income persons for any one of the below described purposes and Guaranteed Section 502 loans made by commercial lenders to persons whose incomes do not exceed 115 percent of the median income for the area in which the loan is made.[88] RD/RHS guarantees the latter loans against default to encourage commercial lenders to make loans to borrowers perceived as a high risk.

The third type of Section 502 loan is a "leveraged loan." Under the program, RD and a private lender join in making two loans to qualifying borrowers. The first loan is an RD/RHS loan, the second is a private loan made by the private lender. RD/RHS only entered into leveraged loans when the private lender agreed to make the loan at an interest rate of less than 3%. To encourage private lenders to participate in the program, RD/RHS typically subordinated its lien position to that of the private lender. Leveraged loans were popular in the 1990s. Few, if any, are being made currently.

Because guaranteed loans are not likely to be made to legal services clients, the following discussion of the Section 502 program is limited to the insured loans made exclusively to low- and moderate-income persons. Because guaranteed loan borrowers may experience reductions in income that threaten their ability to retain their homes, guaranteed borrowers' servicing rights and foreclosure defenses are discussed elsewhere in this manual.[89]

The insured Section 502 program may be used for four distinct purposes: the construction or purchase of new housing, the purchase of existing housing, the repair or rehabilitation of existing housing, and the refinancing of existing housing. New or existing housing includes condominium units, homes constructed on land trusts or on extended land leases, and manufactured homes, provided they meet prescribed standards.[90] Rehabilitation or repair may be carried out in conjunction with the purchase or refinancing of existing housing.

To be eligible for a Section 502 loan, a person must meet the following eligibility criteria:

- be of low or moderate income,
- be a U.S. citizen or a person admitted for permanent residency,
- not reside in or own housing that is decent, safe, and sanitary,
- be unable to obtain a loan from private lending institutions on reasonable rates and conditions,
- have sufficient income to repay the loan,
- have legal capacity to contract, and
- after the loan is made, reside in a rural area.

First time homeowners must also provide documentation that the purchaser has completed a homeownership education program from a certified provide prior to loan closing.[91]

Persons receiving Section 502 loans must reside in the financed home, except farm owners who construct the housing for their tenants, sharecroppers, farm laborers, or farm manager.[92]

Loans are made by RD/RHS at market rate interest based on the federal government's long-term borrowing costs. This rate is revised periodically, although each loan retains its original interest rate throughout its duration. Most Section 502 loans are made for a term of 33 years. RD/RHS may extend the loan term to 38 years to permit persons whose incomes do not exceed 60 percent of the area median income to purchase a home when they would not be able to purchase that home if it were financed for only 33 years. RD may further reduce the borrower's monthly payments by deferring up to 25% of the loan payment for a term of up to 15 years, reviewable annually.

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[87] Even though RD/RHS loans are referred to as insured loans, they differ greatly from loans insured by the Federal Housing Administration (FHA). The latter are made by a mortgage lender and are insured against default by the FHA. An RD/RHS-insured loan is made and serviced by the agency until it is repaid. Because of these distinctions, FmHA loans are often called direct loans.

[88] The Housing and Community Development Act of 1992, Pub. L. No. 102-550, § 703, 106 Stat. 3672 (Oct. 28, 1992), increased the income limits for unsubsidized guaranteed loans from area median income to 115% of median. 42 U.S.C.A. § 1472(h)(2) (West 2003).

[89] *See* § 6.11, *infra*.

[90] 7 C.F.R. § 3550.73 (2009).

[91] *Id.* § 3550.53 (i).

[92] *See* Ch.2, *infra* (complete discussion of eligibility requirements for Section 502 loans).

RD/RHS may shorten the term of a loan when the useful life of the financed structure is less than 33, or 38, years in order to adequately secure its loan. Loans made for the purchase and construction of manufactured homes may not exceed 30 years. Loans made for less than $2,500 may not have a term greater than 10 years.

All RD/RHS loans are evidenced by a promissory note executed by the borrower and generally secured by a first deed of trust or mortgage on the financed property. When the Section 502 homeowner has only a leasehold interest in the property, RD/RHS will take a security interest in the leasehold, provided the borrower's leasehold interest exceeds the term of the loan by 50 percent.[93]

Since low-income persons do not have sufficient income to meet the cost of amortizing a market-rate loan or to pay taxes, insurance, utilities, and maintenance and at the same time maintain a reasonable standard of living, RD/RHS loans to low-income persons are subsidized through one of three interest-reduction programs called Payment Assistance I and II or Interest Credit. Authorized by Section 521 of the Housing Act of 1949,[94] these subsidies enable RD/RHS to lower the borrower's effective rate of interest on the Section 502 loan to as low as one percent. The actual amount of subsidy received by any borrower will vary according to the borrower's income and the amount of the loan. A low-income borrower pays interest at a rate not less than one percent, which enables him or her to pay principal, interest, taxes, and insurance within 20 to 26 percent of adjusted family income.

Moderate-income borrowers are also eligible, under the statute, to receive RD/RHS subsidies.[95] Nevertheless, RD/RHS has never extended interest subsidies to moderate-income borrowers in order to qualify them for a Section 502 loan. The agency does extend subsidies to moderate- and above moderate-income borrowers if they first received assistance when they had low incomes and continue to need the assistance.

To qualify for interest subsidy, a borrower's income must be within the RD/RHS low-income limits published for the area in which he or she resides.

Interest subsidy is extended to borrowers from one to two years at a time through an interest subsidy agreement. At the agreement's expiration, the borrower's eligibility is redetermined and the amount of subsidy to be received upon renewal is recalculated. Persons whose incomes change during the term of an agreement may receive additional or less interest subsidy depending on whether their income went up or down.

Even with interest subsidy, a relatively small number of very low-income borrowers can afford Section 502 loans. As a consequence, Congress authorized RD/RHS to extend the Section 502 loan term to 38 years for those borrowers whose incomes are within 60 percent of median income for the area in which they will reside.[96] In addition, it authorized a demonstration program that enables borrowers to defer up to 25 percent of the amount of their monthly payment.[97] Unfortunately, appropriations for this program have not been available in recent years and the number of borrowers still on the program is very small.

The advent of the HUD Section 8 homeownership program has allowed persons who qualify for the Section 8 program to use their voucher in connection with the Section 502 home loan program. Indeed, nothing in the 502 program prevents them from also qualifying for interest subsidy. As a consequence, some very low income households can qualify for RD/RHS housing by using the Section 8 homeownership program in conjunction with the Section 502 loan program. Unfortunately, it is not known how many borrowers have successfully been able to use both programs.

Persons who qualify for Section 502 loans are eligible to receive amounts up to 100 percent of the cost of the unit's purchase, construction, or rehabilitation.[98] Generally, no down-payment is required for the program, and closing costs may be included in the loan. All housing financed with Section 502 funds must be decent, safe, and sanitary

[93] 7 C.F.R. § 3550.58 (b) (2009).
[94] 42 U.S.C.A. § 1490a(1) (West 2003).
[95] *Id.* § 1490a(a)(1)(B).
[96] *Id.* § 1472(a)(2), 7 C.F.R. § 3550.67 (b) (2009).
[97] *Id.* § 1472(g).
[98] RD/RHS has statutory authority, but no appropriations, to supplement any Section 502 loan made to finance a home located in a remote rural area or on tribal allotted or Indian trust land with a grant in an amount by which reasonable land acquisition and construction costs for that home exceed the appraised value of such property. 42 U.S.C.A. § 1472(f)(1) (West 2003).

after completion. It must also be modest in design and cost, which means that it may not exceed the area loan limits. Larger homes may be purchased or constructed for families needing more space. Amenities or land exceeding that required for a modest home may not be financed with Section 502 funds.

Although newly constructed contractor-built homes were the type of housing most frequently financed with Section 502 funds, most RD/RHS loans are now being made for the purchase of existing housing, except for loans made to participants in self- help housing programs. Under the self-help method, borrowers save money on construction costs by joining with 10 to 20 other families to undertake a major portion of the construction of their homes and to contract out only those portions of the work requiring skilled labor. Usually a local nonprofit organization funded by RD/RHS under Section 523 of the Housing Act of 1949,[99] organizes the borrowers and provides them with technical and supervisory construction assistance. These organizations may also acquire and develop sites to be sold to participant borrowers using low-interest loans from RD/RHS.[100]

Persons who obtain Section 502 loans are eligible for various services from RD/RHS to assist them in contracting or constructing their homes, meeting their financial obligations, or overcoming special problems such as defects in construction or loss or reduction of income during the term of the loan. Advice and technical assistance are available in the form of financial counseling, construction supervision, and inspection. For newly constructed but defective homes, RD/RHS may compensate the borrower under Section 509(c) of the 1949 Housing Act.[101]

Borrowers facing financial difficulties due to circumstances beyond their control may obtain assistance from RD/RHS in the form of additional interest subsidies (provided the maximum amount of subsidy for which the borrower is eligible is not exceeded), a moratorium on payments for up to two years, or reamortization or refinancing of their loan.[102]

Although most RD/RHS loans are made for a term of 33 years, borrowers obligate themselves to refinance the loan whenever they are able to obtain private commercial financing at rates and terms that are both affordable and reasonable. This refinancing is mandated by law and is intended to prevent competition between RD/RHS and private lending institutions.

Borrowers who have obtained loans from RD/RHS since October 1, 1979 and who have also received an interest subsidy, are subject to "recapture" of part of that assistance when they sell or transfer their homes for a price higher than the original purchase price.[103] The actual amount recaptured is based on the increased value of the home, the amount of subsidy received by the borrower, and the number of years the borrower has had the loan.[104] This requirement was added to the Section 502 program by Congress in an attempt to reduce the cost of operating the Section 502 program.

1.7.2 SECTION 504: HOME REPAIR OR IMPROVEMENT LOANS AND GRANTS

The RD/RHS home repair or improvement program authorized by Section 504 of the Housing Act of 1949[105] was designed to assist persons who, either because of income or the condition of their home, did not qualify for a Section 502 loan but needed assistance to remove health and safety hazards from their home or to weatherize it. In 1983, Congress removed the limitation that Section 504 borrowers were not eligible for Section 502 loans and expanded the purposes for which Section 504 funds may be used to include some additions and improvements to existing homes. Although the program has assisted a relatively limited number of people,[106] its funding has remained relatively steady since the 1980s.

Section 504 assistance may be used for repairs and improvements such as repairing roofs, providing or repairing structural supports, adding a bathroom, providing sanitary water and waste dis-

[99] *Id.* § 1490c (West 2003).
[100] *Id.* § 1490c(b)(1)(B).
[101] *Id.* § 1479(c).
[102] *See* Chs. 3 and 4, *infra* (detailed discussion of these forms of assistance).
[103] 42 U.S.C.A. § 1490a(a)(1)(D) (West 2003).
[104] *See* Ch. 7, *infra* (detailed discussion of recapture).
[105] 42 U.S.C.A. § 1474 (West 2003).
[106] Approximately 75,000 persons have been assisted by the program since its inception in 1949. Source: Housing Assistance Council, Inc.

posal systems, connecting to water and sewer lines, weatherizing or modernizing the home.[107] Funds may not be used to construct new dwellings or add to existing dwellings unless the addition is intended to remove a health or safety hazard. Mobile homes may be repaired with Section 504 funds when the home is attached, or will be attached, to the land owned by the applicant.

Section 504 assistance is available in the form of loans and grants. Loans may be made at a one-percent interest rate, with varying terms depending on the borrower's repayment ability, but not exceeding 20 years. Loans may not exceed $20,000. Grants of up to $7,500 may be made to persons over 62 years of age who do not have sufficient income to repay part or all of a Section 504 loan. The amount of grant extended to any individual depends on his or her ability to repay all or part of the loan and the cost of the repairs. When made together, loans and grants may not exceed a total of $20,000.

To be eligible for a Section 504 loan a person must:

- have a low or moderate income and be able to repay the loan;
- be a U.S. citizen or permanently admitted resident;
- reside in the home to be repaired, which must be located in a rural area; and
- be unable to obtain a loan from a private lending institution at reasonable rates and conditions.

Homes repaired with Section 504 assistance need not be decent, safe, and sanitary after the work is completed; however, they must not continue to pose significant health or safety hazards to the borrower.

Persons receiving Section 504 assistance must be the owners of their home. For purposes of the program, ownership is construed broadly to include ownership by deed or other means, such as by evidence of having paid taxes or by obtaining affidavits from others in the community attesting to the applicant's ownership. Persons with leasehold interests or life estates also qualify for Section 504 assistance.

All Section 504 loans are evidenced by a promissory note, with loans over $7,500 secured by a deed of trust, mortgage, or security interest in a leasehold.

Persons who obtain Section 504 loans are eligible for various services from RD/RHS to assist them in contracting for the repair, meeting their financial obligations or overcoming special problems such as loss of income during the term of the loan. These services are available in the form of financial counseling, construction planning, supervision, and inspection. Borrowers facing difficulties meeting their Section 504 loan obligations because of circumstances beyond their control are eligible for a moratorium on their payments, and reamortization of their loan.

Section 504 borrowers are obligated to refinance their loan with private commercial financing if, during the term of the loans, they are able to obtain such financing at reasonable rates and terms. This refinancing is mandated by Congress to ensure that RD/RHS is a lender of last resort and that it does not compete with private financial institutions.

Persons who obtain a Section 504 grant are obligated to repay it if they sell or transfer the home within three years of obtaining the grant.

1.7.3 OTHER RD/RHS HOUSING PROGRAMS

RD/RHS operates several housing programs that are either limited in size or involve indirect distribution of assistance, such as through local or regional nonprofit agencies. A very brief description of those programs follows.[108]

1.7.3.1 Compensation for Construction Defects Program

RD is authorized to compensate owners of newly constructed homes for major defects in those homes, provided the defect is discovered within 18 months of loan closing or completion of construction, whichever is later.[109] A complete description of the program is contained in Chapter 4 of this manual.

[107] 7 C.F.R. § 1944.456 (1994).

[108] Not discussed are programs for which RD/RHS has authorization, but for which it has no appropriations.

[109] 42 U.S.C.A. § 1479(c) (West 2003).

1.7.3.2 Self-Help Housing Technical Assistance Grants and Site Development Loans

Under the Section 502 loan program, RD/RHS makes single-family home loans to borrowers who want to construct their own homes using the self-help method in order to reduce costs. Usually, participants in the program are individuals or families who do not have sufficient income to qualify for a loan for a house constructed entirely by a contractor. Typically, between 10 and 20 families will work together in a self-help group, constructing homes for all the families at the same time. Skilled labor or contractors are hired by the group when the work is beyond the group's capacity.

RD/RHS makes grants to nonprofit and public agencies to provide technical assistance and supervision to participants in the self-help program.[110] Funded agencies typically recruit families, identify construction sites, develop house plans and specifications, and provide construction supervision to participating families.

In addition, RD/RHS operates a self-help housing land development fund that enables nonprofit and public agencies funded to provide self-help technical assistance to purchase and develop land to be sold to self-help program participants. Loans are usually made for a term of two years and bear three-percent interest.[111]

1.7.3.3 Site Loans

RD/RHS also makes site loans to nonprofit or public agencies, including Indian tribes, for the acquisition and development of land as building sites for sale to families and nonprofit or public agencies that intend to develop the site under any of the RD/RHS housing programs or other housing program intended to assist low- and moderate-income families. These loans may be for a term of up to two years and bear RD/RHS' market rate of interest.[112]

1.7.3.4 Rural Housing Preservation Grants

The Housing Preservation Grant Program authorizes RD/RHS to make grants to private nonprofit and public agencies for the rehabilitation of single-family housing located in rural areas and owned by low- and very low-income persons and rental housing or limited-equity-type cooperative housing, also located in rural areas, that serves low- and very low-income occupants.[113] No more than 20% of the funds provided the recipient organization may be used for administration; the balance must be used for programmatic purposes such as loans, grants or subsidies for the rehabilitation of eligible properties.

1.8 PROGRAM FUNDING

1.8.1 THE CONGRESSIONAL PROCESS

Program funding is a two-step process. First, Congress must authorize an appropriation, and then it must actually appropriate funds. For RD/RHS, as with many other agencies, authorizations are enacted every other year, while appropriations are made annually. RD/RHS housing programs, however, are unique. Jurisdiction for their authorization lies with the House and Senate housing committees, while jurisdiction for their appropriations lies with the agricultural committees. Since these committees have not always shared the same perspective on the need for certain programs, it is not uncommon for a RD/RHS program to have an authorization, but lack an appropriation. The Homeownership Assistance Program (HOAP),[114] for example, received annual authorizations from 1978 through 1981, but never obtained funding from the appropriations committees. Another example is the Section 504 program which, according to the authorizing act,[115] enables RD/RHS to make loans and grants to any eligible low-income persons, but, according to the appropriations act, enables it to make grants only to the elderly.[116]

[110] *See id.* § 1490c.
[111] *Id*. § 1490c (b).
[112] *Id*. § 1490d.
[113] 42 U.S.C.A. § 1490m (West 2003).
[114] *Id*. § 1490a(a)(1)(C).
[115] *Id*. § 1474.
[116] *See, e.g.*, Pub. L. No. 102-341, tit. III, 106 Stat. 895 (1992).

Another anomaly in the RD/RHS appropriations process is created by the Rural Housing Insurance Fund (RHIF). Since it is a capitalized fund and is replenished primarily with funds borrowed from the Federal Financing Bank, no significant direct appropriations are needed to operate the loan programs through the RHIF.[117] Therefore, unlike other programs requiring appropriations from the federal treasury, the RD/RHS loan programs only require authority to expend funds from the RHIF. Hence, in the appropriations acts, Congress makes sums from the RHIF "available" for use in the various loan programs.[118]

1.8.2 INCOME TARGETING

Until 1978, FmHA had not made any serious attempts to target its housing loans to areas or persons in greatest need of its housing resources. Loan and grant funds were allocated to states based on past performance, without regard to the states' housing conditions or the number of low-income persons in need of decent housing. As a result, states with aggressive builders and sympathetic state directors led in housing production.

Prior to 1978, the only effort to target FmHA funds was contained in the annual appropriations acts. These required that approximately 60 percent of the RHIF expenditures during any fiscal year be made in the form of subsidized loans to low-income persons.[119] FmHA technically complied with this requirement, but violated its spirit by adopting uniform national guidelines for defining who was low-income[120] and by frequently raising these guidelines by an amount commensurate to the increase in the Consumer Price Index (CPI). This practice had three distinct effects upon the operations of the programs. First, because the CPI increased more rapidly than income, the FmHA low-income guidelines became inflated and enabled persons who were not otherwise considered to be low-income to qualify for loans. Second, in regions with relatively lower incomes, such as the South and Appalachia, the uniform national guidelines operated to the detriment of lower-income persons. Builders and FmHA staff in these areas granted loans to applicants with incomes near the maximum income limits, avoiding truly low-income borrowers.[121]

Third, uniform national guidelines enabled FmHA to continue the Section 502 new construction program as the primary vehicle for serving the housing needs of low-income persons, even though most observers of the program concluded that it no longer served persons who, by any standard other than FmHA's, were truly low-income.[122]

In 1978, FmHA began to target its loan and grant funds by shifting its state allocations from a past performance basis to a need basis. For each of its major programs, it adopted a distribution formula based on four factors: the state's proportion of rural population, persons in poverty, persons living in substandard housing, and the state's relative housing costs. While well intentioned, the distribution formula did not ensure that the funds were actually directed to persons in poverty, who were living in substandard housing, or who were paying a disproportionate share of their income for housing. This is because FmHA had no similar mechanism for allocating funds within each state and generally awarded loans and grants on a first-come, first-served basis instead of on a priority basis related to housing need.

Beginning in 1979, Congress adopted legislation that in various ways forced FmHA to better target its funds to areas and persons in greatest need of assistance. That year, it adopted two amendments to begin the process. First, it defined the phrase "low-income families or persons" as those "whose incomes do not exceed 80 percentum of the median

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[117] The only funds which Congress adds to the RHIF are for "losses" due to the operation of the Interest Credit and Rental Assistance programs, to defaults, and to operating expenses charged to the fund. Even these are usually funded by Congress two to three years after the expenditures are made.

[118] *See, e.g.*, Pub. L. No. 111-8, tit. III, 123 Stat. 539-540 (2009).

[119] *See, e.g.*, Agriculture and Related Agencies Program Appropriations [for FY 1978], Pub. L. No. 95-97, tit. II, 91 Stat. 818 (1977).

[120] Two states, Alaska and Hawaii, and several territories were excluded from these uniform guidelines because of high costs in those states.

[121] Evidence of this practice, commonly referred to as "skimming," appeared in FmHA statistics which showed certain states consistently serving persons with higher incomes than their neighboring states when no other factors seemed to justify the differences.

[122] *See* Housing Assistance Council, Inc., *The Federal Government and Rural Housing* (Washington, D.C., May 1, 1973).

income for the area."[123] Second, it required that at least 30% of the assistance made available in any area of any state in any fiscal year shall, to the extent practicable, benefit persons with incomes below 50% of the median for that area.[124] In 1983, Congress required that not less than 40% of the funds appropriated for the Section 502 loan program be set aside for persons with very low income, and that not less than 30% of the funds allocated to each state under that program be made available to very low-income persons or families.[125]

In 1990, Congress prescribed statutory standards for allocating Section 502 guaranteed loan funds[126] and gave funding priority to first-time homebuyers.[127] It also required FmHA to target 100 counties and communities, as well as colonias,[128] as undeserved areas and, as of Fiscal Year 1992, to direct to those areas five percent of the aggregate of the funds allocated in each fiscal year for the Sections 502, 504, and 524 programs.[129]

In response to the legislation, FmHA has modified its allocation formulas and published them in the Code of Federal Regulations.[130] It also requires its state offices to allocate funds for major programs, such as the Sections 502 and 515 programs, to district and county offices on the same basis as FmHA national allocations are made. The state allocations are now published annually in RD/RHS administrative notices, as are the counties and communities that RD/RHS has designated as undeserved areas.

Most importantly, RD/RHS has revised the manner by which Section 502 loan funds are made available to individual borrowers by eliminating the first-come, first-served application processing system and, instead, adopting a system of approving loans on a priority basis. Under this system, highest priority is given to existing borrowers who need subsequent loans; second priority is given to loans made to purchasers of real estate owned by the agency; third priority is given to applicants who face housing related hardships; fourth priority is given to applicants who are participating in the self-help housing program. All other applications are processed on a first come first served basis.[131]

Unfortunately, notwithstanding all of these changes, RD/RHS has been experiencing some problems recently in meeting the 40% goal established by Congress. It is not clear exactly why low-income borrowers are not being served to the same extent that they were before. In all likelihood, the capacity to serve very low income households has been affected by housing costs that have increased disproportionally to income.

Usually at the beginning of a fiscal year's fourth quarter, after all applications should have been ranked and funded by each state, the National Office pools any remaining but unobligated funds and makes them available to individual states on an individual application and first-come, first-served basis. You should ask for an allocation from the reserves or pooled funds when legal services clients face an extreme hardship and the local or state RD/RHS office maintains that it has no funds with which to assist the applicant.

1.9 RECURRING THEMES IN FEDERAL AND RD/RHS HOUSING POLICIES

Effective representation of poor people in their struggle to secure decent and affordable housing requires an awareness of the many problems they face, including the many, often conflicting,

[123] *See* 42 U.S.C.A. §§ 1471(b)(4) and 1437 (West 2003) (the statute has since been changed to conform the definition to that adopted by Congress for the Section 8 program). The statute authorizes certain adjustments that are not particularly important in this discussion.

[124] *Id.* § 1487(o)(2).

[125] *Id.* § 1472(d).

[126] *Id.* § 1472(h)(11).

[127] *Id.* § 1472(h)(4)(A).

[128] Generally, a colonia is a community in the state of Arizona, California, New Mexico or Texas that existed prior to November 29, 1990; lacks potable water supplies, an adequate sewage system and decent, safe and sanitary housing; and is within 150 miles of the border with Mexico. *Id.* § 1479(f)(8).

[129] *Id.* § 1479(f).

[130] *See* 7 C.F.R. Part 1940, Subpart L (2009). For example, there are five criteria that determine the amount of Section 502 funds distributed to each state. The criteria used and the weights given to each are: the state's percentage of the national number of rural occupied substandard units (25%), the state's percentage of the national rural population (10%), the state's percentage of the national rural population in places with less than 2,500 population (15%), the state's percentage of the national rural households between 50% and 80% of the area median income (30%), and the state's percentage of the national number of rural households below 50% of the area median income (20%). *Id.* § 1940.565(b).

[131] 7 C.F.R. § 3550.55 (2009).

federal housing policies formulated in response to those problems, and the competing interest groups that have influenced policy development. From the history of the federal housing programs over the past 73 years, one can distill much valuable information. Before discussing purchasers' rights in detail, this section will briefly set out several significant themes bearing upon the formulation and implementation of the federal housing programs in general and rural housing programs in particular. This section is intended to provide an overview to guide your judgment in deciding priorities and developing strategies.

1.9.1 OBTAINING A SUFFICIENT SUPPLY OF DECENT AND AFFORDABLE HOUSING FOR ALL POOR PEOPLE

It is morally indefensible that the allocation of America's economic resources denies many members of this society decent housing at prices they can afford. The formulation and implementation of federal housing programs must be guided by the basic principle that no one should go without decent housing. Indeed, this principle has gained some political recognition. As long ago as 1949, Congress enshrined as the cornerstone of our national housing policy "the realization as soon as feasible of the goal of a decent home and a suitable living environment for every American family."[132] This 1949 congressional action was preceded by the policy declaration in the United States Housing Act of 1937, committing the United States "to remedy the unsafe and unsanitary housing conditions and the acute shortage of decent, safe and sanitary dwellings for families of low income in rural or urban communities, that are injurious to the health, safety and morals of the citizens of the Nation."[133] Congress reaffirmed this policy in 1968 by directing that "the highest priority and emphasis should be given to meeting the housing needs of those families for which the national goal has not become a reality."[134]

The obstacle to increasing the supply of decent affordable housing has not been the problem of convincing Congress that no one should be forced to live in substandard housing or in housing beyond their means. The problem has been in getting Congress, the administrations, the states and local governments, and private individuals to take the steps necessary to realize the 1949 goal.

The 1949 Act set a production goal of 810,000 public housing units in the subsequent six years. By the end of 1955, however, slightly fewer than 194,000 of those units had been built.[135] In 1968, Congress, after recognizing that the national housing goal had not been met, optimistically determined that it could be "substantially achieved within the next decade by the construction or rehabilitation of twenty-six million housing units, six million of these for low and moderate income families."[136] Ten years later, Congress and the federal government had fallen shamefully short of that goal.[137]

One reason that the 6 million units promised in 1968 were not delivered was that HUD and FmHA were directed by President Nixon in January of 1973 to make no additional commitments for any subsidized housing units, even though funding for those units had already been authorized and appropriated by Congress. HUD's unilateral decision to halt development and restoration of low- and moderate-income housing, euphemistically labeled a moratorium, was one that neither Congress nor the judicial system was willing to reverse.[138] One court did reverse FmHA's attempt to extend the moratorium to its subsidized housing programs, but only af-

[132] 42 U.S.C.A. § 1441 (West 2003).

[133] Former 42 U.S.C. § 1401 (West 1974), revised and now codified at 42 U.S.C.A. § 1437 (West 2003).

[134] 12 U.S.C.A. § 1701t (West 2001).

[135] *See* REPORT OF THE PRESIDENT'S COMMITTEE ON URBAN HOUSING, A DECENT HOME, 56, 61 (Washington, D.C.: U.S. Gov't Printing Office, Dec. 11, 1968).

[136] *See* Housing and Urban Development Act of 1968, Pub. L. No. 90-448, § 1601, 82 Stat. 601 (Aug. 1, 1968), codified at 42 U.S.C.A. § 1441a (West 2003). Of the six million units, FmHA was assigned responsibility for producing 1.486 million of them. UNITED STATES PRESIDENT, SECOND ANNUAL REPORT ON NATIONAL HOUSING GOALS (1970).

[137] *See* Housing Assistance Council, Inc., *Rural Housing Goals and Gaps* (Washington, D.C., 1977) and *Goals Are Not Enough* (Washington, D.C., 1980).

[138] *See Pennsylvania v. Lynn*, *supra* note 56.

ter they had been inoperative for nearly eight months.[139]

The promised units also were not delivered because during the last half of the 1970s, Congress repeatedly joined the executive branch in a campaign to reduce appropriations for additional subsidized housing. Although FmHA funding faired comparatively better than HUD funding during this period, the total number of units for which funds were appropriated fell critically short of the number needed to meet the 1968 housing goals.[140]

During the decade of the 1980s, the rate of expansion of the federally subsidized housing supply for low-income families was further radically reduced. In 1981, the administration introduced the notion of capping the number of families assisted under the federal programs at approximately 4 million nationwide, but it eventually abandoned the notion of a cap. However, funding for additional families fell well below even a 100,000-unit-per-annum level in Fiscal Year 1982, and in most years thereafter, it hovered between 75,000 and 100,000 units. Despite a demonstrable need, the number of federally subsidized units that became available for additional families during the 1980s is less than one-third the number of units provided in the 1970s.

During the 1990s, the decline in funding for housing assistance for low-income rural households continued. Annual funding for the RD/RHS single family program was either held steady or was reduced, thereby causing a reduction in the number of units financed. By 2002, the number of Section 502 direct loans financed had decreased to fewer than 16,500.

The George W. Bush administration tried to simply terminate the Section 502 direct loan program by proposing the termination of all program funding, something that Congress rejected. Nonetheless, by 2008, the total number of Section 502 loans produced fell to fewer than 10,000.

One of the major tasks facing poor people and their representatives is to pressure RD/RHS, HUD, the Office of Management and Budget, the President, and Congress for more money to subsidize housing for poor people. Rural poor people should also fight to obtain a larger portion of any increased housing funding due to the higher incidence of poverty and substandard housing in rural areas and to offset the disproportionate level of resources channeled into urban areas.

But the struggle is not merely to get more money for housing. It is equally important to prevent Congress, the administration, and special interest groups from diverting to middle- and upper-income people the limited funds available to meet very low-income peoples' needs. In the RD/RHS context this is graphically demonstrated by the reduction in direct Section 502 funding and a dramatic increase in funding available for Section 502 Guaranteed loans, which serve moderate- and above moderate-income households. The most glaring example of such diversion is the income tax policy of allowing homeowners a federal income tax deduction for property taxes and mortgage interest. In Fiscal Year 2009, for example, those deductions are expected to cost the federal government over $115 billion in lost revenue,[141] an amount more than four times the low-income housing subsidies paid out by the federal government in that same year.[142]

The diversion of scarce funds to middle- and upper-income people has not been limited to provisions of the Internal Revenue Code. The history of the low-income housing programs is replete with examples of efforts by special interest groups, administrations, and sometimes Congress itself to shift the subsidy focus away from those in greatest need to those who have a much better chance of obtaining housing in the private market. Two examples are the maximum income limits for the Section 8 program and the definition of maximum low income for the RD/RHS programs, both of which are set at 80 percent of area median income. These programs, which are intended to meet the housing needs of low-income persons, have income limits

[139] *Pealo v. FmHA*, *supra* note 56.

[140] Between 1968 and 1978, FmHA produced 824,940 units or 61% of its goal of 1.486 million units. Housing Assistance Council, Inc., *Goals Are Not Enough* at 12 (Washington, D.C., 1980).

[141] *See* Harney, Taking Aim at the Top Tax Bracket, Budget Proposes New Limits on Mortgage Interest, (Mar. 31, 2009) (available at The Real Deal Online, http://therealdeal.com/newyork/articles/ken-harney-taking-aim-at-the-top-taxbracket, last visited 10.4.09).

[142] *See* E. Lazere *et al.*, Center on Budget and Policy Priorities and the Low Income Housing Information Service, A PLACE TO CALL HOME (Washington, D.C., 1991).

identical to the old FHA moderate-income Section 221(d)(3) program adopted in 1961.[143]

1.9.2 HOW SHOULD HOUSING SUBSIDIES BE PROVIDED?

1.9.2.1 The Role of Private Enterprise

Over the years, ideas concerning the provision of housing subsidies have evolved considerably. One of the primary issues has been the extent of private involvement in the process of providing subsidized housing. Initially, in the 1930s, the federal government developed, constructed, and managed public and farmworker housing without local government or significant private involvement. Indeed, FmHA and RD/RHS have directly financed the construction of single family housing without the involvement of private lenders until the early 1990s.

Today, private enterprise develops, constructs, owns, and/or manages virtually all federally assisted rental housing. This has obvious and often disastrous consequences for the beneficiaries of the federal housing programs. For example, homeowners under the RD/RHS guaranteed loan program have not been extended rights that direct loan borrowers have, such as the right to a moratorium, to appeal adverse decisions, and to refinance their loans with a direct loan in the event of a default that is caused by circumstances beyond the borrower's control, such as loss of income or death of a family member.[144]

1.9.2.2 Homeownership Versus Rental Housing

Whether subsidized housing, particularly rural subsidized housing, should be available for homeownership or for rent is another controversial policy issue. Practically all federally assisted housing built in rural areas prior to 1970 was homeownership housing. Since then, an ever-increasing proportion of such housing has been rental housing. More importantly, low-income persons had been able to purchase single-family homes prior to 1970; today, homeownership is generally beyond their reach. Rising costs and Congress' unwillingness to extend deeper subsidies to the homeownership housing programs have made single-family housing unaffordable to low-income families. Despite arguments that homeownership is more suitable to rural than urban areas, that rental housing cannot be operated economically in small communities, and that homeownership subsidies are probably less costly than rental subsidies, Congress has been unwilling, with two minor exceptions,[145] to extend deep subsidies to low-income homeowners.[146] The reason most often cited is cost; however, many believe that the real reason homeownership subsidies for low-income persons have not passed is Congress's reluctance to provide new homeownership opportunities to low-income persons when those same opportunities are becoming scarce for middle-income families.

1.9.2.3 The Density Debate

Whether housing should be provided in large developments or in scattered sites is an issue debated primarily in urban areas, but this question is also relevant to rural housing. Most early FmHA-financed housing was constructed on farms, in undeveloped areas, and in towns with fewer than 2,500 persons. Expansion of the FmHA service area, application of more stringent development and construction standards, and purported economies of scale in construction and management, as well as FmHA's concern for its security value, have changed the pattern of development. By regulation, FmHA has required that single-family housing be constructed in subdivisions with paved roads, curbs and gutters, and central water and sewer systems.

[143] *See* 42 U.S.C.A. § 1437(f)(1) (West 2003).

[144] For a discussion of these rights *see* §6.11.

[145] In 1983, Congress authorized FmHA to extend the term of the Section 502 loan to 38 years whenever it is necessary to extend the term in order to make a Section 502 loan affordable to a borrower whose household income is within 60 percent of the area's median income. 42 U.S.C.A. § 1472(a)(2) (West 2003). In 1990, it authorized a deferred mortgage demonstration program which authorizes FmHA to defer up to 25 percent of the monthly payment due on a Section 502 loan in order to make it affordable to very low-income families. *Id.* § 1472(g).

[146] In 1979, Congress enacted the Homeownership Assistance Program, which authorizes the extension of deep subsidies for homeownership loans. 42 U.S.C.A. § 1490a(1)(C) (West 2003). Unfortunately, Congress never appropriated any funds for it.

As a result, if rural low-income people want subsidized housing, they are forced to live in more urbanized and highly developed areas.

In recent years, rural housing advocates have persuaded Congress to restrict RD/RHS' efforts to concentrate rural residents in more densely populated areas by requiring it to target its assistance to undeserved areas,[147] authorizing grants for the construction of RD/RHS-financed housing when the reasonable cost of the housing exceeds the appraised value due to the market in which the housing is located,[148] prohibiting RD/RHS from refusing to make loans in areas that it considers excessively rural in character or excessively remote,[149] and by prohibiting RD/RHS from giving funding preference to projects located in communities that have particular essential services.[150]

1.9.2.4 New Construction Versus Existing Units

The issue of whether subsidized units should be in newly constructed, substantially rehabilitated, or in older buildings, has produced numerous battles in the urban housing programs. This has had an effect on the rural programs. With the exception of the Section 504 program and a very small portion of the Section 502 program, practically all FmHA housing financed before 1970 was newly constructed. The policy favoring new construction was modified substantially after adoption of the Housing and Community Development Act of 1974,[151] which placed special emphasis upon the preservation of existing housing.

In 1973, only 28% of FmHA Section 502 loans were used to purchase existing housing; by 1980, 41% of all homes purchased with Section 502 funds were existing structures. By Fiscal Year 2009, the pattern had reversed. Only 36% of the Section 502 loans were made for new construction, while 62% were for the purchase of existing homes.[152] In addition, the number of Section 504 loans and grants used for the repair of existing structures grew from approximately 3,000 in 1973 to nearly 7,000 in 1980. Unfortunately, the reduction in FmHA appropriations reduced that number to below 6,000 by 1992. Due to the fact that appropriations for the programs tripled to $67 million by Fiscal Year 2008, the total number of loans and grants made that year only increased to 9,700. In all likelihood, the disparity was caused by increased housing repair costs.

Numerous factors have influenced the policy change from promoting new construction to utilizing existing housing. For one thing, it is cheaper to finance and subsidize the purchase of an existing dwelling than a new dwelling. Other advantages to existing units include their availability in areas where new construction may not be taking place and in the likelihood of their having amenities not available in newly constructed subsidized housing.

At the same time, there are also disadvantages. Because existing housing is older, there is a greater possibility that it will be substandard and lack adequate insulation or other energy saving devices. On the other hand, newly constructed housing in FHA- and RD/RHS-subsidized developments has a history of rapid deterioration.

The new construction and substantial rehabilitation programs have the advantageous effect of increasing the supply of housing. In contrast, programs promoting use of existing housing inflate housing prices or rents. Developers and builders, of course, prefer the new construction or substantial rehabilitation programs.

1.9.2.5 Housing Allowances Versus Income Maintenance

From time to time, policymakers have considered whether poor people's housing needs should be met by providing housing allowances, or even more radically, by folding shelter costs into an overall income-maintenance scheme. Advocates of such policies point out that, unlike the present housing subsidy programs, a housing allowance would promote:

- universal availability of the subsidies to all eligible applicants;
- greater control of the housing subsidy money by the recipients themselves;

[147] *Id.* § 1479(f).
[148] *Id.* § 1472(f)(1).
[149] *Id.* §§ 1472(f)(2) and 1485(z)(1).
[150] *Id.* § 1485(z)(2).
[151] Pub. L. No. 93-383, 88 Stat. 633 (1974).
[152] The remaining loans were for refinancing or repair of existing loans.

- less diversion of the subsidy dollars to the housing industry and governmental middlemen; and
- fewer incidents of inappropriate site selection, poor management, poor maintenance, and financial failure, which have typified extensive government involvement in subsidized developments.

Whenever such proposals are raised, numerous interest groups come to the defense of existing programs. Builders and developers attack the housing allowance proposals because they prefer the higher profits to be derived from subsidy programs that promote housing construction and rehabilitation. HUD, RD/RHS and state and local government bureaucrats fight for the existing programs because their jobs depend upon the programs' continued funding. Politicians respond to the interests of moderate-income people who presently receive some subsidy benefits, but who might be ineligible for or unwilling to accept direct housing allowances or welfare payments under a true income-maintenance scheme.

Moreover, there are strong arguments, often advanced by low-income housing advocates, that a housing allowance or income maintenance scheme would be worse for poor people than the present housing subsidy programs. First, payments under such a scheme are likely to be minimal and therefore insufficient to meet shelter needs. Historically, welfare payments have run well below the amount needed for survival. An income maintenance scheme would probably be adequate only if supplemented by special categorical assistance such as housing, medical, and food subsidies. Second, because the housing allowance would not necessarily increase the housing supply, the additional spending power provided to low-income people would probably result only in increased rents, absent effective rent control laws. A housing allowance will not produce better quality housing, nor will it give poor families better bargaining power with their landlords or home sellers. Furthermore, it would not give significant relief from high housing costs if a good deal of the allowance goes to pay increased rents or mortgage payments. Finally, any subsidy that pushes tenants into the private market will reduce their rights vis-a-vis landlords and financiers, since private tenants and homeowners have substantially fewer rights than federal housing tenants and homeowners.

1.9.2.6 Time Limits

Since the mid-1990s, when Congress placed time restrictions on receiving TANF, policymakers have proposed the establishment of time limits for receiving housing assistance.

Such a policy would likely be disastrous in the single family homeownership program. It would likely deprive fixed income households from receiving home loans and may lessen the capacity of others to receive long term home loans. Nonetheless, time limit proposals are likely to surface in the future as federal housing policies change.

1.9.3 WHO SHOULD RECEIVE THE LIMITED AMOUNTS OF HOUSING SUBSIDIES?

The housing subsidy programs are unlike the former federally funded welfare programs, which made payments to every eligible applicant. Congress has never appropriated sufficient funding to provide housing subsidies to all eligible persons. As a result, the number of applicants for each housing program far exceeds the number of available units.

This lack of sufficient funding to serve all who need assistance has created disputes about which income groups should be the recipients of limited federal subsidies. The history of the low-income housing programs is replete with examples of efforts by special interest groups, the various administrations and sometimes even Congress itself to shift the subsidy focus away from those with the lowest incomes and the greatest need to those who have a much better chance of fending for themselves in the private housing market.

Because of insufficient funding, decisions must also be made as to which applicants will be denied assistance. Although some obligations have been placed on RD/RHS to serve low-income households, under the single-family programs, this power still belongs to the local RD/RHS official.

Beyond the question of income, there are other significant factors in setting selection priorities for families to participate in the federally subsi-

dized housing programs. On several occasions, Congress amended the HUD federal housing subsidy programs to create priorities for applicants who are being involuntarily displaced, who reside in substandard housing, who pay more than 50% of their income for rent, or who are homeless or living in shelters.[153] These priorities reflect a congressional judgment that otherwise eligible families living in shelters, facing displacement, residing in substandard housing, or paying excessive portions of their incomes for rent should receive, before others, the limited federal housing subsidies. Unfortunately, similar priorities have not been attached to the rural homeownership programs.

Funding is not the only factor affecting the selection process. Past performance as a tenant or borrower will often determine whether a particular applicant will qualify for admission to a rental project or qualify for a RD/RHS loan. For the rejected applicant, this not only means that the family cannot reside in a particular project or home, but also that it will not be able to obtain the desperately needed housing subsidies to reside anywhere else.

Numerous controversies have developed regarding landlords' and RD/RHS officials exercise of their selection powers under the subsidy programs. Sometimes those controversies have involved legitimate policy choices, such as whether an applicant's past behavior may be considered, and if so, which types of past behavior, such as unjustified nonpayment of rent, are relevant. Other controversies stem from abuses of power such as a RD/RHS officials' unwillingness to make a loan to a welfare recipient.

Unfortunately, a great deal of the low-income housing advocates' limited resources is expended at the congressional level and the RD/RHS trying to curb abuses of power in the applicant selection process. Yet, as long as the system grants fewer subsidies than are needed and gives landlords and RD/RHS officials the power to choose among eligible applicants, strict substantive standards to control abuse of that power will be necessary. In addition, applicants, borrowers, and tenants will have to fight for and closely monitor stringent procedural protections in order to detect and correct abuses as they occur.

1.9.4 HOW MUCH SHOULD PEOPLE PAY AND HOW DEEP SHOULD THE GOVERNMENT SUBSIDY BE?

Another policy change in the subsidized housing programs concerns the amount of the monthly payment subsidized families should make and, correspondingly, the amount of subsidy the government should provide.

Home purchasers using the Section 502 program have fared worse than tenants in the tenant payment/government subsidy struggle. The Section 502 program started as one offering slightly below market interest rates. Purchasers were expected to pay all the costs of owning and operating their home, but received only a subsidized interest rate.

As home costs and interest rates began to rise, the FmHA interest rate was maintained at near the original level. This effectively increased the subsidy and implied acknowledgement by the government of its need to subsidize homeownership. In 1968, the Interest Credit program was extended to home purchasers under the Section 502 program. With Interest Credit, the purchasers' effective interest rate was reduced to a level as low as one percent. Participating households paid the higher of 20 percent of their income or the effective one-percent interest. Although this represented a substantial savings, home purchasers were still required to repay principal and interest (albeit at the reduced level), taxes, insurance, utilities, and maintenance.

As home costs and operating costs increased, fewer and fewer low-income families could afford to purchase homes, even at a one-percent interest rate. By the mid-1970s, most people conceded that the new construction Section 502 program no longer served truly low-income persons. In 1977, Congress passed the Home Ownership Assistance Program (HOAP) in an attempt to provide low-income home purchasers the same subsidy as tenants receiving Rental Assistance in the Rural Rental Housing Program. The program authorized FmHA to subsidize the difference between the full cost of amortizing and maintaining a home and 25% of the purchaser's income. Unfortunately, even though Congress tried to reduce the fiscal impact of the subsidy by providing recapture of a major portion of it upon sale or transfer of the home and by limiting the scope of the program, the House Appropriations

[153] *See, e.g.*, 42 U.S.C.A. § 1437f(d)(1)(A) (West 2003).

Committee never approved funding for the program. As noted earlier, the only concessions Congress has made for low-income homeowners has been to increase the period of amortization for Section 502 loans for some borrowers to 38 years and, for a limited time, to authorize a deferred mortgage demonstration program.

In the early 1990's, Congress, in response to the mounting concern about budget deficits, considered reducing the level of subsidy that was being made available to Section 502 homeowners. In that discussion, suggestions were made that the Interest Credit subsidy should be based on homeowners paying 30 percent of adjusted income for shelter just like renters in FmHA housing. While the argument is often couched in terms of equity, in fact it is nothing but a budget cutting measure. In most instances, homeowners pay in excess of 30 percent of income for shelter when one considers the cost of maintenance and utilities that are not included in the Section 502 payment calculations and are included in the rental housing subsidy calculations.

While Congress never changed the percentage of income that homeowners should pay for participating in the homeownership program, RD/RHS did. For new borrowers, RD/RHS introduced, in 1996, what is now known as the Payment Assistance I program, Under that program the minimum amount that a borrower had to pay for principal, interest, taxes and insurance, was raised to 22% if the borrower's income was within the RD/RHS very low income range, 24% if the borrower's adjusted income was within 65% of the area's adjusted income, and 26% if the borrower's income was within 65% and 80% of the area's median income.

In 2009, RD introduced the Payment Assistance II subsidy program for new borrowers. Under that program borrowers are now required to pay 24% of income for principal, interest, taxes and insurance.

While no one has formally looked at the correlation between subsidy and ability to qualify for RD/RHS loans, it is not surprising that RD/RHS is having difficulty directing 40% of its Section 502 loans to borrowers whose incomes are considered low income.

Regardless of the level of income that is devoted to PITI payments, there are also disputes about what can be fairly included in income and what deductions from income should be allowed. There are recurring disputes about whether income that is not available to the household, such as child support payments made to others and earnings of temporarily absent household members that are not remitted to the household, should be counted as household income.

In the early 1970's Congress decided that households should be able to deduct $300 from household income for each dependant household member. Despite the ravages of inflation over 30 years since then, Congress has only raised the deduction to $480 and that was in 1983. As each year passes, this deduction becomes less meaningful and makes it more difficult for low-income households to qualify for Section 502 loans.

1.9.5 RURAL HOUSING PROGRAMS SHOULD RESPOND TO SPECIAL RURAL NEEDS

Historically, it has been assumed that housing programs developed for urban areas will also serve the needs of rural areas. Thus, the National Housing Act of 1934, while acknowledging the need for decent, safe, and sanitary housing in rural areas, did not recognize the need for any special rural programs. It was not until 15 years later, in the Housing Act of 1949, that Congress recognized that the FHA programs were not functioning in rural areas because the mortgage credit institutions upon which they were dependent were not operating there. Congress therefore passed the Section 502 program, modeling it after the FHA Section 203 program.

When Congress enacted the public housing program in the same Housing Act of 1949, it ignored the FHA experience and assumed that the public housing program would also effectively serve rural areas. In fact, it did not. A 1973 study analyzing the distribution of public housing showed that the program had a clear urban bias, and that nearly one half of the nation's counties, most of which may be characterized as rural, had no public housing.[154]

[154] Rural Housing Alliance/Housing Assistance Council, Inc., *Public Housing: Where It Is and Isn't* (Washington, D.C., 1973).

Ironically, at the time the public housing program began experiencing difficulties in urban areas, it was rapidly gaining popularity in rural areas. Nevertheless, the President and the Congress looked only at the urban experience in deciding, in 1974, to terminate the conventional public housing program.

The FHA Section 202 elderly housing program, enacted in 1959, was another program that originally was to operate in both urban and rural areas, but few Section 202 projects were constructed in rural localities. Within three years, Congress recognized the problem and created the parallel Section 515 program.

The history of rural housing is replete with similar experiences. The FHA Section 221(d)(3) Below-Market Interest Rate program, created in 1959, was not extended to rural areas until 1965. The Rent Supplement program, which was available with FHA Section 221(d)(3) financing beginning in 1965, was not replicated for rural areas until 1974, and then not implemented until 1978.

By design or otherwise, rural programs have also been severely constrained by requirements imposed on urban programs. For example, the construction and design standards applicable to HUD/FHA housing have often been applied to RD/RHS housing. Requirements characteristic of urban and suburban developments, such as central water and sewer systems and curbs and gutters, are standard requirements in RD/RHS developments. Davis-Bacon Act wage rules applicable to some RD/RHS programs are typically developed for only urban areas and extended to cover neighboring rural areas, even though wage rates in those areas are generally lower. Even those RD/RHS programs that were not modeled after urban programs, but were designed to meet special rural needs, contain requirements applicable only to urban housing. A good example is farm labor housing, which until 1980 had to meet the HUD Minimum Property Standards and be designed for year-round occupancy. That the housing would not be occupied on a year-round basis or that it may not need to last 40 years apparently were not factors to be considered.

The HUD Section 8 certificate program and voucher programs are yet other examples of urban programs being assumed to operate equally well in rural areas. In fact, some of the assumptions underlying these programs are not necessarily true for rural areas. For example, rural areas have a disproportionate share of substandard housing; consequently, it is more difficult to rent housing that meets the programs' quality standards. The programs also assume that residents have ready access to agencies, such as public housing authorities, that administer the programs. In fact, not all rural areas have public housing authorities and the administrative function had to be taken over by state housing finance agencies or the state government, that often are not readily accessible to rural residents.

Initiatives in rural housing have been limited or opposed for a variety of reasons related to urban housing biases. For example, rural housing development has been hampered by unrealistic expectations of what rural people want or need and by misconceptions of what is marketable in rural areas. The implementation of the Homeownership Assistance Program (HOAP) has been opposed for fear that such a program would have to be expanded to urban areas and thus would become too costly.

If the housing needs of rural people, and particularly of the rural poor, are to be addressed, we will need to stop assuming that programs designed for urban areas are equally effective in rural areas. We will need to look at the special needs of rural people, analyze the magnitude and scope of rural housing problems, and design solutions and programs that address these problems without having to worry about the possibility of having to expand those solutions to urban areas.

1.9.6 HOUSING PLANS AND STRATEGIES

From time to time, Congress imposes upon local governments requirements that they analyze their housing needs, including housing for poor people, and develop plans to meet those needs. In 1954, Congress made each locality develop a Workable Program for Community Improvement if they wanted to qualify for federal urban renewal money and other housing-related federal funds.[155] When Congress replaced urban renewal and other categorical improvement programs with the Community Development Block Grant (CDBG) pro-

[155] 42 U.S.C.A. § 1451(c) (West 2003); Pub. L. No. 83-560, § 303, 68 Stat. 590, 623 (Aug. 2, 1954).

gram, it required all participating localities to develop a Housing Assistance Plan. In that plan, the local government was required to survey the condition of the community's housing stock, assess local housing assistance needs and set out "realistic" activities "best suited" to meet those needs, designating locations for proposed federally or state-assisted housing.[156]

In 1990, Congress replaced the Housing Assistance Plan requirement with the Comprehensive Housing Affordability Strategy (CHAS) requirement.[157] Under that requirement, any state or local government that seeks assistance from HUD must first develop and secure HUD approval of its CHAS. The strategy must analyze the community's housing needs for the following five years, the needs of homeless persons, the local housing market, any public policies that affect the cost or development of housing, and the resources available to meet the needs. The strategy must also include a plan for addressing the needs that exist, and anticipated use of funds under various HUD programs, such as HOME, CDBG, the United States Housing Act, the McKinney Act, and the Low Income Housing Tax Credit program. The plan must also assess the locality's public housing program. The CHAS must explain how the locality will monitor housing activities within its jurisdiction to ensure compliance with the governing federal law. In the strategy, the locality must certify that it will affirmatively further fair housing and that it is in compliance with any applicable CDBG anti-displacement plan.

In 1994, the CHAS was folded into the HUD "Consolidated Plan" process by HUD regulations while extending its coverage to additional programs, including Community Development Block Grants, Emergency Shelter Grants and Housing Opportunities for Persons with AIDS.

Members of the public must be allowed to participate in the development of the CHAS and any substantial amendments that are submitted to HUD for approval.[158] HUD is given 60 days to review and decide whether to approve the strategy[159] and HUD's approval is subject to limited judicial review.[160] Each year the locality must review its performance and submit a report to HUD, and HUD, in turn, must perform a review of the locality's progress.[161]

These strategies and performance reports may prove to be a helpful source of information about the housing conditions in a locality and the plans for resolving the problems. In addition, becoming involved in the strategy process may lead to actions that will alleviate some clients' housing problems, because the plans are supposed to influence the actual development of housing in the near future.

Although useful as an informational resource, a locality's or state's Consolidated Plan has had little influence initially on the type of RD/RHS housing that will be developed in a community because the vast preponderance of RD/RHS housing, particularly single family housing, has been developed by private sponsors who were not required to comply with a CHAS.

1.9.7 HOUSING PAROCHIALISM: THE IMPORTANCE OF COORDINATING HOUSING STRATEGIES WITH OVERALL NEIGHBORHOOD IMPROVEMENT AND ANTI-POVERTY EFFORTS

There is a disturbing tendency among housing specialists, both in government and, to a lesser extent, in legal services programs, to focus solely on low-income housing problems. Specialization often encourages tunnel vision, ignoring the rest of the neighborhood components and persistent problems facing low-income families, including the lack of jobs, inadequate incomes, and poor educational facilities and health services. Frequently, as a result, the housing efforts fail. Improving one building, or one part of a neighborhood, does not significantly enhance the living environment if the rest of the neighborhood is plagued by physical deterioration; rampant crime; and inadequate commercial services, job opportunities, and public transportation.

[156] *See* 42 U.S.C.A. § 5304(c) (WEST, WESTLAW, Current through P.L. 111-69 (excluding P.L. 111-67 and 111-68) approved 10-1-09); 24 C.F.R. § 570.306 (1991). *See also An Advocacy Guide to the Community Development Block Grant Program*, 12 CLEARINGHOUSE REV. 601, 628-636 (Jan. Supp. 1979).
[157] 42 U.S.C.A. § 12705 (West 2003).
[158] *Id.* § 12707.
[159] *Id.* § 12705(c).
[160] *Id.* § 12708(c).
[161] *Id.* § 12708(b).

In short, people cannot improve their lives significantly by merely obtaining a decent home. They will remain oppressed by all of the other symptoms of poverty.

Of course, the problems caused by the narrow focus of housing policymakers are compounded by the manifestly elitist approach of seeking to "give" low-income people decent housing, instead of recognizing that they are entitled to have such housing and to control its operation. Only when low-income people have comprehensive rights to decent homes, food, education, and health care, as well as power over decisions affecting those rights, will we have begun to mount an effective challenge to the problems of poverty.

Over the years, federal housing and community development programs, particularly those operating in urban areas, have reflected some recognition of both the importance of a coordinated approach and the need for program beneficiaries to have decision-making power. Unfortunately, these programs have usually lost sight of poor people. The responsible officials tend to be much more concerned about the well-being of the buildings and other physical elements of the neighborhood than the well-being of the residents. Too often, where federal programs improve neighborhoods and provide new or rehabilitated housing, it is not for the benefit of poor people or the long-term neighborhood residents. Instead, the poor are displaced into other, deteriorated areas with grossly overpriced substandard housing. All the while, HUD and, sometimes, RD/RHS officials stand by, doing nothing. What is worse, the bureaucrats often vigorously argue that too much concern about the plight of displaced poor people might undermine the revitalization momentum of private investors.

1.9.8 FAIR HOUSING AND CIVIL RIGHTS

A significant proportion of households applying for and assisted by RD/RHS loan and grant programs are headed by people of color who are protected against discrimination under federal civil rights laws, including the Fair Housing Act (Title VIII of the Civil Rights Act of 1968).[162] Classes protected under this title include: race, color, religion, sex, familial status, national origin or people with disabilities. Title VIII prohibits both intentional discrimination and, in all circuits that have considered the issue, actions producing unjustified discriminatory impact or perpetuation segregation. In addition, USDA and, therefore, RD/RHS have an affirmative duty to further fair housing objectives.

Since President Kennedy's issuance of Executive Order 11,063 in 1962 and enactment of the Fair Housing Act six years later, federal agencies and HUD and USDA in particular, have had an affirmative obligation to prevent racial discrimination and to further fair housing in the administration of their programs. At a minimum, this requires agencies to collect relevant race and socio economic data and to consider this information when making program decisions.

In fact, RD/USDA is not known for its civil rights enforcement. From its earliest days, when County Committees, composed of local farmers, were required to approve all FmHA loans, people of color were frequently discriminated against in their qualification for housing loans. This improved somewhat when the County Committee authority to approve housing loans was terminated. However, discriminatory practices continued at local offices through the actions of FmHA and RD officials. These practices were never challenged in the housing context. However they were challenged by African-American, Native American, Hispanic and female farmers who filed class action law suits alleging widespread racial discrimination in the farm loan programs.[163] The first of these law suits, brought by African American farmers settled with the plaintiffs receiving over $1.25 billion in damages.[164] The other law suits are still pending.

In many cases, the same persons that were processing the FmHA, RD/RHS farm loans were

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[162] 42 U.S.C. §§ 3601 *et seq.* (West 2003). For other potentially applicable federal and state civil rights statutes, *see generally,* Florence W. Roisman, *An Outline of Principles, Authorities, and Resources Regarding Housing Discrimination and Segregation* (Oct. 27, 2000), available at http://nhlp.org.

[163] *Pigford v. Glickman*, No. 97-1978 (D.D.C. 1997); *Brewington v. Glickman*, No. 98-1693 (D.D.C. 1997); *Keepseagle v. Vilsack*, No. 1:99CV03119 (D.D.C. 1999); *Garcia v. Veneman*, No. 00-2445 (D.D.C. 2000).

[164] Washington Post, *Farmers See Ray of Hope in USDA Bias Case* (Sept. 29, 2009) available at: http://www.washingtonpost.com/wpdyn/content/article/2009/09/28/AR2009092803838.html.

also processing applications and requests for relief under the housing programs. Even when other persons were processing or assisting housing loan applicants or borrowers, there is no reason to believe that they were treated differently than farmers. Accordingly, advocates should always think about discrimination issues when reviewing how their clients were served.

Fair housing complaints can be filed with HUD, which is the agency charged with enforcement of the Fair Housing Act.[165] The USDA also has a civil rights office which will consider discrimination complaints filed against agency personnel. Unfortunately, historically that office has not had the best record of resolving complaints timely or in favor of complainants.

The Obama administration has vowed to improve diversity in agency staff and combat discrimination in the department. It is too soon to tell whether these efforts have or will succeed.

1.9.9 CONCLUSION

Although it is not possible to provide definitive answers to all of these recurring policy conflicts, some guidelines do emerge. Efforts to improve low-income people's living conditions must not be narrowly focused on housing alone. Instead they must be coordinated with their struggles to meet other their needs, in recognition of the fact that people need not only decent homes but also good neighborhoods. The federal subsidies provided must not merely be limited subsidies designed to cover only capital costs, but rather subsidies adequate to make the housing affordable by low-income people. Subsidized housing units must remain available to low-income people on a long-term basis. The programs must be designed and implemented in a manner that will benefit both rural and urban poor, and not primarily the middlemen who have too often benefitted inordinately from past federal housing policies. Subsidized programs must not divert scarce housing resources to people of middle income before meeting the needs of low-income households, and the programs should provide decent housing for all who are eligible, not just for a small fraction of those in need. Finally, the cornerstone of the housing programs must be a recognition that low-income people are entitled to their homes and that they have all the rights that flow from such entitlement. Those rights include good maintenance, affordable payments, and long-term security of tenure. Aggressive pursuit of these principles in the development and implementation of national housing policies will mark a substantial step in the struggle of low-income people in America to improve their lives.

[165] 42 U.S.C.A. § 1437 3608(a) (West 2003).

CHAPTER 2
APPLYING FOR SECTION 502 LOANS AND SECTION 504 LOANS AND GRANTS

2.1 INTRODUCTION

A very large percentage of the loan and grant applications filed annually with RD/RHS are rejected or withdrawn.[166] Historically, countless more persons were informed verbally that they are ineligible for RHS assistance and were discouraged from filing a formal loan or grant application. Although many applicants are discouraged or rejected for valid reasons, significant numbers are discouraged by improper means or rejected for improper reasons. This chapter reviews the process by which applications are submitted to and reviewed by RD/RHS, the standards used to determine eligibility, and the procedural framework of RHS' decision making process. It does not review the process by which private lenders process applications for RHS Section 502 guaranteed loans because those loans are no longer subsidized and few low- and very low-income households qualify for the program.[167]

2.2 AN OVERVIEW OF THE APPLICATION SUBMISSION PROCESS

Applications for RD/RHS loans or grants are typically prepared and submitted to RD/RHS either directly by the applicant or indirectly through packagers, most of whom are contractors or builders.

Pre-Qualification. RD/RHS encourages all applicants to participate in a loan pre-qualification process,[168] which is an informal mechanism by which individuals can meet with an RD/RHS loan originator to learn about the Section 502 loan program and the application process, determine the likelihood of eligibility based on income and other factors, calculate the likely maximum loan amount and encourage the early completion of required homeownership education.[169] The prequalification meeting is not mandatory,[170] and based on that meeting, the loan originator[171] may not refuse to accept a formal application for a Section 502 loan. Unfortunately, there is no readily available data about the number of households who partake in the pre-application process or the number of persons who actually submit a formal application after a pre-qualification meeting. Undoubtedly, however, the process operates to discourage many households from proceeding to file a formal application. Disturbingly, persons who participate in the pre-qualification process are never advised of the fact that they have a statutory right to appeal adverse agency decisions.[172] Consequently, for those persons who do not submit a formal application, the pre-qualification process operates to discourage households from applying for Section 502 loans and deprives these households from learning about their due process appeal rights.

Direct submission by applicant. A person who applies directly for an RD/RHS loan usually submits the application in stages at the appropriate RD Field Office.[173] On the applicant's initial visit,

[166] Applications are considered withdrawn when an applicant fails to submit all the information necessary to complete the loan package within 30 days. Handbook 1-3550 ¶ 3.6 B (7-8-09). (All Rural Development Handbooks are available at: http://www.rurdev.usda.gov/regs/hblist.html) or fails to respond to RHS request that they reconfirm their interest in obtaining a loan. 7 C.F.R. § 3550.55(b)(3) (2009), Handbook 1-3550 ¶ 3.15.

[167] Regulations on processing guaranteed loans are codified at 7 C.F.R. §§ 3550.51 *et. seq.* (2009). The agency's interpretation of those regulations can be found in Handbook 1-3550 (CHAPTER 3: Application Processing).

[168] *See, generally*, Handbook 1-3550, Chapter 3 ¶3.1*et. seq*.

[169] 7 C.F.R. §§ 3550.11 and 3550.53(i) (2009); Handbook 1-3550 ¶ 3.1 *et. seq*.; Homeownership Education Requirements are found at Handbook 1-3550 ¶ 3.4 (7-8-09).

[170] Indeed, it is not even mentioned in RD/RHS regulations.

[171] Loan Originator is an agency employee who works with the loan applicant, conducts the basic underwriting analysis, and makes the loan approval or credit denial recommendation to the Loan Approval Official. Handbook 1-3550 Glossary (Rev. 4-1-08).

[172] *See* 7 C.F.R. §§ 11.1 et. seq. (2009). *See also* Chapter 23, *infra*.

[173] *See* Chapter 1.3 for a discussion of the RHS Administration and the RD Field Office structure.

an RD official, usually a loan originator, will determine whether the person has gone through the pre-qualification process, and if not, will encourage the applicant to do so. The local loan originator should explain the basic documents and contents of an application package. The forms that must be completed are set out in the RD/RHS regulations and handbook.[174]

When these forms are completed and returned, RHS verifies the information and assembles additional information needed to evaluate the applicant's qualifications and credit needs.[175] The Loan Originator should determine whether the applicant appears to meet the eligibility requirements, listed in Chapter 4 of RD/RHS Handbook 1-3550, within 30 days of receiving the complete application.[176] This process includes verification of the applicant's income,[177] including income which is attributable to assets,[178] and a check of the applicant's credit.[179] Applicants must be advised of their eligibility within 30 days of submitting a completed application.[180]

Applications of individuals or households found eligible for Section 502 loans are separated into one of two income groups depending on whether the applicant's income is considered (1) very low-income or (2) low income, moderate income, or other.[181] Applications are next assigned to one of four processing categories. First priority is given to existing borrowers who request subsequent loans to correct health and safety hazards. Second priority is given to loans related to the sale of an REO property or the transfer of an existing RD/RHS financed property. Third priority is given to applicants facing housing related hardships including applicants who have been living in deficient housing for more than 6 months, current homeowners in danger of losing a property through foreclosure, and other circumstances determined by RD/RHS on a case-by-case basis to constitute a hardship. Fourth priority is given to applicants seeking loans for the construction of dwellings in an RHS-approved Mutual Self-Help project or loans that will leverage funding or financing from other sources.[182]

Applicants for funding who do not have a processing priority may only have their applications processed if no applications with priorities remain unprocessed.[183]

Category II, III and IV applications are selected in category order on a quarterly basis or, if necessary, more frequently, in accordance with the level of funds that are available to the RD/RHS office for loans to very low-income applicants and other applicants that are not very low-income.[184] The number of applications selected should be commensurate with the number of loans that can be processed and approved during the quarter.[185]

A selected Section 502 loan applicant is notified in writing of the decision and is asked to submit all the information necessary for RD/RHS to continue processing and approve the loan within a

[174] *See* 7 C.F.R. § 3550.55(a) (2009). The required forms are: RD Form 410-4 'Application for Rural Housing Assistance'; 'Uniform Residential Loan Application' and the RD Form 3550-1 'Authorization to Release Information'. Handbook 1-3550 ¶ 3.5 A (7-8-09). These forms are available on the RD Website http://www.rurdev.usda.gov/regs/formstoc.html.

[175] In the case of Section 502 loans, RD/RHS may defer the verification process until after it categorizes the applications in accordance with priorities established by the agency. Handbook 1-3550 ¶ 3.14 (Rev. 7-8-09).

[176] *Id.* ¶ 3.10.

[177] Form RD 1910-5 (Rev. 12-08); 7 C.F.R. § 3550.54 (2009). *See* 7 C.F.R. §§ 3550.53(a) and (g) (2009); Handbook 1-3550 ¶¶ 4.2 through 4.4 (Rev. 3-15-06).

[178] 7 C.F.R. § 3550.54(d) (2009); Handbook 1-3550 ¶¶ 4.5 through 4.8 (Rev. 3-19-08).

[179] Handbook 1-3550 ¶¶ 4.9 through 4.14 (Rev. 7-8-09). See 7 C.F.R. § 3550.53(h) (2009). When funds are not available to complete processing of applications as they are received, RD/RHS is instructed to conduct a preliminary review of the applicant's credit history and assist the applicant in addressing any deficiencies pending the availability of funding. Handbook 1-3550 ¶ 4.11 (Rev. 7-8-09).

[180] Where RD/RHS does not verify the applicant's employment and credit history, the eligibility determination is preliminary subject to later verification. Handbook 1- 3550, ¶ 3.13 (Rev. 7-8-09).

[181] RHS is required to set aside at least 40 percent of its annual Section 502 appropriations for very low-income families or persons and not less than 30 percent of the Section 502 funds allocated to each state must be made available to those families or persons. 42 U.S.C.A. § 1472(d) (West 2003).

[182] 7 C.F.R. 3550.55(c) (2009); Handbook 1-3550 ¶ 3.14 B (Rev. 7-08-09). Completed applications are processed within each priority category according to the date of filing the application. In the case of applications being filed on the same date, veterans receive a preference.

[183] 7 C.F.R. § 3550.55(c)(5) (2009).

[184] *See* Note 182, *supra*. 42 U.S.C.A. § 1472(d) (2003); Handbook 1-3005 ¶ 3.12 (Rev. 7-8-09).

[185] Handbook 1-3550, ¶ 3.14 D (Rev. 1-9-08).

reasonable time.[186] This requires that the applicant submit to RD/RHS complete information about the house that is to be constructed, purchased, or rehabilitated, documentation of income and verification of expenses that are used to adjust household income.[187]

Applications of individuals or households found eligible for Section 504 loans or grants are notified in writing and are asked to meet with the Loan Originator to develop the full loan and/or grant package. Within 30 days of determination of eligibility the Loan Originator must visit the property to identify which repairs are essential. Photographs of the property and the items needing repairs should be taken during this visit and at final inspection.[188]

Primary responsibility for gathering information necessary to complete a Section 502 or Section 504 loan package rests with the applicant.[189] Therefore, if the applicant seeks a loan to construct a new home, she or he may be required to locate and option a site; develop plans, specifications, and cost estimates; arrange for all necessary permits; select a contractor; and enter into a conditional construction contract. While RD/RHS staff is obligated to provide applicants with some assistance in developing this information,[190] it generally does not.[191] Instead, it directs the applicant to a local builder, realtor, or packager and suggests that the applicant work with that person to complete the necessary loan package materials.

Once the loan package or docket is complete, the Loan Originator reviews it to confirm that the applicant is eligible for the loan, that loan funds will be used only for approved purposes, that the proposed loan is sound, and that all construction plans meet RD/RHS requirements. If everything is satisfactory, the Loan Originator will submit the application to the Loan Approval Official who will approve or reject the loan within 30 days and notify the borrower of the decision.[192]

Depending on the time and method of construction, a loan closing may take place any time after the loan's approval. However, if the closing is scheduled later than 120 days after verification of employment, there is evidence to indicate a change in financial status, or the applicant's employment status had changed within 6 months prior to submission of the application, the Loan Originator must reverify the applicant's income.[193] The Loan Originator should always reverify the applicant's eligibility prior to closing.[194]

Packagers. RD/RHS loan applications are also processed through packagers. These are builders, brokers, contractors and others, including nonprofit organizations that participate in the Self-Help housing Program,[195] who can provide complete information on the applicant and the house to be purchased, constructed, or repaired and have the skills and knowledge to complete an RD/RHS loan docket. Typically, packagers have a self interest, such as the sale of a completed home. Packaging fees paid to tax exempt public and private nonprofit organizations are an eligible loan cost.[196] Loan and grant funds may not be used for fees, commission, or charges to for-profit entities related to loan packaging or referral of prospective applicants to RD/RHS.[197] The administrative cost of packaging may be financed as long as the loan

[186] *Id.* Applicants who fail to submit the required information within 30 days are by-passed during the selected quarter but are re-selected in the ensuing quarter. If they again fail to submit the required information, they are given an additional 15 days in which to submit the information or their application is considered withdrawn.
[187] Handbook 1-3550, ¶ 3.14 D (Rev. 1-9-08).
[188] Handbook 1-3550 ¶ 12.3 (Rev. 11-7-08).
[189] 7 C.F.R. §§ 3550.55 and 3550.104 (2009).
[190] *See, e.g., id.* § 1924.5(f)(2) (2009).
[191] USDA, *Rural Housing Survey and an Analysis of Rural Housing Programs* (Mar. 19, 1979), at 18.
[192] Handbook 1-3550, ¶ 8.2 (Rev. 12-19-07).
[193] *Id.* ¶ 8.6 D.
[194] *Id.* ¶ 8.6 E.
[195] Starting in 1993, RD/RHS has made grants to nonprofit organizations operating in designated underserved areas and colonies to administer and coordinate a housing packaging program. *See* Handbook 1-3550 ¶ 3.5 B. and Attachment 3-A (*Packaging Applications)* (Rev. 7-8-09).
[196] *See* 7 C.F.R. §§ 3550.52(d)(6)(Section 502 loans) and 3550.102(d)(5) (2009) (Section 504 loans and grants). Fees must be reasonable for the area and not exceed the maximum established by the Agency and are not permitted if the applicant selects a Real Estate Owned property or for Mutual Self-Help Housing grantees or recipients of Housing Application Packaging Grants. Handbook 1-3550 Attachment 3-A (*Packaging Applications* Step 5: Packaging Fee)(Rev. 6-9-04).
[197] *See*, 7 C.F.R. § 3550.52(e)(3) (Section 502) and 7 C.F.R. § 3550.102(e)(6) (Section 504) (2009).

amount remains within the required limits and is within the applicant's repayment ability[198] and is therefore usually included in the sales price or construction costs.

Packagers recruit potential applicants through advertising or direct outreach. They screen potential applicants and, if they believe them to be eligible, prepare and submit to RD/RHS a completed loan docket. RD/RHS reviews the docket in the same way that it would review an application submitted directly by the applicant.[199]

Packagers who are builders of newly constructed homes may operate under a system of conditional commitments.[200] Before locating a potential buyer, builders enter into an agreement with RD/RHS, known as a conditional commitment,[201] in which the builder agrees to construct a modest-sized house according to plans and specifications approved by RD/RHS, to allow RD/RHS to inspect the house during construction, and to sell it at a specified price. RD/RHS, in turn, agrees to inspect the construction and to approve a loan for the purchase of the completed structure if an eligible buyer is found by the packager. Under this system, the portion of the loan docket dealing with site and structure is completed and reviewed by RD/RHS when the conditional commitment is issued.[202] The balance of the docket is completed when an applicant is identified.

Under either system of processing, the Loan Originator will verify the information submitted by the packager, confirm that all necessary information has been provided, explain RD/RHS lending and servicing policies, and review the borrower's responsibilities both during and after construction.[203] Thereafter, the loan may be approved and closed in the same manner as if the application had been submitted directly to RD/RHS.

For the persons who annually receive an RD/RHS loan, this application process appears to operate satisfactorily. For those who submit an application but who do not receive a loan, as well as for those who are discouraged from submitting applications, the process is less than adequate. Since you are likely to have clients in the latter group, the balance of this chapter will deal with the tools that are available to ensure that your clients have an opportunity to have their applications submitted and reviewed, and if a loan is denied, that it is denied for valid reasons.

2.3 PROCEDURAL ISSUES

2.3.1 RD/RHS' FAILURE TO ACCEPT OR PROCESS APPLICATIONS

The key to ensuring an applicant's rights is to submit a written loan application. RD/RHS officials must process and respond to an application, and their failure to do either is both administratively and judicially reviewable. Moreover, once a response is received, its validity can be reviewed and if necessary, challenged. Therefore, you should always begin by determining whether your client has filed an application with the agency. If she or he has not, encourage the client to file one as soon as possible.

If an RD/RHS official discourages or precludes the client from filing an application, advise the official of RD/RHS regulations that (1) authorize and encourage any person wishing to submit an application to do so, (2) preclude the discouragement of applications even though funds are not currently available,[204] and (3) preclude discouragement of applicants based upon any grounds prohibited by the Equal Credit Opportunity Act (ECOA).[205] Such prohibited grounds include a person's sex, marital status, race, color, religion, national origin, age (provided the applicant has capacity to contract), the fact that the person's income is derived from public assistance of any kind, or that the applicant has in good faith exercised any right under the Consumer Credit Protection Act.[206] All activities must be in

[198] Handbook 1-3550 Attachment 3-A, Step 4 (Rev. 6-9-04).
[199] Handbook 1-3550 ¶ 3.5 B (Rev. 7-8-09).
[200] 7 C.F.R. §§ 3550.10 and 3550.70 (2009). *See, id* § 3550.56(a)(1) if, during the application and closing process, an area designation is changed from rural to non-rural.
[201] Form RD 1944-36(Rev. 12-05).
[202] *See* 7 C.F.R. § 3550.70) (2009).
[203] Handbook 1-3550 ¶¶ 3.6, 3.7 and 3.8 (Rev. 7-8-09).
[204] *Id.*, ¶ 3.2 ((Rev. 07-08-09).
[205] 15 U.S.C.A. § 1691e (www.gpoaccess.gov, Laws in effect as of January 3, 2007).
[206] 15 U.S.C. § 1601 et seq. (WEST, WESTLAW, Current through P.L. 111-164 (excluding P.L. 111-148, 111-152, 111-159, and 111-163) approved 5-7-10).

accordance with the Fair Housing Act,[207] Executive Order 11246, and Executive Order 11063, as amended by Executive Order 12259, as applicable.[208]

If you are unsuccessful with a particular official, call or write the Area Director, or if necessary, the State or National Offices of RD and RHS.

Although it should not be necessary, you may also file an administrative appeal through USDA's appeal procedure,[209] or file a complaint with the Federal Trade Commission (FTC) if the grounds for refusing your client's application violate the ECOA.[210]

If you have exhausted all these alternatives and your client still has not received satisfaction, seek an injunction or pursue a mandamus action. In *Ball v. FmHA*,[211] the plaintiffs pursued this option when FmHA's Oregon staff engaged in a pervasive scheme of discouraging low- and very low-income households from applying for and receiving Section 502 assistance.

In that case, Oregon FmHA officials refused to discuss the Section 502 loan program with applicants and insisted that they attend an orientation meeting before their applications would be accepted.[212] At the meeting, or during client interviews, Oregon FmHA officials advised applicants that they would need between $500 and $1,000 in cash to close the FmHA loan or to pay moving costs. They also advised applicants that at some future time they would be required to repay the entire FmHA subsidy, which may amount to as much as $56,000.[213] The plaintiffs in *Ball* alleged that the meeting requirement violated FmHA regulations with respect to applicants' right to file an application and that the other statements misrepresented FmHA regulations and policies and operated to discourage low- and very low-income applicants from obtaining FmHA assistance.

FmHA settled *Ball* by agreeing, *inter alia*, not to advise applicants that cash is required for moving costs, appliances or other similar expenses; not to advise applicants that cash is required for closing costs, except where the applicant can afford to pay those costs or where the appraisal is not adequate to cover the selling price of the home including the closing costs; not to reject applications when applicants do not have cash on hand or in the bank; and not to require applicants to attend group meetings either before or after accepting an application.[214]

RD/RHS officials are known to discourage applicants by other means, such as advising them that they must have a minimum level of income, and that they must be employed continuously by a single employer for some minimum period of time. Since none of these requirements is set out in RD/RHS regulations, you should consider challenging these practices whenever they occur.

2.3.2 PACKAGER'S REFUSAL TO PROCESS APPLICATIONS

Since most packagers' primary objective is the sale or construction of a home rather than assistance to low-income persons, they tend to deny assistance to applicants for whom they believe RD/RHS will not approve a loan or whom they view as potentially detrimental to their sales program. Packagers rely on various rules of thumb to screen applicants for eligibility and often discriminate in order not to jeopardize a successful sale.[215]

RD/RHS does not view packagers as its agents and does not exercise significant control over them. Therefore, people who are not assisted by packagers or who are informed by them that they are ineligible for an RD/RHS loan or grant have no direct opportunity to appeal the packagers' decision.

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[207] 42 U.S.C. 3601 et seq. ((WEST, WESTLAW, Current through P.L. 111-164 (excluding P.L. 111-148, 111-152, 111-159, and 111-163) approved 5-7-10).

[208] 7 C.F.R. § 3550.3 (2009).

[209] *Id.* § 3550.4. *See* Ch. 9, *infra*.

[210] The address of the Federal Trade Commission is FTC, Office of Equal Credit Opportunity, 600 Pennsylvania Ave. NW Washington, DC 20580-0001. The telephone number is (202) 289-6092. An electronic complaint process is available at: https://www.ftccomplaintassistant.gov/.

[211] No. 85-2170-JU (D. Or. filed Dec. 23, 1985), 20 CLEARINGHOUSE REV. 613 (Aug./Sept. 1986) (No. 41,054).

[212] *Id.*

[213] *Id.*

[214] *Ball v. FmHA*, note 211, *supra*, (D. Or. consent judgment Dec. 10, 1986), 20 CLEARINGHOUSE REV. 1452 (Mar. 1987).

[215] USDA, *Rural Housing Survey*, *supra* note 191, at 14.

Such persons should be encouraged to apply for assistance directly with RD/RHS, thereby gaining all the procedural and substantive protections of its statutes and regulations.

If a packager discriminates against an applicant on grounds prohibited by Title VIII of the Civil Rights Act of 1968, as amended by the Fair Housing Amendments of 1988, a complaint should be filed with the Department of Housing and Urban Development.[216] If the packager is found to have discriminated, RD/RHS, through the Secretary of Agriculture, has authority to suspend or debar the packager.[217] Unfortunately, neither RD/RHS nor USDA has historically been known for its enforcement of civil rights laws;[218] consequently, it is unlikely that packagers will actually be debarred by the agency.

Therefore, if your client encounters discrimination by a packager and his or her objective is to obtain an RD/RHS loan, it is more advisable to submit an application directly to RD/RHS and to pursue separately administrative and judicial remedies available against the packager rather than to pursue a civil rights complaint.

2.3.3 ORDER OF PROCESSING APPLICATIONS

When an applicant has submitted a completed application form,[219] executed a copy of the Privacy Statement,[220] and completed the Authorization to Release Information,[221] the Loan Originator must process the application in the order in which it was received.[222] RD/RHS' failure to process applications through the eligibility stage in the order received should be enforceable administratively by an appeal or if necessary, judicially by an injunction or mandamus action.

Once eligibility is established, Section 502 loans are separated by income group and categorized into one of four processing categories.[223] Applications selected for processing during a quarter are not necessarily approved in the order in which the applications were originally received. Instead, they are approved in the order in which loan dockets are completed.[224] Therefore, applicants working with packagers and builders, who often submit a completed docket with the initial application, have their loans approved more rapidly than individuals who assemble their loan dockets piecemeal.

Section 504 loan or grant applications are approved in the order in which the loan or grant dockets are completed, except that applications for assistance to remove health and safety hazards receive priority for funding.[225]

RD/RHS will not approve loans unless funds are available to close them. Applicants whose completed applications cannot be funded are held over until the next funding cycle, at which time they are approved in the order in which the completed loan docket was submitted.[226]

Eligible veterans,[227] their spouses, and children of deceased servicepersons who died during specified periods are eligible for funding preferences when there is a shortage of funds, when the funding obligation forms are ready for submission to the RD/RHS finance office, and where there is more than one application having the same application completion date.[228]

2.3.4 TIMELINESS

Within 30 days of receiving a completed application, RD/RHS must review the application and determine applicant eligibility.[229] RHS must

[216] You should also consider bringing a civil action for damages against the packager.
[217] *See* 7 C.F.R. §§ 3017.305 and 3017.405 (2009).
[218] *See* National Housing Law Project, FmHA HOUSING PROGRAMS: TENANTS' AND PURCHASERS' RIGHTS, p. 16/3 (1982). *See also Chiang v. Veneman*, 385 F.3d 256 (3rd Cir. 2004), *Pigford v. Glickman*, No. 97-1978 (D.D.C. 1997).
[219] Form RD 410-4 (Rev. 10-06).
[220] Form RD 410-9 (Rev. 8-95).
[221] Form RD 3550-1 (Rev. 06-06).
[222] *See* 7 C.F.R. § 3550.55(c) (2009).
[223] *See* § 2.2, *supra*.
[224] 7 C.F.R. § 3550.55(c) (2009).
[225] *Id.* § 3550.104(c) (2009). *See id.* § 3550.10 for definition of "hazard".
[226] Handbook 1-3550 ¶ 3.14(D) (Rev. 7-8-09).
[227] The definition for an eligible veteran is codified at 7 C.F.R. § 3550.10 (2009).
[228] *Id.* §§ 3550.55 (c) and 3550.104(c); Handbook 1-3550 ¶ 3.14(C) (Rev. 7-8-09). In the case of Section 502 loans, the preference is accorded only if the application is also in the same processing category. 7 C.F.R. § 3550.55 (c) (2009).
[229] Handbook 1-3550 ¶ 3.10 (Rev. 7-8-09).

inform an applicant in writing of her or his eligibility for a loan.[230]

The unavailability of funds is not a legitimate basis for discouraging the filing of an application or delaying the determination of an applicant's eligibility.[231] Applicants who are determined eligible should be notified, however, that funds are exhausted and that their application will be held until funds are available, at which time they will receive written notification.[232] If the applicant does not respond to a notice that funds are available within 30 days of receipt of the notice, the application is considered withdrawn.[233]

If an RD/RHS official is not processing applications in accordance with these regulations, you can probably force compliance administratively by contacting the Area, State, or National Offices of RD/RHS or by filing an appeal in accordance with NAD appeal regulations.[234] If you are unsuccessful administratively, enjoin RD/RHS' failure to comply with its own regulations[235] or seek equitable or declaratory relief under the Equal Credit Opportunity Act.[236]

If you can show that your client was actually damaged by the delay in processing, because the price of the house increased or the house was no longer available, the client may be eligible for compensatory damages[237] and attorneys' fees[238] under the ECOA. The client is not eligible, however, for punitive damages.[239]

2.3.5 NOTICE OF INELIGIBILITY

Persons found ineligible for RD/RHS assistance must be informed of the decision and the specific reasons for the denial.[240] The notice must be in writing and must inform the participant that an informal administrative review with the person who made the decision may be requested. If the decision is appealable, the applicant will also be informed of her right to seek mediation as a form of Alternative Dispute Resolution (ADR) and request a hearing with the National Appeals Division.[241]

Specific reasons for denial. RD/RHS requires that the Loan Originator inform the applicant of *all* of the specific reasons for the denial of assistance.[242] Similarly, under the ECOA,[243] it is not sufficient for RD/RHS to inform the applicant of only one reason for her or his ineligibility for assistance when in fact, there was more than one reason.[244] It must state the underlying reasons for the decision[245] and arguably, include any mathematical calculations.[246]

The success of any appeal depends on your ability to rebut the reasons for the client's loan denial. Therefore, make every effort to obtain these reasons from the agency official who reviewed your client's application. Since the client is entitled to meet with that official before filing an appeal,[247] use that meeting as an opportunity to review the basis for the denial and to learn of any underlying reasons that may not have been listed in writing.

The client should not go alone to the meeting with the Loan Originator or other agency official. If you cannot attend the meeting, have someone accompany the client to take notes and act as a witness. Both may be useful at an appeal

[230] 7 C.F.R. §§ 3550.55 (b) (4) and 3550.104(b)(4) (2009) respectively for § 502 and § 504 funding.
[231] *See* Handbook 1-3550 ¶¶ 3.11 and 3.13 (Rev. 7-8-09).
[232] *Id.* ¶¶ 3.11 and 3.13.
[233] *Id.* ¶ 3.14(D).
[234] 7 C.F.R. Part 11 (2009). *See* 7 C.F.R. § 3550.4 (2009); *see also* Handbook 2-3550 ¶ 1.9 (Rev. 11-7-07).
[235] *See Guerrero v. Schmidt*, 352 F. Supp. 789 (W.D. Wis. 1973).
[236] 15 U.S.C.A. § 1691e(c) (West 2007).
[237] *Id.* § 1691e(a).
[238] *Id.* § 1691e(d).
[239] *Id.* § 1691e(b).
[240] 7 C.F.R. §§ 3550.55(b)(5) and 3550.104(b)(5) (2009) (respectively for § 502 and § 504 funds). *See also* 12 C.F.R. § 202.9(a)(2) (2009).
[241] Handbook 2-3550 ¶ 1.9 A (Rev. 11-7-07).
[242] Handbook 2-3550 ¶¶ 1.9 and Handbook 1-3550 ¶ 3.9 (Rev. 07-08-09).
[243] 12 C.F.R. § 202.9(a)(2) (2009).
[244] *Carroll v. Exxon Co.*, U.S.A., 434 F. Supp. 557, 561-62 (E.D. La. 1977).
[245] *Id.* at 562.
[246] *See Dilda v. Quern*, 612 F.2d 1055 (7th Cir. 1980). Calculations demonstrating lack of repayment ability must be included with letter. All other calculations to be included in the administrative file.
[247] Handbook 2-3550, ¶ 1.9 A (Rev. 11-07-07).

hearing. The client has a right to have a representative at the meeting.[248]

If, after the informal meeting, the client is still not eligible for an RD/RHS loan, the decision-making official should be reminded to reverify the decision in writing and asked to include all the reasons enumerated during the meeting.[249]

If the agency official consistently fails to provide specific reasons for the denial of assistance, both RD/RHS regulations and the ECOA provide ample grounds for obtaining injunctive or declaratory relief or for seeking a writ of mandamus.[250] Note that damages and attorneys' fees may be recovered under the ECOA,[251] but that punitive damages are not recoverable against the government.[252]

2.4 SUBSTANTIVE ISSUES

2.4.1 INTRODUCTION

The Section 502[253] and Section 504[254] eligibility requirements are, by and large, broad legislative standards that provide agency officials with substantial discretion in determining eligibility.

To challenge an RD/RHS eligibility determination on substantive grounds, become familiar with the regulations and the statutes that RD/RHS implements, the Equal Credit Opportunity Act, and the process by which agency officials make eligibility determinations. Unfortunately, significant portions of that process are only hinted at in the RD/RHS regulations; some are set out in the RD/RHS Handbooks;[255] and some are not detailed in writing in any document. Therefore, after reviewing the eligibility requirements for the Section 502 and 504 programs, the discussion below focuses as much on what agency officials do, or are supposed to do, as on how various decisions may be challenged.

2.4.2 ELIGIBILITY REQUIREMENTS FOR THE SECTION 502 PROGRAM

2.4.2.1 The Applicant Household Must Have a Low or Moderate Income

Effective in 1996, RD/RHS significantly modified income eligibility for the Section 502 loan program. Prior to 1996, persons qualified for the program solely on overall household income. Starting in 1996, the agency split the income eligibility determination into a two-part test. First, the household income must be within the agency's low- and moderate-income limits. If the household meets that test, the persons who sign the promissory note must have repayment ability. In other words, household income simply determines whether the household is at all eligible for a Section 502 loan. Repayment income determines whether the applicant(s) will qualify for the loan. Since, most often, repayment income is likely to be lower, if not substantially lower than household income, many households that are income eligible may not actually qualify for the program because their repayment income is too low.[256] This subsection discusses overall eligibility for the program. Repayment income is discussed separately below.

The first eligibility requirement for a Section 502 loan is that the applicant household must, at the time of application, have an adjusted family income within the low-income limits for the area.[257] At the time of loan closing, the household's income may not exceed the moderate income limits for the area.[258] If the household income is within the adjusted low-income limits, the household may also be eligible for Payment Assistance.[259] If the applicant household income is within 60% of

[248] Handbook 2-3550, Attachment 1-B (Rev. 11-07-07)(option 1).
[249] *See* Handbook 2-3550, Attachment 1-D (Rev. 11-07-07).
[250] 15 U.S.C.A. §§ 1691e(a), 1691e(c) (West 2007).
[251] *Id*. § 1691e(d).
[252] *Id*. § 1691e(b).
[253] 7 C.F.R. § 3550.54 (2009).
[254] *Id*. § 3550.103 (2009).
[255] Handbook 1-3550 Chaps 3 and 4 (Rev 7-8-09).
[256] Ironically, RD/RHS calculates the interest subsidy that a household is eligible for on the basis of household income. It, however, uses the income of promissory note signers to determine repayment income as well as eligibility for moratorium relief. In all of these instances, the borrower is penalized by the inconsistent use of eligibility criteria. For a discussion of interest subsidies, *see* Chapter 3, *infra*. For moratorium relief, *see* Chapter 4, *infra*.
[257] 7 C.F.R. § 3550.53(a) (2009). *See also id.* § 3550.54 and Handbook 1-3550 ¶ 4.2 through 4.4 (Rev. 7-8-09)(calculation of income).
[258] *Id.*
[259] *See* Ch. 3, *infra* (discussion of Interest Subsidy Programs).

median income for the area, it may, in addition, qualify for a 38-year loan term if it is necessary to meet repayment ability standards.[260] Finally, if the applicant household's has a very low income, it may also qualify for the deferred mortgage program.[261]

RD/RHS is required to use the HUD Section 8 statutory definitions[262] for low- and very low-income persons or families in establishing income limits for its Section 502 and 504 programs.[263] Accordingly, low-income households are those whose adjusted[264] incomes do not exceed 80 percent of area median income, while very low-income families are defined as those whose adjusted incomes do not exceed 50 percent of median for the area.[265]

Eligibility for an RD/RHS loan is established by comparing the household's adjusted family income[266] to the maximum income limits established for the area in which the applicant seeks to obtain the RHS loan. If the applicant's adjusted income is within these limits, it is eligible for a loan.

To review an income eligibility decision, you must know RD/RHS' two-step process of determining an applicant's adjusted family income (AFI). First, RD/RHS determines an applicant's annual household income. Second, it adjusts that income according to a prescribed formula that takes into account the size of the applicant's family.[267]

2.4.2.1.1 Annual Income

Annual income is defined by statute to mean income from all sources of each household member, as determined by the Secretary of HUD in consultation with the Secretary of Agriculture, except that any amounts not actually received by the family may not be considered as income.[268] RD/RHS regulations[269] define annual income as all income of all household members from all sources.[270] 'Household' is defined as all persons expected to be living in the dwelling, except for live-in aids, foster children, and foster adults.[271]

Income expressly includes the gross amount of wages and salaries, overtime pay, commissions, fees, tips, bonuses and other compensation for personal services;[272] net income from the operation of a farm, business or profession;[273] interest, dividends and other net income of any kind from real or personal property;[274] full amount of periodic payments received from Social Security, annuities, insurance policies, retirement funds, pensions,

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[260] 7 C.F.R. § 3550.67(b) (2009).

[261] *Id.* § 3550.69 (2009). *See* § 2.4.2.2.1, *infra*.

[262] *See* 42 U.S.C.A. § 1437a(b) (West 2003).

[263] *Id.* § 1471(b)(4). Income limits for the Virgin Islands are statutorily mandated to be no less than the highest comparable levels set for American Samoa, Guam, the Mariana Islands, and the Trust Territory of the Pacific Islands. *Id.* While the RD/RHS Handbook states that the income limits are set out in Appendix 9 to Handbook 1-3550, the limits are not available electronically as RD staff secures the limits from RD State offices. Handbook 1-3550 Appendix 9 (1-23-03).

[264] Unlike HUD, which uses gross income to determine program eligibility, RD/RHS uses adjusted family income. As a consequence, slightly higher income families are eligible for the RHS programs than for the HUD programs. *See* § 2.4.2.1.2, *infra*, for a discussion of adjusted income.

[265] *See* 42 U.S.C.A. § 1437a (West 2003). HUD has the discretion to establish income limits that are higher or lower than the 80- and 50-percent figures based on its findings that such variations are necessary because of unusually high or low family incomes and, in the case of the 80-percent figure, because of prevailing levels of construction costs. *Id. See also* 7 C.F.R. § 3550.10 (2009) (Definitions of 'Low Income' and 'Very Low Income').

[266] RD/RHS is required to use the Section 8 statutory definitions for establishing a person's, or family's, income and adjusted income. 42 U.S.C.A § 1471(b)(5) (West 2003).

[267] 42 U.S.C.A. § 1437a(b)(5) (West 2003); 7 C.F.R. § 3550.54 (c) (2009); Handbook 1-3550 ¶¶ 4.2 A.1., 4.3 A,C & D. and 4.4 A through G (Rev. 7-8-09).

[268] 42 U.S.C.A. § 1437a(b)(4) (2003). *See Johnson v. USDA*, 734 F.2d 774, 778 (11th Cir. 1984).

[269] There have been statutory changes to the definition, some of which have been incorporated into HUD and RHS rental housing regulations. If you represent a client with income issues you should review the RHS rental housing regulations, codified at 7 C.F.R. § 3550.54 (2009), and discussed at Handbook 1-3550 ¶¶ 4.2 through 4.4 as well as the policies related to assets at Handbook 1-3550 ¶¶ 4.5 through 4.8 since certain assets may generate income,. *See also* Ch. 3, *infra*.

[270] *See* 7 C.F.R. § 3550.54(b) (2009).

[271] 7 C.F.R. § 3550.10 (2009). Handbook 1-3550 ¶ 4.2 A.2 (Rev. 10/25/06).

[272] Handbook 1-3550 ¶ 4.3 A.1 (Rev. 3/15/06).

[273] *Id.* ¶ 4.3 A.2.

[274] *Id.* ¶ 4.3 A.3. Households with net family assets in excess of $5,000 must include in annual income the greater of the actual income derived from all the assets or a percentage of the value of such assets based on the current passbook savings rate as determined by the Loan Originator. *Id.*

disability or death benefits, or other similar receipts;[275] payments in lieu of earnings, such as unemployment and disability compensation and severance pay;[276] public assistance;[277] periodic and determinable allowances, such as alimony and child support payments, and regularly recurring cash contributions or gifts received from persons outside the household;[278] all regular and special military pay, except for persons exposed to hostile fire, and living allowances of a member of the armed forces who is the applicant/borrower or spouse, whether or not that family member lives in the household.[279]

Exclusions. Several forms of cash income are excluded from the annual income definition: earned income of persons under the age of 18, unless they are a borrower or a spouse of a member of the household; income received by foster children or foster adults or live-in aides; casual, sporadic or irregular cash gifts; lump-sum additions to family assets, such as inheritances, capital gains, insurance payments and settlements for personal or property loses; amounts that are granted specifically for, or in reimbursement of, the cost of medical expenses; payments received on reverse amortization mortgages, amounts received for participation in Workforce Investment Act of 1998 programs, including: amounts received by a person with a disability that are disregarded for a limited time for Supplemental Security Income eligibility and benefits as set asides for use under a Plan to Attain Self-Sufficiency (PASS); certain amounts received by a participant in other publicly assisted programs that are specifically for, or in reimbursement of, out-of-pocket expenses; incremental earnings and benefits from qualifying state or local employment training programs; and allowances, earnings and payments to AmeriCorps participants. [280]

Also excluded is income received for the care of foster children and adults; educational scholarships or financial aid paid directly to students or educational institutions;[281] deferred Social Security or supplemental security benefits received in a lump sum; any amount of crime victim compensation under the Victims of Crime Act;[282] any allowance paid, under 38 U.S.C. 1805 to a child suffering from spina bifida who is the child of a Vietnam veteran; payments by the Indian Claims Commission to the Confederated Tribes and Bands of Yakima Indian Nation or the Apache Tribe of Mescalero Reservation (Pub. L. 95-433); housing assistance payment to Section 8 Homeownership participants (for the purpose of determining the income category in which the household falls or determining payment assistance); and adoption assistance payments in excess of $480 per adopted child.[283]

Whose income is included? Annual income includes all the income of the applicant and all other adults who live or propose to live with the applicant.[284]

Income of separated spouse. RD/RHS does not include the income of an applicant's spouse if the applicant's spouse lives apart from the applicant and will not become a co-signer on the promissory note.[285]

Income of children. Annual income does not include the income of persons less than 18 years of age unless such person is a party to the note or a party's spouse.[286]

Annual income. In determining annual income, RD/RHS looks at all amounts anticipated to be received from a source outside the family during the 12-month period[287] and projects it for the next 12 months using one or a combination of calculation methods.[288] It reviews past income over a two-year period to determine expected income from

[275] *Id.* ¶ 4.3 A.4.
[276] *Id.* ¶ 4.3 A.5.
[277] *Id.* ¶ 4.3 A.6. Except as indicated in ¶ 4.3 C. and D.
[278] *Id.* ¶ 4.3 A.7.
[279] Handbook 1-3550 ¶ 4.3 A.8 (Rev. 5/7/08). With respect to military persons not living in the household, it is arguable that this practice is a violation of the relevant military statute or regulations, that set forth a reasonable amount that a member of the military should send home for the support of family members.
[280] 7 C.F.R. § 355.54 (2009), Handbook 1-3550 ¶4.3 D (Rev. 05/07/08).
[281] 7 C.F.R. § 3550.54(b)(11) (2009).
[282] 42 U.S.C. 10602 (WEST, WESTLAW, Current through P.L. 111-172 (excluding P.L. 111-148, 111-152, and 111-159) approved 5-24-10).
[283] Handbook 1-3550, ¶ 4.3 D.7 (Rev. 5/7/08).
[284] 7 C.F.R. § 3550.54(b) (2009), Handbook 1-3550 ¶ 4.2 A.1 (Rev. 3/15/06).
[285] 7 C.F.R. § 3550.54(b) (2009).
[286] Handbook 1-3550 ¶ 4.3 C.1 (Rev. 5/7/08).
[287] *Id.* ¶ 4.2 A.1.
[288] *Id.* ¶ 4.3 E. 3.

such sources as seasonal work of less than 12 months, commissions, overtime, bonuses and unemployment compensation to determine if such income is stable and dependable.[289] Nonrecurring income, such as overtime that is not expected to continue or bonuses that are not regularly awarded, must be excluded from income.[290]

The final component of annual income is income produced from net family assets. Assets whose income is counted include the cash value of equity in real property (other than the dwelling or site), cash on hand or in saving or checking accounts, amounts in trusts that are available to the family, stocks, bonds and other forms of capital investments, receipts from lottery winnings, capital gains, inheritances, personal property held as investment and certain excess consideration received for assets disposed of in the preceding two years.[291]

2.4.2.1.2 Adjusted Annual Income

In 1990, Congress amended and liberalized the definition of adjusted annual income[292] but made the changes subject to approval by appropriations acts.[293] Because the appropriations acts passed since 1990 have not approved the changes and because Congress amended portions of the adjusted income definition in 1998,[294] the prior statutory definition of adjusted annual income is still applicable to the RD/RHS programs.

Under the old but still applicable definition, adjusted annual income is defined as the income which remains after excluding from annual income the following: (1) $480 for each dependent, *i.e.*, each member of the family residing in the household other than the applicant, spouse, or co-applicant, who is under 18 years of age, disabled, handicapped or a full-time student;[295] (2) $400 for an elderly family;[296] (3) medical expenses in excess of 3 percent of annual family income for an elderly family;[297] (4) reasonable attendant care and auxiliary apparatus expenses in excess of three percent of annual income for each handicapped member necessary for employment of any member of the family;[298] and (5) childcare expenses necessary for employment or education.[299]

When and if the 1990 amendments go into effect, two new exclusions will go into effect: the first authorizes up to $480 exclusion of earned family income for child support payments; and the second authorizes up to $550 for spousal support payments.[300]

RD/RHS limits the deduction for the care of minors to minors under the age of 12, and requires that the deduction be based on monies reasonably anticipated to be paid for care services which may not exceed the amount of income received from employment when the deduction is taken in order for a family member to be employed.[301]

If the applicant's adjusted annual income equals or is less than the published maximum income limit for the applicant's area, she or he is eligible for RD/RHS assistance. If it exceeds the limits, the applicant is ineligible.

2.4.2.1.3 Resolving Disputes with Respect to Income Eligibility

Disputes with respect to income. At least for purposes of meeting RD/RHS' maximum income guidelines, disputes concerning income are not

[289] *Id.* ¶ 4.2 A. 5.
[290] *Id.* ¶ 4.2 A. 5.
[291] 7 C.F.R. § 3550.54(d) (2009) describes assets, and whether the income from the assets is included in annual income. Handbook 1-3550 ¶ 4.5 (Rev. 1/23/03) addresses the issue in detail. Note that assets which exceed specified limits must be used to pay for costs related to the purchase of the home. Handbook 1-3550 ¶ 4.6 (Rev. 7/8/09); *See also*, Handbook 1-3550 ¶4.7 for calculation of income from assets for annual income, and ¶ 4.8 for income from assets for repayment income.
[292] *See* 42 U.S.C.A. § 1437a(b)(5) (West 2003).
[293] Pub. L. No. 101-625, § 573(e), 104 Stat. 4079, 4237 (1990).
[294] Pub. L. 105-276 § 508(a) (1998).
[295] 7 C.F.R. § 3550.54 (c)(1) (2009); Handbook 1-3550 ¶ 4.4 C (Rev. 10/25/06).
[296] 7 C.F.R. § 3550.54 (c)(4) (2009); Handbook 1-3550 ¶ 4.4 E (Rev. 3/15/06).
[297] 7 C.F.R. § 3550.54 (c)(5) (2009); Handbook 1-3550 ¶ 4.4 G (Rev. 3/15/06).
[298] 7 C.F.R. § 3550.54 (c)(3) (2009); Handbook 1-3550 ¶ 4.4 F (Rev. 3/15/06).
[299] 7 C.F.R. § 3550.54 (c)(2) (2009); Handbook 1-3550 ¶ 4.4 D (Rev. 10/25/06).
[300] 42 U.S.C.A. § 1437a(b)(5)(v) and (vi) (West 2003).
[301] 7 C.F.R. § 3550.54 (c)(2) (2009); Handbook 1-3550 ¶ 4.4 D (Rev. 10/25/06).

frequent, since they will arise only when RD/RHS claims that the applicant's annual income exceeds the area's maximum and the applicant claims that her or his income is below that maximum. Typically, this arises when the applicant's employer reports to RD/RHS a higher annual salary than the applicant reports or the applicant and RD/RHS dispute inclusions or deductions from income.

Level of annual income. RD/RHS verifies income reported by an applicant by asking the applicant's employer to submit an Employment Verification Form which includes an accounting of the applicant's current wages.[302] If the employer provides RD/RHS with an hourly, weekly, or monthly wage rate, the Loan Originator will usually annualize the salary[303] even though the applicant may work only seasonally for that employer. This will result in a higher annual income than the applicant actually receives. A dispute arising from this type of error can usually be resolved by obtaining a letter from the employer stating the number of weeks or months that your client is employed and having RD/RHS adjust its calculations accordingly.

Some employers may over-report income intentionally.[304] In these cases, your client should supply RD/RHS with copies of documents such as paycheck stubs or other records showing that the employer's payments are in fact less than reported to RHS.

Inclusions and deductions. Since income is broadly defined, and exemptions and deductions narrowly and specifically prescribed, practically all disputes concerning inclusions or deductions from income arise from misapplication of the regulations. Careful review of the regulations should resolve most disputes. One possible exception may exist with respect to determining annual income. Specifically, the applicant may exclude certain income as nonrecurring that RD/RHS may insist on including as regular income. This type of factual dispute should be resolved by reviewing the applicant's past years' income records, talking with his or her employer, and reviewing the employer's overtime and bonus practices.

2.4.2.1.4 Appealability of Eligibility Decisions Based on Income

If your client and RD/RHS agree on your client's annual income and that income is above the published guidelines for the area, your client does not have a right to appeal the eligibility decision administratively.[305] This is because the decision is one of general applicability and not made specifically with respect to your client's application.

If your client disagrees with RD/RHS' determination of his or her income, he or she may be advised that the denial of assistance is non-appealable. This is because the Loan Originator may conclude that your client's income is above the RD/RHS limits and that the decision is based on clear and objective statutory or regulatory standards. In such a case, your client should be advised that the substantive decision may be non-appealable, but that he or she has a right to seek a review of the finding that the decision is not appealable.[306]

In seeking a review of such a decision, you should argue that the RD/RHS decision is appealable because your client disputes the method by which RD/RHS determined her or his annual income, either because it failed to exclude or deduct certain income or because your client's employer reported income above that which your client actually earns. Such decisions should be appealable because they are based on individual findings made by the loan originator or supplied by third parties. Your client should be allowed to appeal those findings.

2.4.2.2 An Applicant Must Have Ability to Repay the Loan

RD/RHS judges an applicant's ability to repay a loan by two criteria: first, whether the applicant's income is adequate and second, whether

[302] Form RD 1910-5 (Rev.12-08).
[303] Handbook 1-3550 ¶ 4.3 E. 3 (Rev. 7/8/09).
[304] Farm labor crew leaders have been known to inflate income when they have not complied with labor laws, or when they have included several family members' wages in one payment.
[305] *See* 7 C.F.R. § 11.6(a) (2009). *See also* Handbook 1-3550, ¶ 1.9 B (Rev. 11/7/07).
[306] *Id*. *See* Chapter 9 for a complete review of the USDA appeals process.

it is dependably available.[307] In response to litigation in the 1970s,[308] FmHA adopted rules that define how the adequacy of an applicant's income was to be determined.[309] More recently, RHS adopted 'repayment income' as one standard by which to judge an applicant's capacity to repay a loan. Repayment income is distinct from annual income[310] and adjusted income in that it only looks at the income expected to be received by the signers of the promissory note.[311] While in some limited circumstances it is more generous than the annual income determination, it is generally much more restrictive than past standards in that it excludes income received by household members who do not sign the promissory note from determining whether the household can repay the loan. In many instances, this excludes the income of third parties who co-habit with the applicant or even a spouse of the applicant who chose not to co-sign the promissory note or moved into the house after the borrower had secured the loan.

While RD/RHS clearly has discretion to limit repayment income to those persons who signed the promissory note, it does not use the same standard for determining the amount of subsidy assistance that a borrower may receive. Instead, it relies on household income to make that determination.[312] Effectively, this penalizes borrowers in that it reduces the amount of subsidy that they receive. Interestingly, RD/RHS reverts to the borrower's income to determine whether a borrower is eligible for a moratorium.[313] This again punishes borrowers in that it does not make them eligible for a moratorium when a household member who did not sign the promissory note, but on whose income the subsidy calculations were based, loses her job but the borrower's own income does not decrease.

RHS has been significantly less specific as to how dependably available income is to be established.[314] Its handbook discusses this concept in terms of repayment income being some degree of either stable or dependable, or a combination of the two.[315] Ultimately, the handbook vests significant discretion in the RHS staff in determining the dependability criterion.[316] Responding to the vacuum, Loan Originators frequently use various rules of thumb to determine whether an applicant has dependable income. These rules are easy to apply, but have no basis in law, are not adopted in accordance with the Administrative Procedure Act, and do not verify the conditions that they purportedly are designed to test.

Even when RHS regulations define how eligibility determinations are to be made, as in determining adequacy of income, Loan Originators may resort to illegal rules of thumb to disqualify applicants. You should be alert to these rules of thumb and challenge all adverse decisions that are made in reliance on them.

Since the process of determining whether an applicant has adequate and dependable income is lengthy and complex, the following subsections discuss it in more detail.[317]

2.4.2.2.1 Adequate Income

Repayment Income. The first step in determining income adequacy is to determine the applicant's "repayment income". Repayment income is all income expected to be received by household members who are signatories of the note,

[307] 7 C.F.R. § 3550.53(g) (2009).
[308] *Vickers v. Bergland*, No. 77-0355 (D.D.C. consent decree Mar. 16, 1978), 12 CLEARINGHOUSE REV. 131 (June 1978) (No. 21,443).
[309] *See* 7 C.F.R. § 3550.53(g) (2009); Handbook 1-3550 ¶ 4.22 (Rev. 7/8/09). *See also* RD AN No.4474 (1980-D) September 17, 2009, at http://www.rurdev.usda.gov/regs/an/an4474.pdf.
[310] The baseline amount from which adjusted income is determined. 7 C.F.R. § 3550.54(b) (2009), Handbook 1-3550 ¶ 4.2 A.1 (Rev. 10/25/06).
[311] 7 C.F.R. § 3550.54(b) (2009).
[312] *See* § 2.4.2.1.1, *supra.*
[313] *See* § 5.2.1.2.1, *infra.*
[314] 7 C.F.R. § 3550.53(g) (2009) says that dependability will include consideration of the applicant's past history of annual income. Handbook 1-3550 ¶ 4.2 (Rev. 10/25/06) suggests that the agent look at two years of history to determine dependability of income.
[315] Handbook 1-3550 ¶ 4.2 A.5 (Rev. 7/8/09). Intermittent but recurring construction work may be stable, while SSI payments to a 17 year old which will terminate when she reaches 18 is not dependable.
[316] *Id.* Note that stability and dependability apply to repayment income but not to annual income. *Id*.
[317] 7 C.F.R. § 3550.53(g) (2009). Repayment ability is treated at length at Handbook 1-3550 ¶ 4.22 (7/8/09).

except for certain student financial aid received by any such signatory for tuition, fees, student loans, books, equipment, materials and transportation.[318] All sources considered for annual income are counted so long as those sources are attributable to the loan signatories.[319] Thus, for example, if a married person applies for a loan as an individual, the income of the spouse is not considered in determining repayment income and ability, unless the spouse joins on the application as a co-applicant.[320]

In addition, repayment income includes amounts that are not counted in annual income, including Housing Choice Voucher Homeownership Housing Assistance Payments, adoption assistance payments in excess of $480 per adopted child; payments received for the care of foster children or foster adults; reparation payments paid by a foreign government arising out of the Holocaust; advanced earned income tax credits and mortgage credit certificates; the full amount of student financial assistance in the form of grants, educational entitlements, work study programs, and financial aid packages and living expenses; refunds or rebates under state or local law for property taxes paid on the dwelling unit;[321] various payments which are exempt from federal taxable income;[322] amounts paid by a state agency to a family with a developmentally disabled family member living at home to offset the cost of services and equipment needed to keep the developmentally disabled family member in the home; and the special pay to a family member serving in the armed forces who is exposed to hostile fire.

Certain amounts never counted in annual income are likewise never counted in repayment income.[323] Similarly, income from certain family

[318] 7 C.F.R. § 3550.54(a) (2009).

[319] Handbook 1-3550 ¶¶ 4.3 A (Rev. 3/15/06).

[320] A spouse or third party may not join an applicant as a co-borrower for a variety of reasons including entry status to the United States or credit history. Note, however, that the failure of a person to join as a co-borrower may, subsequently, be detrimental to a household when applying for moratorium relief. *See* § 5.2.1.2.1, *infra*.

[321] Handbook 1-3550 ¶¶ 4.3 B.

[322] This includes: imminent danger duty pay to a service person applicant or spouse away from home and exposed to hostile fire, payments to volunteers under the Domestic Volunteer Service Act of 1973, including, but not limited to: National Volunteer Antipoverty Programs which include Volunteers In Service To America (VISTA), Peace Corps, Service Learning Programs, and Special Volunteer Programs, National Older American Volunteer Programs for persons age 60 and over which include Retired Senior Volunteer Programs, Foster Grandparent Program, Older American Community Services Program, and National Volunteer Programs to Assist Small Business and Promote Volunteer Service to Persons with Business Experience, Service Corps of Retired Executives (SCORE), and Active Corps of Executives (ACE), as well as payments received after January 1, 1989, from the Agent Orange Settlement Fund or any other fund established pursuant to the settlement in the "In Re Agent Orange" product liability litigations, M.D.L. No. 381 (E.D.N.Y.), payments received under the "Alaska Native Claims Settlement Act" or the "Maine Indian Claims Settlement Act," income derived from certain sub-marginal land of the United States that is held in trust for certain American Indian tribes and payments or allowances made under the Department of Health and Human Services Low-Income Home Energy Assistance Program, payments received from the Job Training Partnership Act, income derived from the disposition of funds of the Grand River Band of Ottawa Indians, the first $2,000 of per capita shares received from judgment funds awarded by the Indian Claims Commission or the Court of Claims, or from funds held in trust for an American Indian tribe by the Secretary of Interior, payments received from programs funded under Title V of the Older Americans Act of 1965, the value of the allotment provided to an eligible household under the Food Stamp Act of 1977, any other income which is exempted under Federal statute. Handbook 1-3550 ¶ 4.3 B (Rev. 5/7/08). Note, that tax exempt income received by a household, such as disability payments, is grossed up by 20% for purposes of determining repayment ability. Handbook 1-3550, ¶ 4.4 H (Rev. 3/15/06). Thus, if a borrower receives $5,000 in tax exempt disability income, that amount is increased to $6,000 for purposes of determining household income.

[323] Earned income of persons under the age of 18 unless they are a borrower or a spouse of a member of the household; income received by foster children or foster adults or live-in aides; casual, sporadic or irregular cash gifts; lump-sum additions to family assets, such as inheritances, capital gains, insurance payments and settlements for personal or property loses; amounts that are granted specifically for, or in reimbursement of, the cost of medical expenses; payments received on reverse amortization mortgages, amounts received for participation in Workforce Investment Act of 1998 programs, including: amounts received by a person with a disability that are disregarded for a limited time for Supplemental Security Income eligibility and benefits as set asides for use under a Plan to Attain Self-Sufficiency (PASS); certain amounts received by a participant in other publicly assisted programs which are specifically for or in reimbursement of out-of-pocket expenses; incremental earnings and benefits from qualifying State or local employment training programs, and allowances, earnings and payments to AmeriCorps participants employment income of minors who are not the applicant's spouse. Handbook 1 3550 ¶ 4.3 C (Rev. 5/7/08).

assets which is included in annual income is always included in repayment income, but only that attributable to household members who sign the note.[324] Assets whose income is counted include the cash value of equity in real property (other than the dwelling or site), cash on hand or in saving or checking accounts, amounts in trusts that are available to the family, stocks, bonds and other forms of capital investments, receipts from lottery winnings, capital gains, inheritances, personal property held as investment and certain excess consideration received for assets disposed of in the preceding two years for less than fair market value, unless the assets were disposed as part of a bankruptcy, foreclosure, or divorce.[325]

Method for making determination. You cannot determine an applicant's repayment ability without knowing the monthly payments associated with the loan, including principal, interest, taxes, insurance, and maintenance. Monthly principal and interest payments for a particular applicant can be determined from knowing the applicant's adjusted income[326] and the size and other terms[327] of the loan.[328] The monthly tax costs can either be obtained from the local tax assessor or calculated by multiplying the house's value by the assessment rate. The cost of insurance can be obtained from an insurance agent. The utility costs must be estimated for all but existing structures, for which the previous owner's utility costs may be known.

RHS begins the process of determining repayment ability by assessing repayment income.[329] A very low-income applicant is considered to have repayment ability when the monthly amount required for payment of principal, interest, taxes, and insurance (PITI) does not exceed 29% of the applicant's repayment income, and the monthly amount required to pay PITI plus recurring monthly debts does not exceed 41% of the applicant's repayment income.[330] A low-income applicant is considered to have repayment ability when the monthly amount required for payment of PITI does not exceed 33% of the applicant's repayment income and the monthly amount required to pay PITI plus recurring monthly debts does not exceed 41% of repayment income.[331] Repayment ratios may exceed these percentages if the applicant has demonstrated an ability to meet higher debt obligations, or if RHS determines, based on other compensating factors, that the household has a greater repayment ability.[332]

If the applicant does not have adequate repayment income, or does not qualify for other considerations, she is ineligible for an RHS loan unless the applicant can qualify for a 38-year loan, a Section 502 deferred mortgage program, or another person or household member with adequate income will co-sign the loan with the applicant.[333]

Thirty-eight-year loans. Applicants whose adjusted family income does not exceed 60% of area median may have their initial Section 502 loans amortized over a period of 38 years if the extended term would enable them to show repayment ability.[334]

Deferred mortgage program. Applicants with adjusted incomes that do not exceed the RHS very low-income limits[335] and who do not have repayment ability for a Section 502 loan even if the loan were amortized for 38 years, may qualify for a deferral of up to 25% of the monthly mortgage payment, calculated at one percent interest.[336] To qualify, the applicant's loan must be amortized over

[324] 7 C.F.R. § 3550.54(d) and Handbook 1-3550 ¶¶ 4.5 (Rev. 3/19/08) and 4.8 (Rev. 7/16/08).

[325] 7 C.F.R. § 3550.54 (d) (2009). Handbook 1-3550 ¶ 4.8 (Rev. 7/16/08) advises that only the actual income derived from the assets held by note signers and which are determined stable and dependable, are used to compute repayment income. Assets with a total cash value of $5,000 or less are not to be considered unless it would significantly and adversely impact the loan qualification amount.

[326] *See* § 2.4.2.1.2, *supra*.

[327] Loans for newly constructed Section 502 homes are generally amortized over 33 years, unless the applicant qualifies for a 38-year term. Manufactured homes are amortized over 30 years and loans for less than $2,500 are amortized over 10 years. 7 C.F.R. § 3550.67 (2009).

[328] If the applicant is eligible for an interest subsidy, it must also be considered in determining repayment ability. 7 C.F.R. § 3550.68 (2009).

[329] Handbook 1-3550 ¶ *4.22* (Rev. 7/8/09).

[330] 7 C.F.R. §§ 3550.53(g)(1) (2009).

[331] *Id.* § 3550.53(g)(2).

[332] *Id.* § 3550.53(g)(3); Handbook 1-3550 ¶¶ 4.22 and 4.24 (Rev. 7/8/09).

[333] 7 C.F.R. §§ 3550.53(g)(3), (4) and (5) (2009).

[334] *Id.* § 3550.67(b)(1).

[335] *Id.* § 3550.10, Handbook 1-3550 ¶ 4.2 A.3 (Rev. 4/18/07).

[336] 7 C.F.R. §§ 3550.10 and 3550.69 (2009).

38 years, or 30 years if the loan is for a manufactured home, and the projected payments for principal, interest, taxes and insurance, prior to any deferment, must not exceed 29% of the applicant's repayment income by more than $10 per month for an applicant receiving payment assistance; or exceed 20% of the applicant's adjusted income by more than $10 per month for applicants receiving interest credit.[337]

Under the deferred mortgage program, up to 25% of the applicant's monthly payment may be deferred for a term of up to 15 years. The actual amount deferred is the lesser of (1) the amount by which the applicant's monthly payments for principal and interest, calculated at one percent interest for the maximum allowable term, plus estimated taxes and insurance exceed 29% of applicant's repayment income for applicants receiving payment assistance, or 20% of the monthly household adjusted income for applicants receiving interest credit.[338] Deferrals are effective for a 12-month period, after which the amount of the deferral is reviewed, recalculated and, if necessary, renewed for an additional 12 months.[339]

Note that deferred payments are subject to recapture when the borrower transfers the property or ceases to occupy it.[340]

2.4.2.2.2 Challenging a Finding of Inadequate Repayment Ability

When representing a client who was denied a loan because of inadequate repayment ability, determine whether the decision-making official followed RD/RHS regulations by making his or her determination based on a worksheet for computing income and made all the proper calculations and adjustments for determining repayment ability.[341]

There is only one way in which you are likely to know whether the Loan Originator failed to follow the regulations. You must secure the worksheet for determining household income and repayment income and see whether it was completed properly. If the Loan Originator is unable to provide you with the worksheet, request that he or she redetermine your client's eligibility. If he or she fails to do so, you should appeal.

If the Loan Originator appears to have followed the regulations, obtain a copy of the worksheet and carefully review it with your client to ensure that all figures are included and that they are accurate.

In making this review, pay careful attention to the detailed treatment of PITI and total debt calculations as well as compensating factors, including the examples and exhibits set out in the Handbook.[342]

After reviewing all resulting modifications, calculate PITI and recurring total monthly debt as a percentage of repayment income.[343] If the percentages exceed allowable levels, the client is not eligible for a loan unless he or she qualifies for a 38-year mortgage or the deferred mortgage program, seeks a smaller loan, obtains a co-signer, or builds the home by the self-help method.[344] In addition, you should review the client's debts to determine if any loans that are about to be paid in full may generate sufficient additional net cash to repay the home loan.

If the applicable PITI and total debt to repayment income percentages are within the regulatory limits, the client should seek a meeting with RD/RHS to determine why the agency reached a different result. Unless there was an error in calculation, different results can be explained only by RD/RHS' having reduced the applicant's income by determining that certain items could not be considered as income for repayment purposes or having increased his or her expenses by finding that planned expenditures were not realistic. Insist that the Loan Originator identify and justify any changes in income or expenses that were made.

For purposes of determining the adequacy of an applicant's income, the only legitimate basis for RD/RHS to reduce an applicant's income is either verification from employers or others that the applicant's annual income is less than reported by the applicant. Income levels are factual

[337] *Id*. § 3550.69(a).
[338] *Id*. § 3550.69(b).
[339] *Id*. § 3550.69(c).
[340] *Id.* § 355.69.
[341] *See* Handbook 1-3550, Att. 4-A (Rev. 7/16/08).
[342] Handbook 1-3550 ¶¶ 4.22 and 4.24 (Rev. 7/8/09).
[343] 7 C.F.R. § 3550.53(g) (2009); Form RHS 1944-3, Part 3, line D (Rev. 6/97).
[344] *See* § 2.5, *infra* (discussion of alternatives).

determinations that are rebuttable with evidence that your client has income as reported.

2.4.2.2.3 Dependable Income

In addition to being adequate, an applicant's repayment income must be dependable. RD/RHS regulations do not define how income dependability is to be determined; however, its handbook does provide some guidance.[345] It begins by stating that the agency has no minimum history requirement for employment in a particular position and that the key concept is whether the applicant has a history of receiving stable income and a reasonable expectation that the income will continue. It then sets a two year standard as the basis for determining income stability. In other words, the determining factor is whether the income is likely to continue for the next two years.[346]

The Handbook gives two examples of dependable and undependable income. In the first, the applicant has only worked for his current employer for 6 months, but worked for a prior employer for fifteen months, with only a six week gap that is explainable in the industry in which the applicant works. In the second example, SSI benefits paid to the head of household on behalf of a 17 year old dependent child, is not considered dependable income because the SSI payments will terminate when the child turns 18.

The Handbook also makes clear that self-employment and seasonal income can be dependable if the applicant has verification of the income, such as annual tax returns.[347] However, if the applicant does not have records for sporadic income, the Handbook makes clear that it is not dependable.[348]

Interestingly, the handbook makes a not so subtle change in determining likelihood of future ability to repay into a past two-year working test by suggesting that an applicant who has not had dependable income for the past two years may nonetheless be considered to have dependable income if the applicant has recently returned to work and her employer provides her with a good evaluation that suggests a likelihood of continued employment.

While these Handbook examples are helpful, they are not exclusive and Loan Originators are ultimately required to judge the dependability of each applicant's income, using their own criteria and relying on their own judgment.

In the past, RD/RHS staffs' reliance on their own judgment has led to the adoption of rules of thumb for determining who does not have dependable income and has resulted in applicants being treated on an *ad hoc* basis.[349] It is not clear the extent to which this continues under the guidance provided in the RD/RHS handbooks that were adopted in the 1990s.

2.4.2.2.4 Challenging RD/RHS Decisions on Income Dependability

There are several ways to challenge the validity of a Loan Originator's determination that an applicant does not have dependable income. Knowing the exact basis of the determination should help in challenging the decision.[350]

Rules of thumb and ad hoc decision making. Practically any decision made by a Loan Originator about income dependability may be challenged either because it is based on a rule of thumb, which violates the APA, or because different standards are applied to different applicants and the decision therefore violates the applicant's due process rights under the Fifth Amendment.

Unfortunately, a legal challenge to a denial of assistance will not result in your client being declared eligible for an RD/RHS loan. It is likely to result in RD/RHS' decision being declared invalid, forcing reconsideration of your client's application and possibly reforming the application process. With respect to future applicants, reform is a desirable objective. For your client, however, who is probably more interested in obtaining a loan than in reforming RD/RHS' practices, you should first

[345] Handbook 1-3550, ¶ 4.2 A 5 (Rev. 7-08-09).
[346] *Id.*
[347] *Id.*
[348] *Id.*

[349] USDA, *Rural Housing Survey*, *supra* note 191, at 14.
[350] Review § 2.3.5, *supra*, and § 9.3.1.1, *infra*, on clients' rights to an enumeration of all the specific reasons for which a loan was denied before proceeding to challenge a determination based on income dependability.

consider an administrative challenge to the merits of the decision. There are several grounds upon which to challenge a determination that your client does not have dependable income, in addition to arguing that rules of thumb are invalid[351] and that *ad hoc* decision making violates due process.

Decisions based on proscribed factors. Eligibility decisions, including the determination that an applicant does not have dependable income, may not be based on race, sex, national origin, color, religion, marital status, or age; the fact that the applicant's income is derived from public assistance; or the fact that the applicant is likely to bear children.[352] Most of these factors are clearly irrelevant to determining income dependability, and you should have no difficulty reversing any decision based upon them. In several instances, these factors appear to have an impact on income dependability; therefore a further discussion of them may be helpful in resolving your client's case.

Provided your client has capacity to contract, the age of your client may not be used in considering eligibility,[353] except when it is used to your client's advantage.[354] Therefore, RD/RHS may not consider the length of time until your client's retirement or the fact that the security for the loan may not be adequate in light of your client's life expectancy.[355]

RD/RHS may not request information concerning birth control practices, intention to bear or rear children, or capability to bear children. Assumptions or aggregate statistics relating to the likelihood or probability that any particular group of persons will bear or rear children may not be used for any purpose, nor may assumptions be made that based on those statistics your client will receive diminished or interrupted income in the future.[356]

Receipt of welfare or any other form of public assistance may not be used to disqualify an applicant.[357] Nevertheless, neither RD/RHS regulations nor the ECOA specifically preclude a conclusion that an applicant does not have dependable income when assistance based on the number of dependents living with the applicant may shortly be terminated because the dependents will reach majority.[358]

There are several arguments to challenge such a conclusion. First, unless RD/RHS has evidence to the contrary, it is logical to assume that your client will be able to resume supporting himself or herself once the dependent children have reached majority. Second, you may argue that your client's dependents will then be old enough to work and that they intend to contribute to the support of the applicant. Third, it is as illogical to conclude that an applicant's income is undependable because he or she will cease to receive welfare assistance as it is to assume that an applicant's income will decrease because she or he intends to rear children. Fourth, any determination that an applicant has undependable income because of some future termination of public assistance implicitly assumes that the applicant has dependable income in the intervening period. If that period is expressed in terms of several years, it constitutes an illegal rule of thumb; if not, it violates your client's due process rights.

Irrational decisions. A decision that an applicant does not have dependable income may be irrational and should be refuted on its merits.

For instance, it does not follow that a young person without an employment record does not have a sufficiently stable income to qualify for a loan. Just as the lack of a credit history does not indicate a poor credit history,[359] the lack of an employment record does not indicate unstable employment and undependable income. The dependability of income of applicants with no employment history should be judged on factors such as job skills, a current employer's intent to retain the applicant, and the market for the skill in the community.[360]

[351] 7 C.F.R. § 3550.3 (2009).
[352] *Id.* § 3550.3.
[353] *Id.*
[354] *Id., See* § 3550.103(b) for § 504 loans.
[355] *See* 12 C.F.R. § 202.6(b)(2)(i) (2009).
[356] *See* 7 C.F.R. § 3550.3 (2009).
[357] *Id.*

[358] *See*: Handbook 1-3550 ¶ 4.2 A. 5 (Rev. 7/8/09). Example--Dependable Income.
[359] Note that 7 C.F.R. § 3550.53 (h) (2009) states that: "Applicants must have a credit history that indicates reasonable ability and willingness to meet debt obligations" but does not say that lack of a credit history disqualifies an applicant and enumerates only affirmative failures to meet assumed obligations as indicia of unacceptable credit. *See* Handbook 1-3550 ¶¶ 4.9 through 4.14 (Rev. 7/8/09).
[360] *The Handbook state that: "*The Agency has no minimum history requirement for employment in a particular position.

Short-term employment in a present position is similarly not a valid indicator of income dependability. A person's overall employment record may be indicative of income stability, but length of present employment is not.[361] Again, the employer's intent to retain the employee in a permanent capacity, the employee's training and experience, and the availability of jobs requiring similar skills are better indicators of dependability of income than length of employment.

In certain trades, such as construction, employment is often seasonal. In these cases stability of income is not dependent on the length of employment for any particular employer but rather on the periods of employment and the availability of jobs in the community.[362]

Even if an applicant is not employed in an industry with erratic employment patterns, frequent changes in employment do not necessarily mean that a person does not have dependable income. For instance, if as a result of each job change, the applicant's income increases, there is sound basis to conclude that the applicant will not leave a position unless a better position becomes available. Similarly, a pattern of continuous employment, even though it may have been for different employers, should not lead to the conclusion that future income is not dependable.

Seasonal employment. Although seasonal employment may detract from overall income stability for an applicant when applying for a conventional loan, it should not disqualify an applicant for an RD/RHS loan. For example, a seasonal farmworker may have sufficient annual income to meet her total annual shelter payments,[363] but may not have sufficient income on a monthly basis to make her monthly payments. For instance, she might work for eight months and receive unemployment compensation for four months and the amount of unemployment compensation might be insufficient to meet her living and loan expenses for those months. If her income pattern is consistent, RD/RHS may enter into a loan that would require her to make 33 annual installments, each payable in 12 or fewer unequal installments, instead of a loan payable in 396 equal monthly installments.[364]

If you are unsuccessful in administratively persuading RD/RHS to change its position concerning the dependability of your client's income, the only alternative available is an appeal and a legal challenge.

2.4.2.3 An Applicant Must Be a Person Who Does Not Already Own an Adequate Dwelling

By statute, an applicant must "be without an adequate dwelling or related facilities for his own use."[365] RD/RHS has broadened this provision by providing that an applicant is eligible for a loan if she is an owner of deficient housing.[366] Therefore, a person who resides in but does not own an adequate dwelling is eligible for a Section 502 loan.[367]

There are two statutory exceptions to the non-ownership requirement. First, people are eligible for a Section 502 loan if they own a decent, safe and sanitary home but need to refinance their existing loan(s) because they are likely to lose their home in the near future for reasons beyond their control, and the home otherwise qualifies for such

The key concept is whether the applicant has a history of receiving stable income and a reasonable expectation that the income will continue." Handbook 1-3550 ¶ 4.2 A.5 (Rev.). *See also id*. (Example "Less than two years history").

[361] Note that this may constitute a rule of thumb. *But see id.* Example "Less than Two Years History".

[362] *See* Handbook 1-3550 ¶ 4.2 A.5 (Rev. 7/8/09)('Stable Income' and 'Seasonal Income').

[363] *See* § 2.4.2.2.3, *supra* (discussion of adequate income).

[364] Handbook 1-3550 ¶ 4.2 A.5 (Rev. 7/8/09).

[365] 42 U.S.C. § 1471(c) (West 2003). This provision is inapplicable to farmers who try to supply housing for their tenants or employees using the Section 502 program.

[366] 7 C.F.R. §§ 3550.53(d)(ii) (2009). *See id. §* 3550.10 (definition of 'deficient'). *See also* Handbook 1-3550 ¶ 4.15 (Rev. 6/18/08). Note that 42 U.S.C.A. § 1471(c)(8)(West 2003) uses the word "adequate" which it defines as: "a decent, safe, and sanitary dwelling unit," while the regulations use the word "deficient" which is defined more expansively.

[367] In the Housing and Community Development Amendments of 1980, Congress clarified the statute to exclude from eligibility persons who are renters of adequate dwellings. Pub. L. No. 96-399, 94 Stat. 1614 (1980) (amending 42 U.S.C. § 1471(b) (West 2003). For reasons that are not entirely clear, however, RD/RHS has never interpreted the statute to precluded renters of adequate dwellings from qualifying for Section 502 loans.

financing.[368] Second, people who own a home that is not decent, safe and sanitary may also obtain a Section 502 loan if as a result of refinancing and in combination with a rehabilitation loan, the home will be brought to decent, safe and sanitary standards and if the failure to refinance and rehabilitate the home, will continue to deprive the owner of housing that meets these standards.[369]

2.4.2.3.1 Adequacy of Owned Dwelling

If the applicant does own a dwelling, it may not be adequate. Congress has defined an inadequate dwelling to mean that it is not decent, safe and sanitary.[370] RD/RHS regulations use the word "deficient,"[371] which is defined as "dwelling that lacks complete plumbing; lacks adequate heating; is dilapidated or structurally unsound; has an overcrowding situation that will be corrected with loan funds; or that is otherwise uninhabitable, unsafe, or poses a health or environmental threat to the occupant or others".[372]

Physical inadequacy. The best standard against which to measure the adequacy of a home is one of the three construction codes or standards adopted by RD/RHS for the Section 502 loan program.[373] These are (1) a construction standard adopted by RD/RHS for the state, (2) one of the nationally recognized building codes, or (3) the Existing Construction Requirements of the HUD Minimum Property Standards for One or Two Family Dwellings (hereinafter MPS).[374] Since all houses purchased with RD/RHS loan funds must be "structurally sound and functionally adequate,"[375] it would be difficult for RD/RHS to argue that any house that does not meet these standards is nonetheless adequate for eligibility purposes.

Regardless of the standard chosen, an expert such as a building inspector or contractor who thoroughly inspects a home may be the best judge of its adequacy. An expert's testimony, whether oral or in writing, is likely to carry more weight at an administrative hearing than an applicant's testimony. When using an expert, have her or him specify the standards against which the home was judged.

Functional adequacy. RD/RHS has not defined the term functionally adequate. Presumably a home is not functionally adequate if one or more of its systems are not working properly or a system is so outdated that it is not likely to function much longer.[376]

Inadequate home for a particular occupant. A home that has all standard facilities and is structurally sound may nonetheless be inadequate for a particular occupant. This is most often true for a large family occupying a very small house, although it may also apply to a person with a disability or an elderly person occupying a home not adapted to her or his needs.

Overcrowding. While RD/RHS formerly published standards for determining what constitutes a modest home for households of various sizes who seek to construct or purchase a home with its financing,[377] the current regulations only state room number standards for the multifamily direct loan and grant program.[378] Arguably, the same standard should be used in determining whether the current home of a family seeking to purchase another structure with RD/RHS financing is adequate for the family's needs. Clearly, if occupancy of a particular structure reaches a level that is considered a violation of a local health or safety code, there should be no question with respect to that dwelling's inadequacy for a particular household. When a person needs a larger dwelling, for example, to permanently care for a disabled person, a different standard may be more appropriate. Similarly, if the bedrooms in a person's home are particularly small, an exception or modification of the standard may be sought.

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[368] 42 U.S.C. § 1471(a)(4)(B)(i) (West 2003). *See also* 7 C.F.R. § 3550.53(d)(1)(iii) (2009) and Handbook 1-3550 ¶ 4.15 (Rev. 6/18/08).

[369] 42 U.S.C.A. § 1471(a)(4)(B)(ii) (West 2003).

[370] *Id.* § 1471(b)(8). *See also* Handbook 1-3550 ¶ 5.7 (Rev. 7/16/08).

[371] 7 C.F.R. § 3550.53 (2009).

[372] *Id*. § 3550.10.

[373] *See id.* § 1924.4(h).

[374] HUD MINIMUM PROPERTY STANDARDS, One and Two Family Dwellings Handbook 4910.1 (1994). Available at: http://www.hud.gov/offices/adm/hudclips/handbooks/hsgh/4910.1/index.cfm

[375] 7 C.F.R. § 3550.57(c) (2009).

[376] *See* Handbook 1-3550 ¶ 5.7 A (Rev. 7/16/08).

[377] 7 C.F.R § 1944.16(b) (1994).

[378] 7 C.F.R. § 3560.155(e) (2009). Other considerations for what is a "modest" home appear at *id.* § 3550.57 (a).

Elderly or person with a disability. Most national, state and local codes prescribe special standards for housing for elderly or individuals with disabilities. These may also be relied on to show that a home is inadequate to meet the occupant's needs.

Other grounds of inadequacy. It may be argued that applicants also do not have adequate housing when they are faced with imminent displacement, when their payments exceed their reasonable ability to pay,[379] or when their home is inconveniently located in relation to the work place.

2.4.2.4 An Applicant Must Not Be Able to Obtain Credit from Other Lenders on Reasonable Terms and Conditions

The housing programs authorized in title V of the Housing Act of 1949 are designed to assist persons who are unable to obtain credit from conventional credit sources.[380] RD/RHS, as a lender of last resort, may not compete with private lending institutions.[381] Therefore, to qualify for an RD/RHS loan, an applicant[382] must not have sufficient resources to provide the housing she proposes to construct or purchase with an RD/RHS loan.[383] Moreover, the applicant must be unable to secure the necessary financing from other sources upon terms and conditions that the applicant reasonably could be expected to fulfill.[384] This requirement is commonly known as the "credit-elsewhere requirement."

At one time, FmHA required applicants to secure letters from lenders documenting the fact that they could not secure a loan for the purchase of a home. FmHA abandoned that practice in the late 1970s and allowed local staff to make the determination whether an applicant could secure a loan from a private lender. When the FmHA staff person so believed, the applicant could be required to document the fact that she could not secure a private loan. That practiced was abandoned by RD/RHS in the mid-1990s and the agency's regulations and handbooks make no mention of the requirement. Presumably, the cost of housing has increased to the point where very few low- and moderate-income households can secure a private loan to purchase a decent safe and sanitary home on reasonable terms. Accordingly, RD/RHS has dropped the requirement entirely from its regulations.

2.4.2.5 An Applicant Must Be a Citizen of the United States or Its Territories, or Be a Person whose admission to the United States is documented.

Until 1988, there was no statutory provision limiting eligibility for the Section 502 program on the basis of citizenship or status as a permanent resident. Nonetheless, RD/RHS required that applicants for the program be citizens, permanent residents of the United States or its territories, or that they be admitted on indefinite parole.[385] In 1988, Congress indirectly sanctioned RD/RHS' limitation by prohibiting it from granting assistance to persons for whom assistance may be denied by the Secretary of HUD under Section 214 of the Housing and Community Development Act of 1980.[386] That section precludes HUD and USDA from providing assistance to non-citizens unless they are residents of the United States who are lawfully admitted for permanent residence or lawfully present in the United States.[387] In addition, in 1986, Congress disqualified certain non-citizens who were lawfully admitted for temporary residence pursuant to Section 245A or 210A of the Immigration and Naturalization Act from obtaining federal assistance for a period of five years from the

[379] *See* 42 U.S.C.A. § 1471(a)(4)(B) (2003).
[380] *Id.* §§ 1441, 1471(c)(3).
[381] *See* 7 C.F.R. § 1951.253 (2009).
[382] When persons other than the applicant have an undivided interest in the land to be improved with the RD/RHS loan, the applicant and the co-owners, individually and jointly, must be unable to improve the property with their own resources or through outside credit.
[383] 7 C.F.R. § 3550.53(h) 2009).
[384] 42 U.S.C.A § 1441 (West 2003); 7 C.F.R. § 3550.53(h) (2009).
[385] 7 C.F.R. §§ 3550.53(b) and 3550.10 (2009); Handbook 1-3550 ¶ 4.20 (Rev. 6/18/08). *See also* 12 C.F.R. § 202.6(b)(7) (2009) (ECOA permits creditors to consider an applicant's immigration status).
[386] 42 U.S.C.A. § 1471(h) (West 2003).
[387] 42 U.S.C § 1436a (West 2003); 7 C.F.R. §§ 3550.53(b) and 3550.10 (2009)(Definition of *Legal Alien).*

date that their status was confirmed.[388] Consequently, the only persons who qualify for RD/RHS assistance are citizens, permanent residents, and a group of persons admitted to the United States under specifically enumerated conditions specified in 42 U.S.C. § 1436a(a).

RD/RHS requires applicants other than citizens to verify that they are legally admitted to the United States.[389] If the authenticity of the documentation is in doubt, RD/RHS requires the Loan Originator to verify the applicant's status through the Rural Development "Interagency Agreement" with the Department of Homeland Security, U.S. Customs and Immigration Service (USCIS) which allows housing program staff access to the Systematic Alien Verification for Entitlements (SAVE) program database.[390]

Notwithstanding the fact that RD/RHS may inquire as to the immigration status of an applicant, arguably, Section 214 of the Housing and Community Development Amendments of 1980 places limitations on that inquiry. Section 214 precludes RD/RHS from verifying the status of a person who is over 62 years of age if the person submits a written declaration stating under oath that she is a citizen, permanent resident or has otherwise satisfactory immigration status.[391] RD/RHS has not incorporated this provision into its regulations and may be violating the statute.

Although most applicants for Section 502 loans are not affected by these requirements, several classes of applicants may be adversely affected by their enforcement. For example, non-citizens who are without documentation of their status or whose documents are questioned by RD/RHS may experience significant delays in loan processing.

Note that although RD/RHS may deny assistance to certain non-citizens, it should not be able to deny assistance to eligible applicants who are married to or reside with ineligible individuals. Such a denial may well raise constitutional questions.[392] However, if a borrower resides in a home with an undocumented ineligible person, RD/RHS is statutorily authorized to prorate the assistance received by the household.[393] For reasons that are unknown, RD/RHS has chosen not to implement that authority as no regulations have been adopted by the agency that restrict the amount of interest subsidy provided to any household in which ineligible undocumented persons reside.

Due Process Violations. Section 214 of the Housing and Community Development Act of 1980 generally precludes undocumented persons, other than six specified subgroups of persons, from receiving assistance under the Section 502 direct loan program.[394] Section 214 also provides a process for persons who claim to be eligible for assistance to appeal adverse determinations made by RD/RHS under information received from the Immigration and Customs Enforcement agency.[395] As with several other provisions of Section 214, RD/RHS has chosen not to implement this provision and does not advise persons who are refused financial assistance an opportunity to contest the finding with respect to their status. This omission is a violation of borrowers' statutory rights and a violation of their due process rights, and under appropriate circumstances, should be challenged.

Possible civil rights violations. When an RD/RHS official systematically questions the authenticity of only certain applicants' documents based on such factors as their appearance, race, national origin, or inability to speak English, the applicant should be encouraged to pursue remedies under Title VI of the Civil Rights Act of 1964.[396]

As a practical matter, if the SAVE verification process unduly delays the RD/RHS eligibility determination, RD/RHS may reduce the time by verifying an applicant's status by telephone. This has been done in some of California's Central Valley counties, where applications from non-citizens are commonplace.

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[388] 8 U.S.C.A. § 1255a(h) (WEST, WESTLAW, Current through P.L. 111-172 (excluding P.L. 111-148, 111-152, and 111-159) approved 5-24-10).

[389] Handbook-1-3550 ¶¶ 4.20 and 4.21 (Rev. 6/18/08).

[390] *Id.*

[391] 42 U.S.C. § 1436a(d) (2003).

[392] *See Umoh v. Pierce*, No. A-84-CA-117 (W.D. Tex. Mar. 8, 1984), 18 CLEARINGHOUSE REV. 175 (June 1984) (No. 36,355) (citizen spouse of an alleged non-immigrant student alien challenged -- on statutory, due process, and equal protection grounds -- a subsidized landlord's attempt to revoke her subsidy pursuant to HUD statute and regulations).

[393] 42 U.S.C.A. § 1436a(c) (West 2003).

[394] 42 U.S.C.A. § 1436a (b)(West 2003); 7 C.F.R. § 3550.10 (2009) (definition of *Legal Alien*).

[395] 42 U.S.C.A. § 1436a(c)(West 2003).

[396] Pub. L. No. 88-352, 78 Stat. 241 (1964).

2.4.2.6 An Applicant Must Possess the Legal Capacity to Incur the Legal Obligation of the Loan

RD/RHS requires applicants to have the legal capacity to incur the loan obligation and to have reached majority under state law, or to have had minority status removed by court action.[397]

While RD/RHS regulations and its handbook recognize that applicants with a mental disability may not be discriminated against, they do not explicitly reconcile these obligations with the agency's loan making process or its obligation to accommodate persons with disabilities. The RD/RHS regulations clearly state that a person who has a court appointed guardian or conservator who is empowered to obligate the applicant in real estate matters has the legal capacity to enter into a loan agreement with RD/RHS.[398] Moreover, the RD/RHS handbook states that Loan Originators should assume that any applicant has the legal capacity to enter into the loan unless there is evidence to the contrary.[399] They do not resolve how a determination is made that there is evidence to the contrary, and if there is, whether such an applicant must have an appointed guardian or conservator. Applicants should be aware of these limitations. However, it is beyond the scope of this manual to define the issues and remedies that are involved in making real estate loans to persons with mental disabilities. Clearly, RD/RHS should not deny assistance to a person who has a representative payee if the person has not been judged incompetent by a court.

2.4.2.7 Owner and Potential Occupant

RD/RHS requires that applicants for Section 502 loans have the potential ability to occupy the home on a permanent basis.[400] Consequently, RD/RHS generally denies loans to persons who intend to use the property as rental property,[401] as well as to full-time students and military personnel on active duty.[402] RD/RHS will make loans to military personnel if the applicant will be discharged within a year of applying for a loan and intends to make the home a permanent residence, if there are reasonable future employment prospects in the community, and if the loan is for a newly constructed home, an adult member of the household will be available during construction.[403] Similarly, RD/RHS will make loans to full-time students who intend to make the home their permanent residence and there are reasonable prospects that employment will be available in the area after graduation.[404]

Because of its interpretation of the Garn-St. Germain Depository Institutions Act of 1982,[405] RD/RHS no longer forecloses on loans where a borrower rents an RD/RHS-financed home without RD/RHS' written permission.[406] Moreover, nothing in the RD/RHS regulations precludes a borrower who is a permanent resident of the home from renting parts of it to others, although the dwelling size may not be increased with that purpose in mind.[407]

2.4.2.8 The Applicant Must Be Creditworthy

Probably the largest single reason applications for Section 502 loans are rejected is the applicant's creditworthiness. Applicant credit-

[397] 7 C.F.R. § 3550.53(e) (2009); Handbook 1-3550 ¶ 4.18.
[398] 7 C.F.R. § 3550.53 (e) (2009).
[399] Handbook 1-3550, ¶ 4.18 (6-18-08).
[400] 7 C.F.R. § 3550.53(c) (2009); Handbook 1-3550 ¶ 4.17 (Rev. 6/18/08).
[401] 7 C.F.R. § 3550.53(c) (2009).
[402] Handbook 1-3550 ¶ 4.17 (Rev. 6/18/08). RHS justifies its position on the ground that military personnel are likely to be transferred and that students are likely to move after graduation.
[403] 7 C.F.R. § 3550.35(c)(3) (2009); Handbook 1-3550 ¶ 4.17 (Rev. 6/18/08).
[404] 7 C.F.R. § 3550.35(c)(3) (2009); Handbook 1-3550 ¶ 4.17 (Rev. 6/18/08).
[405] Pub. L. 97-320, 96 Stat. 1469 (1982).
[406] *See* § 6.2.1, *infra*, for a more complete discussion of RHS' right to foreclose on property leased to third parties. If an applicant is receiving an interest subsidy, RHS may terminate the assistance if the applicant's fails to reside in the home. 7 C.F.R. § 3550.68(a) (2009).
[407] Note, however, that for purposes of calculating the owner's income for the purpose of determining interest subsidy eligibility, the renter's income, not merely the rent payment, will be included in household income.

worthiness is discussed extensively in the RD/RHS regulations and Handbook.[408]

Creditworthiness is determined separately for each proposed party to the promissory note. If only one of two applicants for a loan has an acceptable credit history, that person can submit a separate application without the person who has an unacceptable credit history. You should be aware, however, that only that person's income will be counted towards the establishment of repayment ability and it may be insufficient to purchase the home that the household needs.

RD/RHS regulations do not define what an acceptable credit history is. They focus exclusively on factors that constitute an unacceptable credit history.[409] The RD/RHS Handbook does the same, except in one instance. It states that an applicant with no outstanding judgments obtained by the United States in a Federal court and who has a credit score of 640 or higher on a Residential Mortgage Credit Report (RCMR) has an acceptable credit record and the RD/RHS loan originators are directed not to conduct further investigation.[410]

Unacceptable credit history. Under current RD/RHS regulations, any of the following circumstances are considered indicators of an unacceptable credit history:

- payments on any account where the amount of the delinquency exceeded one installment for more than 30 days within the last 12 months;
- payments on any account which was delinquent for more than 30 days on two or more occasions within a 12-month period.
- the applicant's loss of property securing a loan due to a foreclosure completed within the last 36 months;
- an outstanding tax lien or delinquent government debt with no satisfactory arrangement for its payment;
- the existence of an outstanding court-created or affirmed judgment or one that has been outstanding within the last 12 months (unless that debt is a bankruptcy and the applicant has been meeting plan obligations for the 12 months preceding the date of application);
- two or more incidents of rent payments paid 30 days or more past due within the last 24 months (If the applicant has no other credit problems, then only one year of rent history will be evaluated and rent history can be waived if the RHS loan will significantly reduce the applicant's shelter costs);
- outstanding collection accounts with a record of irregular payment with no satisfactory arrangements for repayment, or collection accounts that were paid in full within the last 6 months;
- non-agency debts written off within the last 36 months unless paid in full at least 12 months prior to the RD/RHS application;
- the existence of non-RD/RHS debts that were written off within the last 36 months unless paid in full at least 12 months prior to the application.
- delinquency on a federal debt.[411]

The following sections review how RD/RHS collects credit information about applicants, how to challenge erroneously compiled information, and how to weigh the substantive factors that may be considered in determining an applicant's creditworthiness. They also review the circumstances under which RD/RHS may disregard an otherwise unsatisfactory credit history.[412]

2.4.2.8.1 Sources of Credit Information

Preliminary Credit Checks. If funding for a loan is not available and the applicant will be placed on the waiting list, the Loan Originator is told to conduct a preliminary review of the applicant's

[408] 7 C.F.R. § 3550.53(h) (2009); Handbook 1-3550 ¶¶ 4.9 through 4.14. (Rev. 4/18/07).
[409] *See* 7 C.F.R. § 3550.53 (h) (2009).
[410] Handbook 1-3550 ¶¶ 4.12 A, B, and C and 4.24 C (Rev. 7/8/09).
[411] 7 C.F.R. § 3550.53(h) (2009). *See* § 2.4.2.8.4, *infra*, for a discussion of the circumstances under which RHS may excuse an otherwise unacceptable credit history.
[412] *See* § 16.4.2.8.4, *infra*.

credit history by accessing the Department of Housing and Urban Development's (HUD) online Credit Alert Interactive Voice Response System (CAIVRS), ordering an infile credit report, and checking MortgageServ's Borrower Cross Reference screen (Customer/XREF/Social Security), provided these checks were not performed during a pre-qualification review.[413]

If the applicants have an acceptable credit history, they are put on the RD/RHS waiting list. If the credit history is unacceptable, the applicants must be advised of the reasons for the unacceptable credit history. The applicant should be given advice on how to correct the credit history or to document that the adverse factors were caused by circumstances beyond the applicant's control.[414] While the fact that the applicant has an unacceptable credit history does not preclude the applicant from being placed on the waiting list, the likelihood of approval is small unless the applicant addresses the issues that were found in the credit history.

RD/RHS will not provide applicants with copies of their credit reports, but it will advise the applicant that she can obtain a free credit report once every 12 months from each of the nationwide consumer reporting companies.[415]

Credit reports. Once an applicant is selected for loan processing, RD/RHS conducts a full review of the applicant's credit history. To do so, it obtains information about the applicant from several sources, with the primary source being a residential mortgage credit report obtained from a credit reporting company serving the applicant's geographic area.[416]

Residential mortgage credit reports contain court records checks that include adverse items for the prior 7-year period, a 2-year employment and rental history, as well as results of a check against the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) database.[417] The RMCR includes a listing of all known creditors of the applicant, the date the accounts were opened, when the last transaction took place, the amount of credit extended, the balance due, balance past due, payment terms, and payment record. If the applicant has filed for bankruptcy or has any liens or judgments recorded against him or her, these will also be included.

Credit scores received by RD/RHS about an applicant cannot be the basis for rejecting the applicant. In other words, if an applicant has a credit score below 640, the applicant cannot be rejected based on the score. The applicant can only be rejected if an unacceptable credit criterion appears on the applicant's credit history.[418]

When applicants have a credit score below 640, RD/RHS will use other information to verify credit history and employment. This includes reference and landlord letters as well as employment verification.

Applicant reference letter. RHS may obtain additional information by sending Applicant Reference Letters[419] to all creditors listed by the applicant on the RD/RHS application and to any other businesses from which the applicant obtains credit on a regular basis. The information collected on this form is similar to that collected by credit reporting bureaus. The reference letter is, however, typically sent to credit references that do not appear on the credit report but do appear in the borrower's application form.

Landlord Verification. Loan Originators may also obtain information about the applicant from the applicant's landlords for the past two years.[420]

Employment verification. Although credit reporting companies usually verify employment, RHS will also verify employment separately if check stubs or earning statements are not consistent or unavailable. A Request for Verification of Employment[421] is sent directly by RD/RHS to the applicant's employer. The latter is requested to

[413] Handbook 1-3550 ¶ 4.11 (Rev. 7/8/09).
[414] *Id.*
[415] *Id*.
[416] RHS, HUD/FHA, and the VA contract with various credit reporting agencies throughout the country. A list of those companies may be found in App. A to RD Instruction 1910-B, available in any RD/RHS office. Also available at http://www.rurdev.usda.gov/regs/regs/pdf/1910b.pdf, but portions have not been revised for many years.
[417] Handbook 1-3550 ¶ 4.12 A (Rev. 7/8/09).
[418] *Id*. ¶ 4.12 B (11-07-07).
[419] Form RD 410-8 (Rev.12-08).
[420] Form RD 1944-60 (Rev.12-08).
[421] Form RD 1910-5 (Rev. 12-08).

provide RD/RHS with the following information: whether the applicant is employed, length of employment, the probability of continued employment, the applicant's regular wages and wages for the past 12 months including any overtime wages, commissions, or bonuses. In addition, the employer is asked to add any remarks that he or she wishes to make about the applicant.

2.4.2.8.2 Correcting Erroneous Information

Occasionally, RD/RHS will receive erroneous information about an applicant, particularly from credit reporting companies. This may result from use of outdated records, misfiled information, or erroneous reports to the credit reporting company. To correct erroneous reports, you must first determine the information source.

Credit bureaus. If the denial of assistance is based on information provided in a residential mortgage credit report, the letter of assistance denial must provide the applicant with the name, address and toll free number for the credit bureau, inform the applicant that the denial was made by the RD/RHS and not the credit bureau, inform him or her if their right to obtain a free copy of the report within 60 days of the Agency's adverse action and that any dispute about the information may be resolved only with the reporting company.[422]

Other sources. The regulations provide that "[w]hen an application is rejected because of unacceptable credit, the applicant will be informed of the reason and source of information."[423] It is not clear from RD/RHS regulations or handbooks whether RD/RHS takes the position that if the information is from a source other than a credit reporting company, the letter of denial need state only that the denial of assistance was based on information received from persons or organizations other than a credit reporting company and that upon written request, the nature of the information, but not the source, will be disclosed. If RD/RHS takes that position, you should consider challenging it as a violation of the Privacy Act,[424] which, among other things, provides that, upon request, any individual may gain access to any information maintained about him or her by any federal agency in any of its record systems.[425] Although there are certain exceptions to this requirement,[426] none appears intended to shield RD/RHS' credit reports.

2.4.2.8.3 Obtaining Corrections[427]

The Fair Credit Reporting Act requires credit reporting agencies to disclose to a consumer the nature, substance and source of all files on the consumer at the time of the request.[428] Therefore, if the denial of assistance by RD/RHS was based on a report from a credit agency, review the credit agency's files.

If the file is incomplete or erroneous, inform the agency in writing of the information in dispute. The agency must, within a reasonable time, reinvestigate and record the current status of the information unless it has reasonable grounds to believe the dispute is frivolous or irrelevant. If, after reinvestigation, the information is found inaccurate or can no longer be reverified, the agency must delete the information and upon request of your client, inform all persons designated by your client who received a report from the agency within the past two years of the deletion.[429] Make sure that a copy of the updated report is sent to RD/RHS because it will not reconsider your client's eligibility until it receives a corrected report.[430]

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[422] Handbook 1-3550 ¶ 4.12 (7/8/09).
[423] 7 C.F.R. § 3550.53(h)(3) (2009).
[424] 5 U.S.C.A. § 552a (WEST, WESTLAW, Current through P.L. 111-172 (excluding P.L. 111-148, 111-152, and 111-159) approved 5-24-10).
[425] *Id*. § 552a(d).
[426] *Id*. § 522a(k).
[427] It is beyond the scope of this manual to review in detail consumer rights under the Fair Credit Reporting Act. For these issues you should review National Consumer Law Center, *Fair Credit Reporting Act* (2006 6th ed. and 2008 Supplement) at https://shop.consumerlaw.org/index.asp?PageAction=VIEWPROD&ProdID=10.
[428] 15 U.S.C.A. § 1681g (West 2007). There are several exemptions in this Act that should not be applicable in most RHS cases.
[429] 15 U.S.C.A. § 1681i (WEST, WESTLAW, Current through P.L. 111-172 (excluding P.L. 111-148, 111-152, and 111-159) approved 5-24-10).
[430] RHS takes the position that the credit report they have is accurate until the applicant demonstrate otherwise. *See*: Handbook 1-3550 ¶ 4.12 (Rev. 7/8/09).

If the reinvestigation does not resolve the dispute, your client may file a brief statement with the credit agency setting forth the nature of the dispute. Upon the client's request, the agency must then send all persons designated by your client who received a report within two years of the dispute either a copy of your client's statement or a summary of it.[431]

The Fair Credit Reporting Act now appears also to apply to tenant screening companies.[432] Thus, if RD/RHS relied on information received from a tenant screening company, your client may have the same rights with respect to that company as he or she does with respect to a credit reporting agency.

Although no similar rights are guaranteed by federal law with respect to other sources of information, the ECOA requires RD/RHS to consider any submitted information indicating that the credit history being considered by it does not accurately reflect your client's creditworthiness.[433] Therefore, even though your client may not know the source of the information he or she believes to be erroneous or irrelevant, he or she should submit any additional information tending to show creditworthiness.

If your client is aware of the information source and believes that the information is erroneous, you or your client should meet with the responsible person to review the basis for the report to RD/RHS and to see if the dispute can be resolved. If it can, the creditor should write to RD/RHS to correct the erroneous information previously submitted. If it cannot, your client should file a statement with RD/RHS as permitted by the Fair Credit Reporting Act.[434]

Separated or divorced persons. If your client is separated or divorced, the application may have been rejected because his or her creditworthiness could not be established independently from that of a spouse or former spouse, or because the spouse's or former spouse's credit history was confused with your client's. You should take two steps to ensure that your client's creditworthiness was properly considered. First, review your client's application to determine whether she or he applied for the loan individually rather than jointly. Married persons may file for a loan separately,[435] and RD/RHS may not consider the creditworthiness of the applicant's spouse if the applicant is not relying on alimony, child support, separate maintenance or the spouse's income for repayment of the loan.[436] If your client is relying on alimony, child support, separate maintenance or the spouse's income for repayment, he or she may still apply for a loan individually. RD/RHS may, however, inquire and verify the receipt and dependability of that income and may also determine the creditworthiness of the spouse providing the income.[437]

2.4.2.8.4 Challenging Substantive Decisions as to Creditworthiness

Credit history. RD/RHS' regulations defining what constitutes an unacceptable credit history leave little, if any, room for dispute. The only questions that remain for resolution are whether the Loan Originator properly concluded that your client had an unacceptable credit history and whether the Loan Originator should have approved your client's creditworthiness because of an authorized exception.

If your client's loan was rejected for an unsatisfactory credit history, ask the Loan Originator to give you a specific listing of all the instances that led to that conclusion.[438]

Impermissible considerations. Your client's loan was improperly rejected if it was denied not

[431] 15 U.S.C.A. § 1681i (WEST, WESTLAW, Current through P.L. 111-172 (excluding P.L. 111-148, 111-152, and 111-159) approved 5-24-10).
[432] National Consumer Law Center, *Fair Credit Reporting Act*, § 1.3.2.14.1 (2006 6th ed. and 2008 Supplement) at https://shop.consumerlaw.org/index.asp?PageAction=VIEWPROD&ProdID=10.
[433] 12 C.F.R. § 202.6(b)(6) (2009).
[434] 15 U.S.C.A. § 1681i (WEST, WESTLAW, Current through P.L. 111-172 (excluding P.L. 111-148, 111-152, and 111-159) approved 5-24-10).
[435] 7 C.F.R. § 3550.3 (2009).
[436] *Id.* § 3550.54(a) (only the income of signatories to the note can be counted as 'repayment income'); Handbook 1-3550 ¶ 4.2 A. 1 (Rev. 10/25/06); *See also* 12 C.F.R. § 202.5(c) (2009).
[437] Handbook 1-3550 ¶ 4.3 (Rev. 3/15/06).
[438] Your client has a right to this information under the regulations. *See* § 2.3.5, *supra*.

because of a poor credit history but because of (1) the lack of a credit history,[439] (2) a bankruptcy proceeding in which your client's debts were discharged more than 36 months before the date of application,[440] a foreclosure completed more than 36 months before the date of application[441] or (3) because your client had a satisfied judgment that was completed more than 12 months before the date of application.[442] None of these circumstances are acceptable indicia of a poor credit history.[443]

Exceptions. RHS may determine an applicant with an unacceptable credit history eligible for a loan if the applicant documents that the poor credit history was caused by circumstances that were of a temporary nature, beyond the applicant's control, or that it arose due to the applicant's refusal to make full payment because of defective goods or services or some other justifiable dispute relating to goods or services purchased or contracted for.[444] A discussion of these exceptions follows.

Poor payment record caused by circumstances beyond applicant's control. If your client's loan was rejected because of a recent record of poor payments, bankruptcies,[445] foreclosures, or judgments, carefully review the causes of these incidents to determine whether they were temporary in nature and beyond your client's control. If they were, the Loan Originator may determine your client eligible.[446]

RD/RHS' regulations list several typical circumstances that the agency considers beyond the applicant's control. These include loss of job, delay or reduction in benefits, other loss of income, or increased living expenses due to illness or death.[447] This list is not exclusive and other circumstances may be included, such as loss of income because of natural disaster, underemployment, divorce or separation, and unanticipated expenses due to damage to personal property or increases in rent or utility costs. If any of these circumstances caused your client's poor payment record, try to document them and present the evidence to the Loan Originator for reconsideration of the loan or, to the appropriate official on appeal.

Poor payment record due to dispute with creditors. If your client's poor payment record arises from a dispute with a creditor, such as the creditor's delivery of defective goods or the provision of incomplete or defective services, any adverse action by that creditor that disparages your client's credit history should not preclude his or her obtaining a loan.[448]

Again, review your client's payment record carefully, and if any delinquencies, judgments or bankruptcies were the result of justifiable disputes with creditors or contractors, document the transaction and present it to the agency.

Different treatment of applicants. If your client's credit history was considered in a manner different than that of any other applicant, you should seek review of your client's application by the Federal Trade Commission. It is a violation of RD/RHS regulations and the ECOA to require certain applicants to meet credit requirements not required of others.[449]

Other factors for determining credit-worthiness. If your client's loan application was rejected for any other reason deemed to reflect on his or her creditworthiness, challenge the decision as a violation of the Administrative Procedure Act or the client's due process rights.

There are several grounds that may be cited by RD/RHS for rejecting your client's application that can probably be overturned administratively because they violate a statute or have previously been rejected as improper considerations.

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[439] 7 C.F.R. § 3550.53(h) (2009) and Handbook 1-3550 ¶ 4.10 (Rev. 7/10/09) both state that applicants must have a credit history that indicates reasonable ability and willingness to meet debt obligations.

[440] The RHS regulation implies that an applicant may be denied assistance because of a bankruptcy filing within the last 36 months. In fact, the regulation conflicts with the Bankruptcy Act and with other RHS regulations, both of which prohibit discrimination by governmental agencies against debtors who have filed bankruptcy cases. Thus, RHS may not deny a loan based upon a previously discharged debt. 11 U.S.C.A. 525(a) (WEST, WESTLAW, Current through P.L. 111-172 (excluding P.L. 111-148, 111-152, and 111-159) approved 5-24-10); *see* 7 C.F.R. § 3550.53(h)(2)(i) (2009).

[441] 7 C.FR. § 3550.53(h)(1)(iii) (2009).

[442] *Id.* § 3550.53(h)(2)(ii).

[443] *Id.* § 3550.53(h) (2009).

[444] Handbook 1-3550 ¶ 4.14 (Rev. 7/8/09).

[445] *See supra* note 440.

[446] Handbook 1-3550 ¶ 4.14 (Rev. 7/8/09).

[447] *Id.* ¶ 4.14.

[448] Handbook 1-3550 ¶ 4.14 (Rev. 7/8/09).

[449] Handbook 1-3550 ¶ 4.10 (Rev. 7/8/09). *See also* 12 C.F.R. § 202.6(b)(6) (2009).

At one time, RD/RHS regulations required that the applicant possess the "character, ability, and experience, necessary to carry out the undertaking and obligations required of him in connection with the loan."[450] Although this reference to character has been absent for some time, some Loan Originators insist on considering the applicant's character in determining her or his creditworthiness. This is inappropriate and should be appealed. In support of your argument, cite an FmHA Bulletin[451] dated November 19, 1973 and signed by then-Administrator Frank Elliott, which states in part: "We go beyond our authorities when we consider aspects of an applicant's personal life or character that have no bearing on his or her ability to succeed or repay the loan."[452]

The ECOA prohibits discrimination in the extension of credit on the basis of the applicant's marital status.[453] Therefore, any consideration by RD/RHS of your client's marital status is inappropriate and illegal accept as authorized by the ECOA.

The ECOA also prohibits discrimination in the extension of credit because of race, color, religion, national origin, marital status, or age; because an applicant's income is derived from public assistance; or because the applicant has exercised any right under the Consumer Credit Protection Act. Therefore, RD/RHS' consideration of these factors in determining creditworthiness is inappropriate and illegal.[454]

Challenge to RD/RHS regulations. It is arguable that the RD/RHS creditworthiness regulations are so restrictive that they are contrary to the purposes of the Section 502 program and that they are otherwise arbitrary and capricious. Among the grounds for such an argument is RD/RHS' failure to recognize that many low- and very low-income persons experience severe rent and utility overburden by virtue of their living in unsubsidized and often inadequate housing and that the financial burdens placed upon them are beyond their control to the same extent that loss or reduction of income are beyond their control. Fortunately, the RD/RHS Handbook recognizes as an exception the circumstance in which the loan will significantly reduce the applicant's shelter costs, resulting in improved debt repayment ability.[455] Unfortunately, absent clear statutory or regulatory guidance on the issue of an applicant's creditworthiness, there is significant doubt that a court will invalidate RD/RHS' exercising its discretion to determine who should be eligible for the Section 502 loan program.[456]

2.4.2.9 Homeownership Education

First-time homebuyers are required to have participated in a homeowner education course prior to loan closing.[457] The course must have been conducted by a certified homebuying education provider[458] and must be evidenced by a certificate of completion.[459] RD State Directors may make an exception to this requirement on a case by case basis, if they determine that such a provider is not reasonably available in the area where the applicant resides.[460] An exception may also be granted if the applicant has special needs that would unduly impair completion of such a course.[461]

2.4.2.10 The Home Must Be in a Rural Area

All homes financed by RD/RHS must be located in a rural area.[462]

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[450] 7 C.F.R. § 1822.4 (1969).
[451] FmHA Bulletins are no longer used. They have been replaced by Administrative Notices (ANs).
[452] FmHA Bulletin 4798 (410) (*See* note 451, *supra*.)
[453] 15 U.S.C.A. § 1691 (West Supp. 1994); 12 Fed. Reg. § 202.2(z) (2009); *see also* 7 C.F.R. § 3550.3 (2009).
[454] *See also* 7 C.F.R. § 3550.3 (2009).
[455] Handbook 1-3550 ¶ 4.14 (Rev. (7/8/09).
[456] *See Woodsmall v. Lyng*, 816 F.2d 1241 (8th Cir. 1987).
[457] 7 C.F.R. § 3550.53(i) (2009).
[458] RD State Directors are required to maintain and update a list of certified providers for each state. 7 C.F.R. § 3550.11 (2009).
[459] 7 C.F.R. § 3550.53(i) (2009).
[460] *Id*.
[461] *Id*.
[462] 7 C.F.R. § 3550.51 (2009). There are three limited exceptions to this requirement. First, a home may be purchased if it is located in a non-rural area when the area in which it is located has been reclassified from rural to non-rural after an application for purchase of that property has been received by RD/RHS. *Id.* § 3550.56. The second exception is when the purchase involves property owned by RD/RHS, that is, property repossessed in what was previously, but is no longer, a rural area. *Id*. The third

A rural area is defined as open country, or any town, village, city or place, including the immediately adjacent densely settled area, which is not part of or associated with an urban area and has a population not in excess of 10,000 if it is rural in character; or has a population in excess of 10,000, but not in excess of 20,000, is not contained within a Metropolitan Statistical Area (MSA) and has a serious lack of mortgage credit for low- and moderate-income families as determined by the Secretary of Agriculture and the Secretary of HUD.[463]

As a result of a 1990 amendment, areas classified as rural as of October 1, 1990, with populations in excess of 10,000 persons, remain eligible for RD/RHS assistance until receipt of the decennial census data in the year 2010, provided the population of the area does not exceed 25,000 and the area is rural in character and has a serious lack of mortgage credit for lower and moderate-income families.[464]

RD State Directors are authorized to designate all rural areas within each state, except that no area in excess of 10,000 in population may be designated "rural" unless the National Offices of RD/RHS and HUD have designated it as lacking mortgage credit for low- and moderate-income families.[465]

Maps showing rural areas within each state may be inspected in the respective State Offices. Each RD sub-state office has maps showing eligible rural areas within that office's jurisdiction.

RD/RHS staff must review the status of eligible areas at least every five years.[466] The review process, which includes public notice, and the criteria used to make rural area determinations are set out in the RD/RHS Handbook[467] and are beyond the scope of this manual.

Challenges to RD/RHS determinations of rural areas should be made within the USDA appeals process.[468] Judicial review of an RD/RHS decision may be sought under the Administrative Procedure Act.[469]

2.4.2.11 Other Eligibility Requirements

Home and Site Requirements. Dwellings financed with RD/RHS funds must provide decent, safe and sanitary housing, be modest in size design and cost, and not exceed the housing needs of the applicant.[470] Generally, this means that the characteristics of the financed housing must not exceed what is typical for the current needs of low- and moderate-income families in the area. Moreover, the value of the dwelling may not exceed the applicable area loan limits and may not have certain prohibited features such as swimming pools or income producing land or structures.[471] Exceptions to these limitations may be provided on a case by case basis to accommodate the specific needs of an applicant, such as to serve exceptionally large households or to provide reasonable accommodation for a household member with a disability. Any additional loan amount approved must not exceed the amount required to address the specific need.

Generally, sites upon which the RHS-financed housing is located or constructed may not be large enough to subdivide into more than one site under existing local zoning ordinances; must not include farm service buildings, though small out-buildings such as a storage shed may be included; and the value of the site must not exceed 30 percent of the as improved market value of the property. The State Director may waive the 30 percent re-

exception is when the loan, known as a subsequent loan, is for repairs on a home financed with a Section 502 loan. *Id.*

[463] 7 C.F.R. § 3550.10 (definition of Rural area)). Generally, within an MSA, any densely populated area containing more than 10,000 persons is considered an urban area and therefore not eligible for RD/RHS assistance. Outside an MSA, any densely populated area containing more than 20,000 persons is considered an urban area.

[464] *Id.* § 3550.10 (2009); Handbook 1-3550 ¶ 5.3 (Rev. 12/17/09).

[465] *Id.* § 3550.10 (2)(ii) (2009) (definition of Rural area).

[466] Handbook 1-3550 ¶ 5.3 C (Rev. 12/17/09).

[467] *Id.*

[468] *See* 7 C.F.R. Part 11 (2009).

[469] *But see Montano v. Hudson*, No. Civ.-84-579C (D.N.M. Sept. 4, 1984) (redesignation of previously eligible rural area is not a rulemaking act within meaning of 5 U.S.C.A. § 551(4)).

[470] 7 C.F.R. § 3550.57(a) (2009); Handbook 1-3550 ¶ 5.7 (Rev. 7/16/08).

[471] Handbook 1-3550 ¶ 5.6 D (9-10-03).

quirement in high cost areas where other lenders permit a higher percentage.[472]

Manufactured Homes. RD/RHS will finance the purchase of new manufactured homes, provided the home is constructed and set up in conformance with the Federal Manufactured Home Construction and Safety Standards.[473] When financing a manufactured home, RD/RHS may include in the loan the cost of purchasing the unit, including transportation and set up costs, site purchase and site development work, provided they are all carried out by the same contractor.[474]

Loan funds may not be used to purchase an existing manufactured home unless it is already financed by RD, to purchase a site without a unit, to undertake alteration or remodeling in association with the original purchase, or to provide furnishings.

The seller of a manufactured home must be an approved dealer contractor who is responsible for all the site development work.[475] The dealer must also provide a warranty that conforms to RD/RHS requirements.[476]

The term of a loan for the purchase of a manufactured home may not exceed 30 years. Thus, manufactured home purchasers are ineligible for loans that are extended to 38 years. They may, however, be eligible for deferred mortgages.[477] They are also eligible for interest subsidies.[478]

2.4.3 ELIGIBILITY REQUIREMENTS FOR SECTION 504 LOANS AND GRANTS

The Section 504 eligibility requirements[479] incorporate by reference many of the Section 502 individual eligibility requirements and add several new ones. Because of this incorporation, Loan Originators are provided as much discretion in determining Section 504 eligibility as they are for Section 502 eligibility. The following discussion, therefore, focuses as much on what RD/RHS officials do, or are supposed to do, as it does on challenging their various decisions. Whenever there is no distinction between the Section 504 and Section 502 eligibility criteria, a cross-reference to the Section 502 discussion is given.

2.4.3.1 The Applicant Must Be a Citizen of the United States or Its Territories, or be Admitted as a Documented Person[480]

This eligibility criterion is identical to that for Section 502 loans.[481] It is important to emphasize, however, that the 502 regulations do not permit persons over 62 years of age to self certify their status by submitting a signed statement stating their citizen or residence status. In other words, the regulations do not allow persons over 62 years of age to avoid the citizenship verification process. This is particularly important for the Section 504 grant program since only persons over 62 years of age are eligible for Section 504 grants. If you represent a client who is 62 years of age or older, consider challenging this requirement.[482]

2.4.3.2 The Applicant Must Possess the Legal Capacity to Incur the Legal Obligation of the Loan or Have a Court Appointed Guardian or Conservator Who is Empowered to Obligate the Applicant in Real Estate Matters.

This criterion[483] is identical to that for the Section 502 loan program.[484]

2.4.3.3 The Applicant Must Have a Credit History that Indicates Reasonable Ability and Willingness to Meet Debt Obligations.

This eligibility criterion[485] is technically identical to that for the Section 502 program.[486]

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[472] 7 C.F.R. § 3550.56 (2009); Handbook 1-3550 ¶ 5.4 (Rev. 9/10/03).
[473] 7 C.F.R. § 3550.73 (2009), The standards are set out in 7 C.F.R. Part 1924, subpart A (2009).
[474] *Id.* § 3550.73 (2009).
[475] 7 C.F.R. § 3550.73 (b) (2009).
[476] *Id*. § 3550.73(h).
[477] *See* § 2.4.2.2.1, *supra*.
[478] *See* Chapter 3, *infra.*
[479] 7 C.F.R. § 3550.103 (2009).
[480] 7 C.F.R. § 3550.103(d) (2009).
[481] *See* § 2.4.2.5, *supra.*
[482] *Id.*
[483] 7 C.F.R. § 3550.103(f) (2009).
[484] *See* § 12.4.2.6, *supra.*

However, Loan Originators are authorized to exercise greater flexibility with respect to Section 504 applicants. When the total RHS indebtedness (not counting escrow for taxes and insurance) is less than $7,500, RHS may also waive title insurance and the use of a closing agent.[487]

2.4.3.4 The Applicant Must Be a Person Who Owns and Occupies a Dwelling Located in a Rural Area

Ownership requirement. Contrary to the Section 502 eligibility criteria, the Section 504 applicant must already be the owner of the dwelling to be repaired.[488] The form of ownership required for the program may be satisfied in a variety of ways, including full marketable title; a land purchase contract; an undivided interest in the property;[489] a written leasehold interest in the property that in the case of a loan, extends at least two years beyond the term of the loan or in the case of a grant, extends for at least five years; a life estate with a right of possession;[490] and in the case of unsecured loans or grants to Indians living on reservations, grazing permits or land assignments.[491] Evidence of ownership may be established by a written instrument, whether or not recorded, that is commonly considered evidence of ownership, by evidence that the applicant is listed as the owner by the local taxing authority and that the applicant pays the taxes, and by affidavits by others in the community that the applicant has occupied the property as an apparent owner for no fewer than 10 years and is generally believed to be the owner of the property.[492] In short, the applicant need not have good and marketable title to the property.

Occupancy requirement. As with the Section 502 program, persons obtaining a Section 504 loan or grant must be the occupants of the home.[493]

A dwelling. Section 504 assistance may be used to repair health and safety hazards in houses and mobile or manufactured homes,[494] provided the applicant owns the home and site and the home is on a permanent foundation or will be placed on one with the loan or grant proceeds.[495]

The home must be located in a rural area. The discussion concerning Section 502 loans and the rural location requirement is applicable, to Section 504 loans and grants.[496]

2.4.3.5 The Applicant Must Not Be Able to Obtain Financial Assistance from Non-RD/RHS Credit or Grant Sources and Must Lack Personal Resources That Can be Used to Meet His or Her Needs[497]

The discussion concerning Section 502 loans and credit availability is applicable to the first

[485] 7 C.F.R. § 3550.103(i) (2009).
[486] *See* § 2.4.2.8, *supra.*
[487] 7 C.F.R. §3550.108 (2009); Handbook 1-3550 ¶ 8.4 (Rev. 8/1/07).
[488] 7 C.F.R. §3550.107 (2009).
[489] Section 504 funds may be made available to a person with an undivided interest only if the Loan Originator has no reason to believe that the applicant's position as owner/occupant will not be jeopardized as a result of the RD/RHS assistance, and that any co-owner residing on the property will in the case of a Section 504 loan, execute the mortgage or in the case of a Section 504 grant, sign the repayment agreement. If one or more co-owners are not legally competent, cannot be located, or are too numerous so as to make signatures impractical, and such interests do not exceed 50%, they may be excluded from signing so long as the loan does not exceed the value of the interest held by those who do sign. 7 C.F.R. § 3550.107 (d) (2009).
[490] *Id.* § 3550.107 (c) (2009). Similar provisions apply with respect to remainder interests as to co-owners.
[491] *Id.* § 3550.107 (e).
[492] *Id.* § 3550.107 (g).
[493] *Id.* § 3550.103 (a).
[494] A *Mobile home* is defined by RD/RHS as "an older manufactured unit often referred to as a trailer designed to be used as a dwelling but built prior to October 8, 1980." A Manufactured home is a structure that is built to Federally Manufactured Home Construction and Safety Standard and RD/RHS Thermal Performance Standards. It is transportable in 1 or more sections, which in the traveling mode is 10-body feet (3.048 meters) or more in width, and when erected on site is 400 or more square feet (37.16 square meters), and which is built on a permanent chassis and designed to be used as a dwelling with or without a permanent foundation when connected to the required utilities. It is designed and constructed for permanent occupancy by a single family and contains permanent eating, cooking, sleeping, and sanitary facilities. The plumbing, heating, and electrical systems are contained in the structure. A permanent foundation is required. 7 C.F.R. § 3550.10 (2009).
[495] *Id.* § 3550.102(c).
[496] *See* § 2.4.2.9, *supra*; 7 C.F.R. § 3550.105 (2009).
[497] 7 C.F.R. § 3550.103(e) (2009).

prong of this eligibility requirement for the Section 504 program.[498]

The second prong requires elderly applicant households to use any net family assets in excess of $20,000 to reduce their section 504 request. Non-elderly families must use any net family assets in excess of $15,000 to reduce their section 504 request. Applicants may contribute assets in excess of the aforementioned amounts to further reduce their request for assistance. The definition of assets for this purpose is net family assets as described in 7 C.F.R. § 3550.54 less the value of the dwelling and a minimum adequate site.[499] In determining the level of an applicant's resources, the Loan Originator must consider all resources such as cash, stocks, bonds, certificates of deposit, other liquid assets[500] and real estate.[501] The following assets are excluded from the calculations: the applicant's dwelling and the site upon which it is situated (provided it is a minimally adequate site); interest in American Indian trust land, cash on hand which will be used to reduce the amount of the loan; the value of necessary items of personal property; assets that are part of the business, trade, or farming operation of any member of the household who is actively engaged in such operation; and the value of an irrevocable trust fund or any other trust over which no member of the household has control.[502] Moreover, if the applicant is experiencing medical expenses in excess of 3% of the household's income, this personal resource application requirement may be waived or modified.[503]

2.4.3.6 The Applicant Must Have Very Low Income

To qualify for a Section 504 loan or grant, the applicant must have an adjusted family income that does not exceed RD/RHS' very low-income limits as provided to the RD state offices by HUD and inserted into the local office Handbook as Appendix 9.[504] The method for determining income and calculating adjusted income for the Section 504 program is the same as that for the Section 502 program.[505]

2.4.3.7 The Applicant Must Have Sufficient and Dependable Income to Repay the Loan

This eligibility criterion[506] is identical to that for the Section 502 loan program. Note, however, that the sufficiency of the applicant's ability to pay is measured against the loan obligation under the Section 504 program rather than under the Section 502 program. Moreover, if the applicant is also eligible for a Section 504 grant,[507] the borrower's repayment ability must be based only on the Section 504 loan.[508] Furthermore, if the applicant is eligible for a grant and has no repayment ability for a loan, the grant may not be denied for lack of repayment ability.[509]

If you represent a Section 504 loan applicant, make sure that repayment ability is determined accurately because it may also determine the number of years that your client has to repay the loan. Loan Originators are authorized to make Section 504 loans for a term of up to 20 years, but must base the actual term on the applicant's repayment ability.[510] For example, if your client's repayment ability is $35 per month, RD/RHS will reamortize a $7,500 loan over the full 20 years.[511] If, on the other hand, your client's repayment ability is $66 per month, RD/RHS would amortize the same $7,500 loan over 10 years.[512]

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[498] *See* § 2.4.2.4, *supra.* In cases where the household is experiencing medical expenses in excess of three percent of the household's income, this requirement may be waived or modified. 7 C.F.R. § 3550.103(e) (2009).
[499] *See* 7 C.F.R. § 3550.103(e) (2009).
[500] Liquid assets are cash or any other asset that can be converted to cash within 90 days.
[501] 7 C.F.R. § 3550.54(d)(1) (2009).
[502] *Id.* § 3550.54(d)(2).
[503] *Id.* § 3550.103(e) (2009).
[504] *See,* Handbook 1-3550 ¶ 4.2 A.3 (Rev. 4/18/07).
[505] 7 C.F.R. § 3550.103(c); *See* § 2.4.2.1, *supra.*
[506] *Id.* § 3550.103(h).
[507] *See* § 2.4.3.9, *infra*.
[508] Handbook 1-3550 ¶ 12.4 (Rev.11/7/08).
[509] *Id.*
[510] 7 C.F.R. § 3550.113 (2009); Handbook 1-3550 ¶ 12.6 (Rev. 12/19/09).
[511] The amortization factor for a 20-year one-percent loan is $4.60 per thousand dollars. Thus, the monthly payment on a $7,500 loan would be $34.50 ($4.60 x 7.5).
[512] $66/7.5 = $8.80/thousand dollars of loan. At $8.80 per month, a $7,500 loan can be amortized over 10 years (the cost of amortizing a $7,500 loan at 1 percent over 10 years is actually

2.4.3.8 The Applicant Must Need the Grant to Remove Health or Safety Hazards[513]

Section 504 loans may be used to make general repairs and improvements to properties as long as the dwelling remains modest, or to remove health and safety hazards.[514] Section 504 grants may be used only to make repairs and improvements that remove identified health or safety hazards or to repair or remodel dwellings to make them accessible and useable for household members with disabilities.[515] Dwellings repaired with Section 504 loan or grant funds need not be brought to agency development standards or thermal performance standards, nor must all existing hazards be removed, provided the dwelling does not continue to have a major health or safety hazard after the planned repairs are made.

Loan and grant funds may be used for payment of reasonable connection fees or pro-rata installation costs for utilities such as water, sewer, electricity, and gas,[516] to install or repair sanitary water and waste disposal systems (together with related plumbing and fixtures), energy conservation measures, heating systems (including alternative systems such as wood-burning stoves), electrical wiring, structural support, roofing and siding.[517]

Loan funds may not be used to construct a new dwelling, to make repairs to a dwelling that is in such poor condition that it will continue to pose a major hazard after the planned repairs are completed, or to move a mobile home.[518] Grant funds may not be used to improve the appearance of an existing dwelling or to make it more convenient, unless such changes are directly associated with the removal of health or safety hazards.[519]

2.4.3.9 Additional Eligibility Requirements for the Section 504 Grant Program

2.4.3.9.1 The Borrower Must Be Over 62 Years Old

The Section 504 authorizing legislation does not restrict grants to elderly persons.[520] The restriction is incorporated into the program by the annual Agricultural Appropriations Act which limits grant expenditures to the elderly.[521] RD/RHS has interpreted this to mean persons over 62 years.[522]

2.4.3.9.2 The Borrower's Income Must Be So Low That He or She Is Unable to Repay a Part or All of the Money Needed to Make Necessary Repairs

A Section 504 grant may be made with or without a Section 504 loan.[523] To qualify for a grant, the applicant must have an income so low that he or she would be unable to repay part or all of the cost of the needed repairs in the form of a loan.[524] Therefore, the amount of the grant that an applicant will receive depends on the total cost of repairs and the applicant's ability to repay any part of that cost if it were to be paid by a loan.

Since in any particular case the cost of repairs are known, the amount of the grant is determined by the borrower's ability to repay, which is calculated from the borrower's Family Budget[525] in the same manner that a borrower's ability to repay is determined for the Section 502 program.[526]

$65.70 per month). If the term of the Section 504 loan is less than 15 years, always check to *see* whether your client may qualify for a Section 502 loan and whether it may not be more advantageous to obtain a Section 502 loan. For example, a client with $66 repayment ability who qualifies for maximum amount of interest subsidy could, potentially, obtain a $22,000 Section 502 loan amortized over 33 years.

[513] Section 504 loans and grants are treated in detail in Handbook 1-3550, Chapter 12.

[514] 7 C.F.R. § 3550.102(b) (2009).

[515] *Id.* § 3550.102(a).

[516] *Id.* § 3550.102(d)(3).

[517] 42 U.S.C.A. § 1474(a) (West 2003).

[518] 7 C.F.R. § 3550.102(e)(1)(2) and (3) (2009); Handbook 1-3005 ¶ 12.2 A (1/23/03).

[519] 7 C.F.R. § 3550.102 (2009); Handbook 1-3550 ¶ 12.2 A (Rev. 1/23/03).

[520] 42 U.S.C.A. § 1474(a) (West 2003).

[521] *See, e.g.*, Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act, 2010, Pub. L. No. 111-80, 123 Stat. 2090 (2009).

[522] 7 C.F.R. § 3550.103(b) (2009).

[523] 42 U.S.C.A. § 1474(a) (West 2003).

[524] Handbook 1-3550 ¶ 12.4 D (11/7/08).

[525] Form RD 1944-3 (Rev. 6/97); 7 C.F.R. § 3550.112 (c) (2009).

[526] *See* § 2.4.2.2, *supra*.

2.4.3.10 Calculation of the Grant Amount

Once the borrower's ability to repay and the cost of the repairs are known, it is relatively easy to determine the grant amount for which the borrower is eligible. First, determine the loan amount that the borrower can amortize given his or her repayment ability. Second, subtract the loan amount from the total cost of the repairs. The result is the amount of the grant, provided it does not exceed $7,500.[527]

The loan amount that the borrower can amortize depends on the number of years over which the loan is to be repaid and the loan's rate of interest. For purposes of determining the size of a Section 504 grant, RD/RHS amortizes the loan over 20 years.[528] The rate of interest for all Section 504 loans is one percent.[529] Once you have determined the applicant's ability to repay, the loan term, and the interest rate, you can determine the amount of loan that the applicant can afford by using an amortization table.

Example. Assume an applicant is able to repay $9 per month and that she needs $6,200 to make repairs to her home. An amortization table indicates that a loan of $1,000 amortized over 20 years at one-percent interest will require a monthly payment of $4.60. Dividing $9, your client's payment ability, by $4.60, results in 1.9565. Therefore, your client can afford a loan of $1,956.50 (1.9565 x $1000). The balance between $1,956.50 and $6,200 will be provided to your client in the form of a grant.

2.5 ALTERNATIVES FOR VALIDLY REJECTED APPLICANTS

Applicants whose applications for RD/RHS assistance have been rejected for valid reasons should explore whether they can qualify for other forms of RD/RHS assistance if they reduce the amount they seek, change the program under which they seek assistance, or otherwise bring themselves within RD/RHS' requirements. For example, applicants who are eligible for RD/RHS assistance, but do not have sufficient income to repay a loan of a particular size should try to find a co-signer or find out whether they can obtain adequate housing with a smaller loan. RD/RHS will accept co-signers whenever an applicant does not have adequate income or when the applicant's credit history is unsatisfactory. The co-signer's income and creditworthiness must meet RD/RHS' requirements.[530] Note, that under certain limited circumstances, RD/RHS may not allow your client to use additional assistance because it considers the risk too great. This is the case when RD/RHS determines that your client's overall housing expenses will increase over his or her previous housing expenses. RD/RHS refers to this as "Payment Shock."[531]

Applicants who do not qualify for a newly constructed Section 502 home may want to consider purchasing a newly constructed home with fewer amenities, constructing the home under the self-help housing program[532] or the Deferred Mortgage Demonstration Program,[533] purchasing a manufactured home, purchasing an existing home, or qualifying for the Section 8 voucher program and using the voucher as a homeownership subsidy.[534] Applicants who do not qualify for a Section 502 or Section 504 rehabilitation loan should explore whether the RHS Rural Housing Preservation Grant Program[535] is operating in their area. If none of these alternatives will qualify the applicant for a loan, the applicant should explore the RD/RHS rental housing programs.

Persons who do not qualify for assistance because they are not creditworthy should meet with the Loan Originator to review the agency's expectations concerning debt levels and payment record. Financial counseling from other sources should also be explored. If the applicant's payment record changes or sufficient time has passed since

[527] 7 C.F.R. § 3550.112 (c) (2009).
[528] *Id.* § 3550.112(b).
[529] *Id.*

[530] 7 C.F.R. §§ 3550.53(g)(4) and .103(h)(1) (2009).
[531] Handbook 1-3550, ¶ 4.24 C (Rev. 7/8/09).
[532] *See* § 1.7.3.2, *supra*.
[533] *See* § 1.7.4, *supra*.
[534] *See* Chapter 1.2.1, *supra*, for a description of the Section 8 Homeownership program. Note, not every housing authority has implemented a Section 8 Homeownership program. Your client, therefore, will have to check with the local housing authority to determine if one is operating in the area in which your client wants to live.
[535] *See* § 1.7.3.4, *supra*.

the applicant's poor credit history was established, the applicant should be encouraged to reapply for an RD/RHS loan.

CHAPTER 3
THE INTEREST SUBSIDY AND DEFERRED MORTGAGE PAYMENT PROGRAMS

3.1 INTRODUCTION

Section 502 direct loans to eligible borrowers[536] are made at a market interest rate that is set and periodically revised in accordance with a statutory formula.[537] Effective January 1, 2009, the Rural Development/Rural Housing Service (RD/RHS) rate for a low or very-low income borrower was 4.375%.[538] Even at this relatively low market interest rate low- and very low-income borrowers may be unable to participate in the Section 502 program. These loans have, therefore, been made affordable to borrowers through three distinct types of payment subsidies: Interest Credit,[539] Payment Assistance Method 1[540] and Payment Assistance Method 2.[541] Depending on family size, income, and the size of the loan, these subsidies may reduce the effective interest rate on a Section 502 loan to as low as 1%.[542]

In addition to payment subsidies, RD/RHS offers certain very low-income Section 502 direct loan borrowers an opportunity to defer up to 25% of their monthly principal and interest loan payments for a term of up to 15 years.[543] Borrowers are only eligible for deferrals at the time of the initial loan closing. The deferred portion of the loan accrues interest at 1% but is not payable until the deferral is terminated due to changes in the borrower's circumstances or the term expires. At that point, the sum of the deferred amount and the accrued interest is included in the principal balance of the loan. The effective interest subsidy on deferred mortgages is subject to recapture.[544] The borrower's continued eligibility for deferral is reviewed annually.

Borrowers who secure a Section 502 loan execute a promissory note at the current market interest rate.[545] Borrowers who are eligible for an interest subsidy or mortgage payment deferral also execute a subsidy agreement that varies somewhat depending on the form of subsidy that the borrower receives. The subsidy agreement reduces the borrower's obligation to pay principal and interest to RD/RHS. The amount of the reduction varies depending on the form of the subsidy.

Payment Assistance Method 2 (PAM 2) was first put into effect on December 27, 2007. It is the form of subsidy that RD/RHS currently uses for all new loans and for existing borrowers who are in need of subsidy but do not have another subsidy agreement currently in place.

Payment Assistance Method 1 (PAM 1), was first put into effect in 1996 and remained in effect until PAM 2 was adopted in 2007. However, borrowers who are assisted by PAM 1 continue to receive assistance under that program provided they remain eligible for a subsidy and there has not been a gap in their payment assistance agreements. If their PAM 1 assistance ended, and subsequent to the termination of the PAM 1 agreement, they again became eligible for a subsidy, they would receive assistance under the PAM 2 program.

The Interest Credit subsidy program was in place between 1968 and 1996. Borrowers who receive Interest Credit Assistance continue to receive it so long as they are eligible and their subsidy agreement is renewed at its expiration. Borrowers who have had their Interest Credit Agreement terminated because they were no longer eligible for

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[536] *See* Chapter 2, *supra.*
[537] 42 U.S.C.A. § 1490a(a)(1)(A) (West 2003).
[538] Interest Rate Changes for Housing Programs and Credit Sales (Unnumbered Letter from Russell T. Davis, Administrator, Housing and Community Facilities Program (Jan 16, 2009) (available at http://www.rurdev.usda.gov/regs /ul_list .html (last visited 4.14.09)).
[539] 7 C.F.R. § 3550.68(d) (2009).
[540] *Id*. § 3550.68(c).
[541] *Id.*
[542] 42 U.S.C.A. § 1490a(a)(1)(B) (West 2003).
[543] 7 C.F.R. § 3550.69 (2009).
[544] Recapture is discussed fully in Chapter 6, *infra*.
[545] RD/RHS Handbook 2-3550, DLOS Field Office, Chapter 8, Loan Approval & Closing (Rev. 12/19/07) (available at http://www.rurdev.usda.gov/regs/hblist.html#hb2) (last visited 4.14.09). Hereinafter references to this and other RD/RHS handbooks will simply be to the handbook number and paragraph).

assistance, and thereafter became eligible for a subsidy, would then receive assistance under the PAM 2 program. However, borrowers who let their Interest Credit Agreement expire while they remained eligible for Interest Credit may renew their Interest Credit Agreement provided they do so within 6 months of termination of their prior Interest Credit Agreement.[546]

While the formulas for each of the three subsidy programs differ, the ultimate difference between the three forms of assistance is the amount of subsidy that the borrower is receiving. Generally, the Interest Credit program provides borrowers the deepest subsidy and PAM 1 the least; PAM 2 is somewhere in between. RD/RHS' obligations to service loans and assist borrowers with interest subsidies are the same regardless of which form of subsidy the borrower receives.

Borrowers who receive any one form of interest subsidy cannot switch to any other form of assistance, even if such assistance would provide them with deeper subsidies.[547]

Regulations for the three subsidy programs are set out in 7 C.F.R. § 3550.68 (2009). Additional information about the programs, including example calculations, can be found in Chapter 4 of Handbook 2-3550[548] and in Chapter 6 of Handbook 1-3550 DLOS.[549]

This chapter reviews all three interest subsidy mechanisms, their eligibility, renewal, and cancellation criteria, and their use as loan servicing tools. It also discusses the deferred mortgage program since it is effectively a subsidy that is reviewed annually by RD/RHS for continued eligibility.

Rural Housing Trust loans. In 1987, RD sold a significant number of Section 502 loans to the Rural Housing Trust 1987-1, a private Delaware-based trust. These loans, now serviced by Chase Mortgage, are eligible for Interest Credit and Payment Assistance on the same basis as direct Section 502 loans that are serviced by RD/RHS. Thus, the discussion in this chapter is equally applicable to Rural Housing Trust loans as it is to Section 502 borrowers.

Leveraged Loan Borrowers. Borrowers with leveraged loans[550] are eligible for interest subsidy provided the leveraged loan is amortized for a period of at least 30 years and the interest rate on that loan does not exceed 3%.[551] The amount of interest subsidy that these borrowers are eligible for is discussed in §§ 3.2.1.5.1 and 3.2.1.5.2, *infra.*

3.2 ELIGIBILITY FOR RD/RHS INTEREST SUBSIDIES

Interest subsidies are only available to Section 502 direct loan program participants who occupy their dwelling. Additional eligibility requirements apply to the subsidy programs depending on whether the loan is an initial or subsequent loan or whether the assistance is extended in connection with a loan reamortization or refinancing.

3.2.1 INITIAL LOANS

A person who applies for interest subsidy in connection with an initial Section 502 loan, including a loan for the purchase of inventory property, is required to meet four eligibility criteria to receive and interest subsidy. First, the applicant's adjusted family income (AFI) has to be within the published maximum income limits for moderate-income families in the area where the applicant is seeking a loan.[552] Second, the applicant must personally occupy the dwelling. Third, the loan term has to be for at least 25 years, although a borrower who receives a subsequent loan can qualify for a subsidy if the remaining term of the loan is less than 25 years but

[546] Handbook 2-3550, ¶ 4.2 A.1. (Rev. 4/1/08).
[547] *Id.* ¶ 4.2.
[548] *Id.*
[549] Available at http://www.rurdev.usda.gov/regs/hblist.html (last visited 4.14.09).

[550] Leveraged loans are described fully in Chapter 2, *supra.*
[551] Handbook 1-3550 ¶¶ 6.12A and B (Rev. 4/1/08).
[552] 7 C.F.R. § 3550.68 (2009). There is a conflict between the RD/RHS regulations and the Handbook. The regulations clearly state that an applicant must have adjusted income below the moderate-income limits for the area in order to qualify for interest subsidy. The RD/RHS Handbook states that the applicant must have income within the low-income limits for the area at the time of initial loan application, and if the applicant's income increases, he or she may not have income above the RD/RHS moderate income limits at the loan closing. Handbook 1-3350, ¶ 4.2 B (*1)* ((Rev. 4-1.08). Since regulations have the force and effect of law and the handbooks do not, the regulations should prevail in any dispute with the agency with respect to subsidy eligibility.

the original term of the loan was more than 25 years. Fourth, the loan must have been approved on or after August 1, 1968.[553]

3.2.1.1 The Applicant's Adjusted Income Must Be Within the RD/RHS Moderate-Income Guidelines

RD/RHS uses the applicant's adjusted income for determining eligibility for interest subsidies. The calculation of adjusted income for interest subsidy is the same as for determining eligibility for the Section 502 loan program.[554] It is household income less certain allowable deductions.[555] The maximum adjusted income for a moderate income household in any area is equal to the HUD published low-income limit, which is set at 80% of median income, plus $5,500.

3.2.1.2 The Applicant Must Personally Occupy the Dwelling

Interest subsidy will not be made available to borrowers unless the borrower occupies the home. Usually, this is not an issue at the time the subsidy is made available, however, it may become an issue when RD/RHS seeks to terminate the subsidy.[556]

3.2.1.3 The Term of the Loan Has To Be 25 Years

A payment subsidy may be made on an initial loan or a subsequent loan made in conjunction with an assumption of an existing Section 502 loan if the term of the loan is 25 years or more. A payment subsidy for a subsequent loan, not made in conjunction with an assumption, can only be made if the initial loan was for a term of 25 years or more.[557]

3.2.1.4 The Loan Must Have Been Approved After August 1, 1968.

Congress enacted the RD/RHS subsidy programs on August 1, 1968. Since then, RD/RHS has taken the position that subsidy assistance may only be granted in connection with loans made after that date. Due to the passage of time, this should not pose a problem to very many applicants or borrowers. However, this limitation has been successfully challenged in connection with a borrower who sought to refinance a Section 502 loan. *See* § 3.7.4, *infra.*

3.2.1.5 Calculating Amount of Subsidy

The RD/RHS subsidy authorizing statute states that the subsidy extended to borrowers may not reduce the effective interest rate on the loan below 1% percent per annum.[558] The regulatory formulas,[559] which were all adopted administratively, vary depending on whether the borrower is receiving PAM 1, PAM 2 or Interest Credit. However, in no instance may the subsidy exceed what effectively is a 1% mortgage loan. The RD/RHS Section 502 Handbook has excellent examples of how the various subsidy calculations are made.[560] Advocates are urged to look at those calculations if the level of subsidy is an issue with their client's loan. These examples will not be included or discussed in this manual. It is, however, important to note that when making subsidy calculations, the borrower's payment for real estate taxes and insurance must be included in the calculations.

Real estate taxes. Real estate taxes are part of the subsidy calculations. Advocates should make sure that RD/RHS included all taxes and assessments that will be due and payable while any of the subsidy agreements will be in effect. The tax assessment should be reduced by the amount of any

[553] *Id.*§ 3550.68(b)(1) and (d). *See also*, Handbook 2-3550, § 4.2 (Rev. 4.1.08).
[554] *See* § 2.4.2.1.2, *supra*.
[555] 7 C.F.R. § 3550.54 (2009).
[556] *See* § 3.8.1, *infra.*
[557] 7 C.F.R. §§ 3550.68 (a)(2) and (3) (2009).
[558] 42 U.S.C. § 1490a(a)(1)(B) (West 2003).
[559] 7 C.F.R § 3550.68(d) (2009) and Handbook 2-3550, ¶ 4.4 (Rev. 4/1/08).
[560] *See*, Handbook 2-3550, Exhibits 4-1, 4-3, and 4-4 (Rev. 4/1/08).

tax exemptions available to the borrower, regardless of whether such exemptions are actually claimed.[561]

Insurance. The regulations require the inclusion of hazard insurance in the subsidy determination calculation, and in appropriate cases, flood insurance is also included.[562] However, regular homeowner's insurance is not included.

3.2.1.5.1 Payment Assistance Method 2

The maximum amount of Payment Assistance Method 2 that a Section 502 direct loan borrower will receive is the lesser of:

(1) the annualized promissory note payments for the loan plus the cost of taxes and insurance less 24% of the borrower's income, or

(2) the annualized promissory note payments for the loan less the amount the borrower would pay if the loan were amortized at 1%.

Effectively, under the Payment Assistance 2 program, the borrower pays at least 24% of income for principal, interest, property taxes and insurance. If the borrower's income is so low that a 1% interest rate plus taxes and insurance does not fall within 24% of the borrower's income, the borrower will pay more than 24% of income for principal, property taxes and insurance.

The PA 2 subsidy is calculated in the same manner for borrowers with leveraged loans except that the first part of the calculation is based on the cost of amortizing both the RD/RHS loan and the leveraged loan.

3.2.1.5.2 Payment Assistance Method 1

The amount of Payment Assistance Method 1 that a borrower will receive is the difference between the annualized promissory note rate and the lesser of:

(1) The floor payment, which is defined as a minimum percentage of adjusted income that the borrower must pay for principal, interest taxes and insurance (PITI). This is defined as

- 22 percent for very low-income borrowers,
- 24 percent for low-income borrowers with adjusted income below 65 percent of area adjusted median, and,
- 26 percent for low-income borrowers with adjusted incomes between 65 and 80 percent of area adjusted median; **or**

(2) The annualized promissory note rate installment and the payment at the equivalent interest rate, which is determined by a comparison of the borrower's adjusted income to the adjusted median income for the area in which the security property is located.

The following table replicates an RD/RHS chart that shows the percentage of median income and the equivalent interest rate that is applicable under the second part of this formula:

Adjusted Local Area Median Income

Equal to or More Than	But Less Than	Equivalent Interest Rate
00.00%	50.01%	1.0%
50.01%	55.00%	2.0%
55.00%	60.00%	3.0%
60.00%	65.00%	4.0%
65.00%	70.00%	5.0%
70.00%	75.00%	6.0%
75.00%	80.01%	6.5%
80.01%	90.00%	7.5%
90.00%	100.00%	8.5%
100.0%	110.00%	9.00%
110.00%	or more	9.5%

The PAM 1 formula penalizes low income persons who live in areas that have very low area median incomes because, under the second prong of the formula, the borrower's income is compared to other household incomes in the same area. Thus, a person with, for example, $25,000 of income, who resides in an area where the median income is $30,000, will pay an effective interest rate of 7.5% where a household with the same income that resides in an area with a $50,000 area median income will effectively have a 1% loan.

[561] 7 C.F.R. § 3550.10 (2009) (Exemptions may include homestead exemptions, special exemptions for low-income families, seniors, or veterans).

[562] *Id.* § 3550.110 (sets out the requirements for hazard insurance, which is required if the indebtedness is in excess of $15,000, and for flood insurance).

Leveraged loan borrowers are not subject to floor payments. Accordingly, leveraged loan borrowers simply make the leveraged loan payments and the RD/RHS loan payment at the Equivalent Interest Rate set out in the above table.

3.2.1.5.3 Interest Credit

The Interest Credit subsidy is effectively the same as the PAM 2 subsidy except that the borrower pays the higher of 20% of adjusted income for PITI or the equivalent of a 1% loan.

Under the first calculation, RD/RHS calculates twenty percent of the borrower's income, deducts the cost of real estate taxes and insurance (which may be escrowed or paid outside of the loan) and pays the difference between that amount and the amount necessary to amortize the loan at the interest rate set forth on the note. Under the second calculation, the RD/RHS calculates the amount necessary to amortize the loan at 1% per annum and pays the difference between that amount and the amount necessary to amortize the loan at the interest rate set forth in the promissory note. RD/RHS pays the lesser of these amounts, requiring the borrower to pay the greater of 20% if his/her income or 1% annual interest.[563]

Because leveraged loans were first introduced by RD/RHS after the agency ceased to make interest credit available to initial loan borrowers, leveraged loan borrowers are not eligible for the Interest Credit subsidy.

3.2.2 SUBSEQUENT LOANS

Borrowers who receive a subsidy on their existing loan may receive the same subsidy on a subsequent loan[564] if their income does not exceed the RD/RHS moderate-income limits for the area, the subsequent loan is for 25 years or more, and they continue to qualify for payment subsidy.[565] If the remaining term of the loan is less than 25 years, the borrower can still qualify for the subsidy if the original term loan was for more than 25 years.[566] If the borrower is receiving a subsequent loan in conjunction with an assumption of an existing loan, the term of the assumed loan must be for at least 25 years in order for the borrower to qualify for an interest subsidy.

3.2.3 SUBSIDY IN CONNECTION WITH TRANSFERS AND INVENTORY SALES

Borrowers who assume a Section 502 loan from another borrower are eligible for interest subsidy only if the term of the term of the new loan is for 25 years or more.[567] The subsidy assistance is subject to the borrower's meeting all the other interest subsidy eligibility criteria.

Similarly, borrowers who purchase inventory property from RD/RHS can qualify for interest subsidy provided the loan term is for 25 or more years and the borrower meets all the other eligibility criteria.

3.2.4 INTEREST SUBSIDY FOR BORROWERS NOT PRESENTLY RECEIVING ASSISTANCE.

There are times that RD/RHS borrowers are not receiving any interest subsidies. Typically, this is because their household income has increased and they are no longer eligible for or in need of a subsidy. Unfortunately, these borrowers frequently suffer a loss of income due to a household member moving out, death, separation or divorce, loss of a job, or illness.

Existing borrowers who do not have a current subsidy agreement are eligible for subsidies if they suffer a loss of income, are low-income, reside in the dwelling, and the loan was closed after August 1, 1968.[568] In addition, the borrower must be competent to contract, be a United States citizen or a permanently admitted resident, and not have been suspended or debarred from receiving RD/RHS as-

[563] *See* 'Sample Interest Credit Calculations, Handbook 2-3550, Exhibit 4-3 (Rev. 4/1/08).
[564] A subsequent loan is a second 502 loan made to a borrower who secured a Section 502 loan to purchase the home. Typically, subsequent loans are made to rehabilitate or repair homes financed under the 502 program.
[565] 7 C.F.R. §§ 3550.68 (a)(2) and (3) (2009). Handbook 2-3550, ¶ 4.2 A. 2 (Rev. 4/1/08).
[566] 7 C.F.R. §3550.68(a)(3) (2009).
[567] *Id.* 3550.68(a)(2).
[568] *Id.* § 3550.157(b).

sistance.[569] Lastly, in order to qualify for assistance, the borrower's then-existing or original loan must have been for a term of more than 25 years.[570]

Note that existing borrowers whose loans were financed prior to August 1, 1968 may be able to refinance the RD/RHS loans and thereby become eligible for subsidy assistance.[571]

Unfortunately, these regulations exclude moderate income borrowers from qualifying for interest subsidy assistance. It is not clear why RD/RHS has not been willing to extend assistance to these borrowers; however, in light of a 1981 statutory change that removed RD/RHS' mandatory obligation to extend interest subsidy to moderate income households, it is doubtful that one can prevail in a challenge the RD/RHS regulation.[572]

Both the regulations and the Handbook are silent on whether borrowers who were not receiving an interest subsidy and whose loans are then reamortized become eligible to receive the subsidy after reamortization. In the past, RD/RHS regulations made them eligible for the subsidy.[573] There is no reason why they should not be currently eligible.

3.3 ELIGIBILITY FOR DEFERRED MORTGAGE PAYMENTS PROGRAM

In 1996. RD/RHS instituted a deferred mortgage payments program to enable some very low-income borrowers to qualify for a loan. Under the program, up to 25% of the borrower's initial Section 502 loan payments can be deferred for a term of up to 15 years. The deferred amount accrues interest at 1%, and the subsidy is subject to recapture under the RD/RHS recapture program.[574]

3.3.1 ELIGIBILITY

An applicant for the deferred mortgage payments program must:

- have adjusted household income that is within the *RD/RHS* very low income limits;
- qualify for a 38 year loan term[575] for the direct 502 loan program or a 30 year loan term if the Section 502 loan is for the purchase of a manufactured home;
- have principal, interest, property tax and insurance payments that exceed 29% of the borrower's repayment income by $10 if the borrower is receiving payment assistance, or exceed 20% of the borrower's adjusted income by $10 if the applicant is assisted by interest credit.

3.3.2 DEFERRED AMOUNT

The amount of the mortgage payment that is deferred under the program is the amount by which the borrower's monthly principal, interest, taxes and insurance payments exceed 29% of the borrower's repayment income if the borrower is receiving Payment Assistance. If the borrower is receiving Interest Credit assistance, the amount that is deferred is the amount by which these payments exceed 20% of the borrower's adjusted income.

3.4 TERM OF INTEREST SUBSIDY AND DEFERRAL AGREEMENTS

Subsidy agreements for monthly borrowers[576] are for a term not to exceed 24 months. If the term of the agreement is more than 12 months, it is reviewable at the end of 12 months and may remain

[569] *Id.* (referring to 7 C.F.R. §§ 1950.53(b)(e) and (f) (2009).
[570] *Id.* § 3550.157(b).
[571] *Id.*
[572] *Compare* 42 U.S.C.A. § 1490a(a)(1)(B) (West Supp. 1982) *with* 42 U.S.C.A. § 1490a(a)(1)(B) (West 2003).
[573] 7 C.F.R. § 1944.34(f)(4)(ii)(1994).
[574] *Id.* § 3550.69.

[575] As noted in § 1.7.1, Section 502 loans are typically amortized over 33 years. RD/RHS has authority to extend that term to 38 years to enable lower income households to qualify for the program. 7 C.F.R. § 3550.67 (2009).
[576] Monthly borrowers are borrower's whose promissory note obligates them to make monthly payments on their mortgage loan. Most borrowers are monthly borrowers. RD/RHS used to enter into promissory note agreements with borrowers that obligated them to only make one mortgage payment per year. Typically, this was the case when the borrower was seasonally employed and did not have any income during the balance of the year. RD/RHS has ceased entering into annual payment agreements with borrowers; however, some borrowers still have old annual loan agreements.

in effect for an additional 12 months if the borrower's circumstances do not change.[577]

It is not generally clear from RD/RHS regulations when subsidy agreements are entered into for 12 months or for longer terms. There are some circumstances, however, when the agency prescribes a specific term that may be longer or shorter than 12 months. For example, when borrowers are self-employed, the agency recommends that the initial subsidy agreement entered into extends for three months after the end of the borrower's business year.[578] This allows the borrower and RD/RHS to determine more precisely what the borrower's earnings are and thereby project earnings for the next year. For unemployed borrowers, RD/RHS enters into a six-month agreement in order to evaluate their status at the end of six months.[579]

In the past, RD/RHS borrowers could make their payments to RD/RHS on an annual rather than monthly basis. This is no longer an option for new borrowers.[580] For annual borrowers, interest subsidies were also applied on an annual basis. Recently, RD/RHS has been actively encouraging borrowers that have previously entered into annual payment contracts to convert to monthly payment plans. Indeed, it now requires conversion when a borrower enters into a new payment assistance agreement or secures a subsequent loan.[581] When annual borrowers enter into a new subsidy agreement, the initial term of the agreement will extend only until January 1 of the following year, the due date of the annual payment.[582]

During the term of a subsidy agreement, *RD/RHS* credits to the borrower's account, either on a monthly or annual basis, the amount of subsidy for which the borrower is eligible. In effect, this reduces the borrower's monthly or annual obligations to RD/RHS under the promissory note.

Deferred Mortgage payment agreements, which are combined in one form with the Payment Assistance Agreement[583], are supposed to be entered into for a term of 12 months, after which they become reviewable.

3.5 RENEWAL OF INTEREST SUBSIDY AND DEFFERAL AGREEMENTS

3.5.1 PROCEDURES FOR REVIEWS AND RENEWAL OF SUBSIDY AGREEMENTS

Reviews. When a subsidy agreement is for more than 12 months, RD/RHS or its servicing contractor must conduct a review of the borrower's continued eligibility for the interest subsidy prior to the 12 month anniversary of the agreement.[584] It does so by sending a letter to the borrower advising him or her that the agreement will remain in effect for the balance of its term unless the borrower's income has changed by more than 10%.[585] In such a case, the borrower is requested to provide RD/RHS with information about the nature of the change. RD/RHS then verifies the income level with the income source. If the borrower's income has changed by less than 10%, the subsidy agreement remains in effect until its expiration date. If it has changed by more than 10%, RD/RHS will renew the agreement at the adjusted subsidy level for the remaining term of the agreement.[586]

Renewals. Prior to the expiration of the term of any subsidy agreement, RD/RHS or a representative of an RD/RHS contractor,[587] initiates the required "annual" review before entering into a new subsidy agreement.[588] In order to complete the review in a timely manner, approximately ninety (90) days before the expiration of the current subsidy agreement, RD/RHS' Centralized Servicing Center (CSC) will send the borrower a *Payment Subsidy*

[577] 7 C.F.R. §§ 3550.68 (e), and 3550.157 (a)(1) (2009); Handbook 2-3550, § 4.6 A (Rev. 4/1/08).
[578] Handbook 2-3550 ¶ 4.2 D 2 (Rev. 04/01/08).
[579] *Id.*
[580] 7 C.F.R. § 3550.152, 3550.203 (2009).
[581] *Id.* § 3550.153(a) .
[582] Handbook 2-3550 ¶ 4.2 D 3 (Rev. 4/1/08).
[583] Form RD 1944-14 (Rev. 5/08).
[584] 7 C.F.R. §3550.69(c) (2009).
[585] *Id.*
[586] *See, Handbook* 2-3550 ¶ 4.6 (Rev. 4/1/8).
[587] In several states, RD/RHS is contracting with private contractors to conduct various loan servicing functions previously carried out by RD/RHS staff. Subsidy level reviews and renewals are among these functions. Thus, references to an RD/RHS staff member also include employees of contractors.
[588] 7 C.F.R. §§ 3550.68(e), 3550.157(a) (2009). Handbook 2-3550 ¶ 4.6 (Rev.04/01/08).

Renewal Certification,[589] which requires the borrower to submit information and supporting documentation necessary to conduct the eligibility evaluation,[590] together with an *Authorization to Release Information*[591] which allows the RD/RHS to verify the information with third-party sources.[592] Generally, the review is conducted to confirm that the borrower's income is at or below the applicable moderate-income limit,[593] that the appropriate level of assistance is being provided, and that the borrower continues to reside in the property.[594]

The CSC then projects the borrower's expected income for the next 12 months,[595] calculates the borrower's annual and adjusted income,[596] and notifies the borrower by letter of the required monthly payment amount.[597]

Interim Reviews. Borrowers are required to inform RD/RHS of any changes in employment of adults in the household, changes in household composition, and increases in income of 10% percent or more.[598] All of this information is necessary in order to calculate the borrower's adjusted income, and ultimately, the amount of subsidy that the borrower will receive.[599]

Reviews occasioned by the borrower informing RD/RHS of interim changes are called Interim Reviews.[600] A borrower may also trigger an interim review by reporting a decrease in income or change in household composition. The review will only result in an increase in interest subsidy if the change in scheduled principal and interest payments will be at least 10% percent.[601] This threshold is arbitrary and may be subject to a challenge.[602]

In-Depth Reviews. The RD/RHS Handbook directs the CSC to conduct in-depth reviews of interest subsidy eligibility on a random basis of at least 1% of all renewals. In addition, it requires in-depth review when a borrower's Payment Subsidy Renewal Certification Form[603] appears inaccurate or when RD/RHS has information that conflicts with information provided by the borrower.[604] The CSC is authorized, but not required, to perform such a review if unauthorized assistance has been reported.[605]

When representing RD/RHS borrowers, you should always review whether they were properly informed and took advantage of all the exclusions and deductions in income available to them on renewal or upon entry into a new subsidy agreement.[606] If they did not, you may wish to argue that RD/RHS did not adequately inform them of their subsidy eligibility and that it improperly withheld one of the three interest subsidies.

Review Effective Date. In most cases, agreements with terms of more than 12 months will continue in effect until their expiration date without any further action, provided the borrower's household income has not changed by more than 10%. If the borrower advises RD/RHS of a change in income, RD/RHS verifies the changed income and then modifies the subsidy agreement. If the modification results in an increase in the borrower's payment, it does not go into effect until 30 days after the borrower is notified by RD/RHS. If it results in a decrease in the payment, it goes into effect on the next payment due date.[607] The modified agreement typically remains in effect for an additional 12 months, at which point RD/RHS undertakes a more comprehensive review.[608]

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[589] Form RD 3550-21(Rev. 3/06). The form is available at: http://www.rurdev.usda.gov/regs//formstoc.html#3500.

[590] Handbook 2-3550 ¶ 4.6 A. (Rev. 4/1/8). Supporting documentation includes most recent tax return and two pay stubs for employed adults, and proof of any non-employment income such as Social Security, child support, etc. *id.* ¶ 4.8 E. *See* Verification Requirements and Procedures, *id.* ¶ 4.8 E.

[591] RD form 3550-1 (Rev. 6.06). The form is available at: http://www.rurdev.usda.gov/regs//formstoc.html#3500.

[592] *Id*. Handbook 2-3550, ¶ 4.8 (Rev. 4/1/08).

[593] For definition of 'moderate-income' *see*, 7 C.F.R. § 3550.10 (2009).

[594] *Id.* § 3550.157(a).

[595] Handbook 2-3550 ¶ 4.8 F (Rev. 4/1/08).

[596] *Id*. ¶ 4.9; 7 C.F.R. 3550.54(b) & (c) (2009).

[597] Handbook 2-3550 ¶ 4.6 A.

[598] 7 C.F.R. §§ 3550.68 (e) and 3550.157 (a)(3) (2009). *See also* Handbook 2-3550, ¶¶ 4.6 B. and 4.2 D (Rev. 4/1/08). Note that under the prior regulations the borrower was required to notify RD/RHS of changes only upon review or renewal, but borrower-initiated interim reporting is now mandatory.

[599] *See* § 2.4.1.2, *supra.*

[600] Handbook 2-3550, ¶ 4 (Rev. 4/1/08).

[601] *Id.*; 7 C.F.R. § 3550.157(a)(3) (2009).

[602] *See* §§ 3.5.1, *supra*, and 3.7.3, *infra*, for a discussion of the validity of this requirement.

[603] Form RD 3550-21 (Rev. 3.6).

[604] Handbook 2-3550 ¶ 4.6 C (Rev. 4/1/08).

[605] *Id.*

[606] *See* § 2.4.2.1.1, *supra*.; 7 C.F.R. § 3550.54 (2009).

[607] Handbook 2-3550, ¶ 4.6 (Rev. 4/1/08).

[608] *Id.*

New Agreement Effective Date. Three months prior to the expiration of a subsidy agreement, RD/RHS commences a comprehensive review of the borrower's continued eligibility for subsidy assistance, and if everyone is timely, proceeds to enter into a new agreement based on the information provided by the borrower and verified by RD/RHS. The term of the new agreement will be for a term of between 12 and 24 months.

Problems arise when borrowers do not submit information on a timely basis or RD/RHS fails to process it by the expiration date of the existing agreement. When failure to timely renew the subsidy agreement is caused by RD/RHS, the new agreement takes effect as of the date of expiration of the old agreement.[609] If the failure to renew the agreement prior to the expiration of the old agreement is caused by the borrower, the new agreement goes into effect as of the date that the next payment is due.[610]

If a client's subsidy agreement was not executed on a timely basis, you should review whether the delay was caused by the client, RD/RHS, or a third party. It should be relatively easy to discern when the failure to enter into a new agreement is the fault of the client or RD/RHS. Unfortunately, neither the regulations nor the RD/RHS Handbook addresses the issue of delay caused by a third party, such as when an employer, or other source of income, fails to confirm the borrower's income on a timely basis. Clearly, this is not the fault of the client or RD/RHS, but RD/RHS will typically not make the new agreement effective as of the old agreement expiration date. In these cases, as well as in cases where the delay caused by the client will cause a hardship such as foreclosure to the client, you have several alternatives. The RD/RHS National Office Housing Administrator has authority to make an exception to any RD/RHS regulation when it is in the government's best interest.[611] It is easily arguable that it is in the government's best interest to make an exception to the renewal regulations in order to avoid foreclosure and the expenses involved. In the alternative, if the failure to timely renew a subsidy agreement was beyond the borrower's control, explore whether your client is eligible for moratorium relief.[612] You can also explore whether RD/RHS will collect the increased expenses through a delinquency work-out agreement.[613]

Whenever RD/RHS fails to renew a borrower's subsidy agreement--even when it is due to the borrower's failure to respond to the recertification letter--or when it reduces the amount of subsidy assistance that is provided to the borrower, RD/RHS must send a letter to the borrower advising him or her of the specific reasons why it did not renew the agreement and informing him or her of the right to appeal the decision.[614]

As discussed in § 3.8.3.1, RD/RHS is precluded by statute from reducing, canceling or refusing to renew a subsidy agreement due to an increase in the borrower's income, if the reduction, cancellation or non-renewal will cause the borrower to be unable to reasonably afford the resulting payments required under the loan.[615] Unfortunately, RD/RHS has not incorporated this statutory requirement into its regulations and is not following its mandate in servicing borrowers' loans. There are numerous instances where this provision may assist borrowers to avoid hardship and possible default and foreclosure of their loan. For example, if a borrower's income has increased, but the borrower's household expenses have also increased due to medical or other reasons, RD/RHS should not decrease the amount of subsidy that it provides the borrower.

3.5.2 LEVEL OF SUBSIDY ASSISTANCE ON RENEWAL

The amount of subsidy that is extended to a borrower upon renewal is determined and calculated in the same manner as the original subsidy agreement was calculated. Generally, it is based on a household's adjusted income, number of dependents in the borrower's home at the time of the renewal, the borrower's anticipated property taxes and insur-

[609] 7 C.F.R. § 3550.157(a)(2) (2009).
[610] *Id.*
[611] *Id.* § 3550.8 (2009). RD/RHS is known to have made such exceptions in the past. Letter from Arthur Collings, Jr., Special Assistant to the Administrator, to Martha Bergmark, Executive Director, S.E. Miss. Legal Services (Sept. 11, 1980).
[612] *See* Chapter 5, *infra.*
[613] 7 C.F.R. § 3550.205 (2009).
[614] *Id.* § 3550.4. *See id*. § 1900.55.
[615] 42 U.S.C. § 1490a(a)(1)(B) (West 2003).

ance payments, and for PAM 1, the relation of the borrower's income to incomes in the area in which the borrower resides.

Borrowers' incomes often increase during the term of a subsidy agreement. Consequently, the new agreement is frequently for a smaller amount of subsidy than the old agreement. Accordingly, borrowers' monthly or annual payments usually increase when the new subsidy agreement goes into effect. New subsidy agreements are usually made for the same term as the original agreement.

3.5.3 REVIEW AND RENEWAL OF DEFERRAL AGREEMENTS

RD/RHS reviews the mortgage payments deferral agreement every 12 months and will adjust the deferred payment in the same manner that it determined the deferred payment amount initially. If the borrower's income has increased, the amount deferred will be decreased, effectively increasing the borrower's monthly mortgage payment.

RD/RHS can also reduce the borrower's payments if the household income has been reduced. When increasing the amount of the deferral, RD/RHS is limited by the fact that its regulations authorize only the deferral of up to 25% of the monthly payments. RD/RHS actions with respect to the renewal and adjustment of deferred mortgage payment amounts are subject to the same challenges as challenges to the renewal, termination or reduction of interest subsidies, which are discussed below.

3.5.4 CHALLENGING THE FAILURE TO RENEW SUBSIDY AGREEMENTS

Since the eligibility criteria for renewal of a subsidy agreement are identical to those for initial eligibility, the arguments made for denial of initial subsidy assistance can also be made for denial of renewal of a subsidy agreement. There are two additional issues that may arise exclusively in the renewal process: the borrower's ability to refinance the RD/RHS loan with a commercial loan and the renewal of the subsidy if a foreclosure has been commenced.

Ability to refinance with a commercial loan. If a client was refused a new subsidy agreement because his or her income or assets are determined to be sufficient to enable the borrower to obtain a commercial loan, you should review the chapter on refinancing RD/RHS loans with private loans.[616] It discusses all the issues with respect to refinancing and the arguments that can be presented in resisting the refinancing obligations. RD/RHS should not refuse to renew the borrower's subsidy if it believes that the borrower is able to refinance. Rather, it should independently treat the issues by first renewing the subsidy and thereafter pursuing the refinancing. The borrower should not lose a subsidy while he or she explores refinancing or contends that he or she is unable to do so.

Foreclosure commenced. Lastly, if your client's subsidy agreement was not renewed after foreclosure proceedings were commenced, review the discussion of defaults under the various subsidy agreements.[617]

Above moderate income. If a client is refused a subsidy because his or her income is determined to be above the moderate-income limits for the area, review the eligibility requirements for Section 502 loans.[618] In particular, check the client's 'adjusted income' calculation to see that all allowable deductions have been considered and included in the calculations.[619] This is critical because RD/RHS determines eligibility based on adjusted income and not gross income.

You should also remember that the RD/RHS Housing Administrator has statutory authority, and arguably a mandate, not to terminate a borrower's subsidy if it will cause a hardship to the borrower.[620] You should seek an exception from the Administrator if you can show that your client will suffer such a hardship.

3.6 BORROWER OBLIGATION TO REPORT INCREASED INCOME DURING THE TERM OF THE SUBSIDY AGREEMENT

RD/RHS regulations and subsidy agreements obligate borrowers to notify the agency when an adult member of the household becomes em-

[616] *See* Chap. 7, *infra*.
[617] *See* § 3.8.5, *infra*.
[618] *See* § 2.4.2.1.1, *supra*.
[619] *See* § 2.4.2.1.2, *supra*
[620] *See* § 3.8.3.1, *infra*.

ployed, changes employment, there is a change in household composition, or if the household income increases by at least 10%.[621] Under each of these circumstances, RD/RHS will conduct a review of the borrower's subsidy to determine whether the household subsidy should be decreased. Arguably, RD/RHS should also increase the subsidy that is due to the borrower when it is advised of a change in employment or there is a change in household composition. By the terms of the RD/RHS regulations, the 10% limitation on increased subsidy only applies to circumstances where the borrower reports a decrease in income.

It is arguable that the 10% limitation on increased subsidy is arbitrary and capricious. In many cases, this 10% threshold means that the borrower will not qualify for additional assistance until the household gross income decreases by more than 13%. In light of the fact that RD/RHS requires borrowers to report changes in increased household income of more than 10%, but only accommodates a reduction in income when the household income decreases by 13%, the RD/RHS regulation appears arbitrary and capricious and subject to a challenge. The two thresholds should be identical.

3.7 INTEREST SUBSIDY AS A LOAN SERVICING TOOL FOR SECTION 502 BORROWERS

Since most conventional lenders have no readily available means of reducing a borrower's loan payments, the consequence of a substantial decrease in income or increase in expenses for low- and moderate-income homeowners is often foreclosure. Unlike conventional lenders, RD/RHS has statutory authority to reduce the payments of eligible borrowers and avoid foreclosure through the use of one of its interest subsidy programs. Through annual and borrower initiated reviews,[622] RD/RHS may be able to increase the amount of subsidy that the borrower receives and thereby reduce the burden on the borrower in case of decreased income, increased household size, or increased medical expenses. The subsidy thus becomes an important servicing tool with which RD/RHS can help borrowers retain their homes in cases of financial problems.

3.7.1 RD/RHS' OBLIGATION TO INCREASE THE INTEREST SUBSIDY DURING THE TERM OF AN EXISTING AGREEMENT

RD/RHS has no obligation to monitor whether a borrower becomes eligible for additional interest subsidy during the term of a subsidy agreement. Moreover, since direct contact between a borrower and RD, including CSC, is very limited these days, it is unlikely that RD/RHS will become aware of a change in the borrower's circumstances. However, RD/RHS staff may become aware of a decrease in household income when the borrower notifies the agency of a change in income or through some other exchange of information.[623]

Limited contact notwithstanding, when borrowers whose payment record has generally been good start missing payments or their payments become erratic, CSC should be on notice of a possible change in the borrower's circumstances. When a borrower with a good payment record becomes delinquent, CSC is arguably sufficiently aware of a potential change in the borrower's circumstances to obligate it to contact the borrower and review the borrower's circumstances, and if necessary, to provide additional subsidy assistance for which the borrower is eligible.[624] A more complete discussion of the ramifications of the CSC's failure to inquire about the borrower's circumstances may be found in the chapters on moratorium relief[625] and foreclosure.[626]

3.7.2 ELIGIBILITY FOR INCREASED INTEREST SUBSIDY

If RD/RHS becomes aware of a significant decrease in the borrower's income, no change is

[621] 7 C.F.R. § 3550.157 (a)(3) (2009).
[622] *See* § 3.5.1, *supra*.
[623] 7 C.F.R. § 3550.157(a)(3) (2009); Handbook 2-3550, ¶ 4.6 B (Rev. 4/1/08). RD Form 3550-4 (Rev. 2/08), Employment Certification form may be used by the borrower to notify the RHS.
[624] RHS Handbook-2-3550, ¶ 1.6 (Rev. 4/1/08).
[625] *See* Ch. 5, *infra*.
[626] *See* Ch. 6, *infra*.

made in the subsidy amount unless the subsidy would increase by at least 10%.[627]

If such change is made, the resulting new twelve-month agreement becomes effective on the next payment due date following the verification of the borrowers information by RD/RHS. The anniversary for annual review is then moved to the new date.[628]

3.7.3 CHALLENGING THE ELIGIBILITY RESTRICTIONS

RD/RHS' predecessors, the Farmers Home Administration (FmHA) and the Rural Housing and Community Development Service (RHCDS), had histories of imposing severe restrictions on adjustment of payment subsidies, requiring as much as a 30% reduction in income before allowing consideration of an increase in subsidy. While the current trigger of a 10% percent change is much more reasonable, there still may be instances that raise a claim under the statutory prohibition against reducing, canceling or refusing to renew a subsidy if such action "will cause the borrower to be unable to reasonably afford the resulting payments required under the loan."[629]

A refusal by RD/RHS to consider such an impact on the borrower may be challenged on the ground that it is arbitrary and capricious and contrary to law. The Housing Act of 1949 requires that the RD/RHS exercise all of its authority in a manner consistent with the National Housing Goal of providing every American family with decent, safe and sanitary housing.

Indeed, FmHA revised the moratorium regulations, lowering from 30% to 20% the reduction in income required to qualify for moratorium relief. The reason for its change was that the 30-percent reduction requirement was "excessive."[630] Similar arguments could be used in appropriate cases where the 10% requirement is a barrier to increased subsidies. To the extent that a refusal to consider the impact of the 10% rule on individual borrowers deprives such borrowers of needed interest subsidy and causes them to default on their loan, the requirement should be challenged as being contrary to the national housing goals.[631]

3.7.4 BORROWER INABILITY TO CHANGE FORM OF SUBSIDY

The RD/RHS self-imposed limitation of not allowing borrowers to change the form of the interest subsidies that they are receiving has not been tested in court. Arguably, borrowers who received PAM 1 and who defaulted on their loans due to circumstances beyond their control, could challenge RD/RHS' failure to extend Interest Credit or PAM 2 to them if the extension of those generally more generous forms of assistance would have avoided foreclosure. The limitation is similar to two other RD/RHS positions: the failure to extend Interest Credit subsidy to borrowers whose loans were financed before August 1, 1968[632] and its refusal to consider refinancing of Section 502 loans when refinancing would be more advantageous than other loan servicing options.

RD/RHS takes the position that Interest Credit is only available to borrowers whose loans were approved after August 1, 1968, the date of enactment of the Housing and Urban Development Act of 1968,[633] which first authorized the Interest Credit program. In so doing, it arguably violates both the Housing Act of 1949 and the Housing and Urban Development Act of 1968 by failing to extend Interest Credit to borrowers whose loans were financed prior to that date.

In the Housing Act of 1949, Congress declared that the national goal is to provide "a decent home and a suitable living environment for every American family."[634] To achieve that goal, Congress directed that RD/RHS "shall exercise [its] powers, functions, and duties under this or any other law, consistently with the national housing policy

[627] 7 C.F.R. § 3550.157(3) (2009); Handbook 2-3550, ¶ 4.6 B (Rev. 4/1/08); Employment Certification form may be used by the borrower to notify the RD/RHS.
[628] 7 C.F.R. § 3550.157(3) (2009).
[629] 42 U.S.C. § 1490a(a)(1)(B) (2003).
[630] 56 Fed. Reg. 6,939, 6,943 (Feb. 21, 1991).
[631] *See Pealo v. FmHA*, 361 F. Supp. 1320, 1324 (D.D.C. 1973).
[632] This provision, which appeared at 7 C.F.R. § 3550.68(a)(2) (2008), was deleted from the recently published version of the rule. S*ee*, Single Family Housing Loans, Payment Assistance (sic), Final rule, 72 Fed. Reg. 73252, 73255 (Dec. 17, 2007) (codified at 7 C.F.R. Pt. 3550 (2009)).
[633] Pub. L. No. 90-448, 82 Stat. 476 (1968).
[634] 42 U.S.C.A. § 1441 (West 2003).

declared by this Act and in such a manner as will facilitate sustained progress in attaining the national housing objective hereby established. . . ."[635] Congress reaffirmed these goals in the Housing and Urban Development Act of 1968, requiring that in the administration of those housing programs authorized by the act designed to assist families with incomes so low that they could not otherwise decently house themselves and of other government programs designed to assist in the provision of housing for such families, the highest priority and emphasis should be given to meeting the housing needs of those families for which the national goal has not become a reality.[636]

Since RD/RHS has refused to extend Interest Credit to borrowers whose loans were financed before August 1, 1968 even when it could be shown that the borrowers needed Interest Credit to avoid foreclosure, it could be argued that the agency's position violates the mandate that the agency exercise all of its powers consistently with the national housing goals and that it give the highest priority to assisting those persons for whom the national housing goal has not become a reality.[637] Interestingly, in the one case in which this argument was made with respect to the post-August 1, 1968 criterion, RD/RHS settled the case by granting the borrower Interest Credit even though her loan was closed prior to August 1, 1968.[638]

Similarly, RD/RHS took the position that it would not refinance existing Section 502 loans under any circumstances, even when a borrower defaulted under a loan and refinancing of the loan would be more advantageous than any other servicing tools that RD/RHS could use to assist the borrower. When RD/RHS was challenged on its position, the court held that it was contrary to law.[639] While RD has not generally changed its position significantly with respect to refinancing of Section 502 loans, it has made it possible for some borrowers whose loans were approved prior to August 1, 1968 to refinance the loans in order to qualify for Payment Assistance.[640]

Just like borrowers whose loans were approved prior to August 1,1968 or who are in need of refinancing, borrowers who are not receiving a particular form of subsidy because they have not previously received that subsidy should consider challenging the RD/RHS regulations as being contrary to law. The arguments in support of such a challenge may indeed be quite strong since the prohibition on extending various forms of subsidy to borrowers is self-imposed by the agency and not mandated by statute.

Borrowers who seek to challenge the RD/RHS position should not, however, do so unless they can show that the provision of another form of assistance will actually help them avoid foreclosure. For example, a borrower who is receiving PAM 1 and whose loan is amortized at 1% may not benefit from receipt of Interest Credit or PAM 2 assistance. Such a borrower should not challenge the RD/RHS regulations because he or she will simply not be benefitted by the change. On the other hand, a PAM 1 borrower whose effective interest rate is 3% because the borrower is living in an area where median incomes are low and the borrower's income is relatively high compared to the area's median income should consider such a challenge if the switch to PAM 2 or Interest credit will result in the borrower's loan being financed at 1%. Remember, the only reason RD/RHS dropped the Interest Credit

[635] *Id*.
[636] 12 U.S.C.A. § 1701t (West 1989).
[637] *United States v. Smith*, No. H-76-230 (D. Conn. Dec. 21, 1977) (stipulation for dismissal), 11 CLEARINGHOUSE REV. 1013 (Apr. 1978) (No. 23,370). *See United States v. White*, 429 F. Supp. 1245, 1253 (N.D. Miss. 1977), *aff'd*, 536 F.2d 1386 (5th Cir. 1977), *vacated and remanded on other grounds*, 542 F.2d 1139 (5th Cir. 1977); Pealo v. FmHA, 361 F. Supp. 1320, 1322-24 (D.D.C. 1973). In 1977, when FmHA implemented the Rural Rental Assistance program authorized by § 514(b) of the Housing and Community Development Amendments of 1974, Pub. L. No. 93-383, 88 Stat. 633 (1974), 42 U.S.C.A. § 1490a(a)(2)(A) (West 2003), it did not limit the availability of Rental Assistance to projects financed after passage of that Act. It did not do so even though the legislative history to that program is silent on the availability of Rental Assistance to existing borrowers just as the 1968 Act was silent on the availability of Interest Credit to borrowers whose loans were approved before passage of the 1968 Act. Note that with respect to Interest Credit, the statute states that "the Secretary *may* provide . . . assistance in the form of credits so as to reduce the effective interest rate . . . " 42 U.S.C. § 1490a(a)(1)(B) (2003) (emphasis added).
[638] *United States v. Smith*, *supra* note 637.
[639] *United States v. Garner*, 767 F.2d 104 (5th Cir. 1985).
[640] Handbook 2-3550 ¶ 5.3 A (Rev. 1/9/08).

Program, the most beneficial of the three subsidy programs, was an effort to save money. In light of the statutory mandate to assist borrowers in securing decent and affordable housing, the motivation of saving the government money may not withstand scrutiny.

3.8 CANCELLATION OF SUBSIDY AGREEMENTS

RD/RHS will cancel a subsidy agreement if the borrower has sold or transferred title to the property, does not occupy the property, or is no longer eligible for payment subsidy.[641] The borrower could also be found no longer eligible if he or she had a substantial increase in income and is clearly able to repay the loan without assistance, if the subsidy agreement was entered into by error or through falsification, or if RD/RHS has acquired the property.[642] A provision in the subsidy agreement not found in RD/RHS regulations further reserves RD/RHS' right to cancel the agreement if the borrower has defaulted under any of the conditions of the agreement, promissory note, or any instrument securing the loan obligation.[643] Because this provision is inconsistent with RD/RHS regulations, it is probably without force and effect.

3.8.1 SALE, CONVEYANCE, OR FAILURE TO OCCUPY

Interest subsidies are intended to assist the original borrower, and the amount of assistance extended is based on that borrower's family income or the subsidy formula limitation. Therefore, it is logical for RD/RHS to cancel the subsidy agreement when the borrower sells, conveys, or does not occupy the dwelling. Note, however, that questions with respect to occupancy are fact-based, and borrowers may continue to receive assistance if they temporarily vacate the dwelling for legitimate reasons.

3.8.2 VACATING THE DWELLING

The regulations do not clearly state when RD/RHS will consider a borrower to have vacated the dwelling. Presumably, it will only cancel the assistance when the borrower has taken up another permanent place of residence. The Handbook states that: "the borrower may be temporarily absent . . . for a period of 6 months with a reason acceptable to the Agency, such as seasonal or migratory employment, military call-ups, or hospitalization. In the case of a deceased borrower, subsidy may continue for six months or until assumption of the loan . . . whichever occurs sooner."[644] Thus, while the agency is given discretion by its Handbook, subsidies should not be canceled when a borrower decides to go to school in a distant locality without giving up his or her permanent residence, or where the borrower's home was burned down and the borrower has not permanently relocated to other housing. In this type of situation, the borrower should arrange for the maintenance of the property, but may rent it to another person only with RD/RHS approval.[645] In the latter case, the subsidy will not be continued.

3.8.3 SUBSTANITAL INCREASE IN INCOME

A borrower has an affirmative obligation to report increased income during the term of a subsidy agreement to RD/RHS.[646] If the information provided discloses that: 1) the application of the interest subsidy formula[647] results in zero or a negative subsidy amount, or 2) a borrower's adjusted income is in excess of the applicable moderate-income limit,[648] the borrower is no longer eligible for a subsidy unless the borrower is eligible for an exception, discussed in the next subsection.

Remember that under RD/RHS regulations, once a recipient of either Interest Credit or Payment Assistance 1 becomes ineligible or otherwise ceases to receive the subsidy, that borrower cannot return to the Interest Credit or Payment Assistance 1 pro-

[641] 7 C.F.R. § 3550.157(c) (2009).
[642] *Id.* § 3550.211(g).
[643] Form RHS 1944-6, ¶ VIII.a (Rev. 3/97).
[644] Handbook 2-3550 ¶ 4.2 B.2 (Rev. 4/1/08).
[645] While a lease for more than three years or one containing an option to purchase may prompt RD/RHS to liquidate the loan, any lease requires RD/RHS approval, and the borrower is not eligible for subsidy or special servicing benefits during the term if the lease. 7 C.F.R. § 3550.159(d) (2009); *see, also* Handbook 2-3550 ¶ 2.16 (Rev. 5/27/98).
[646] *See* § 3.6, *supra*.
[647] 7 C.F.R. § 3550.68(d) (2009).
[648] *Id.* § 3550.10.

gram.[649] If the borrower later becomes eligible for payment subsidy, he or she will now receive Payment Assistance Method 2.[650]

3.8.3.1 Exception To Termination Of Subsidy Agreements

The RD/RHS regulations state that "[a] borrower currently receiving [a form of interest subsidy] will continue to receive it … as long as the borrower is eligible…"[651] The regulations then define financial eligibility as having adjusted household income at or below the applicable moderate-income limit.[652] The authorizing statute creates an exception to this requirement.

> . . .[T]he Secretary may not reduce, cancel, or refuse to renew the assistance due to an increase in the adjusted income of the borrower if the reduction, cancellation, or nonrenewal will cause the borrower to be unable to reasonably afford the resulting payments required under the loan.[653]

Unfortunately, this exception is not addressed directly in either the regulations or the handbooks, and borrowers are not advised of it at any time.

There are potentially numerous circumstances under which RD/RHS should not be allowed to reduce the mortgage subsidy even though the borrower may no longer be eligible for assistance under the subsidy formulas because of increased income. Most notable is the situation where the borrower has incurred increased expenses due to circumstances beyond his or her control. This may be due to medical expenses or expenses related to the death of a family member. It may also relate to expenses incurred by the borrower for sending a dependent to college. Arguably, it may also relate to expenses that the borrower incurred for reasons within his/her control, such as purchasing a new car, when the borrower was not aware of the fact that the interest subsidy would be terminated due to increased income. The determining factor in such cases should be whether or not the borrower has actual repayment ability under his/her family budget.

The fact that RD/RHS does not notify borrowers of the fact that they may have their subsidy continued even though the formula calculations show that they are no longer eligible for assistance is a potential defense to an RD/RHS foreclosure. In cases where the borrower could have benefitted from the exception, the failure to inform borrowers of the exception and to consider their eligibility may be a violation of the borrower's due process rights under RD/RHS statutory framework as well as under the Constitution.[654]

3.8.4 UNAUTHORIZED ASSISTANCE

The extension of an interest subsidy may be improper if it results from an inadvertent error by a borrower, a packager, or an RD/RHS employee or contractor or from an intentional act by the borrower.[655] Unauthorized assistance includes any loan, payment subsidy, deferred mortgage payment or grant for which the recipient was not eligible.[656] The regulations distinguish and provide for different treatment of intentionally false information and inadvertently inaccurate information.

3.8.4.1 False Information

False information is information that the borrower knew or should have known was incorrect, but intentionally provided or failed to provide for the purpose of obtaining a subsidy for which the recipient was not eligible.[657]

If the RD/RHS discovers that a subsidy was issued based upon false information, it will give the

[649] 7 C.F.R. §§ 3550.68(b) and 3550.10 (2009)
[650] *See* § 3.1, *supra.*
[651] 7 C.F.R. §§ 3550.68 (b)(1) and (2) (2009).
[652] *Id.* § 3550.68(a)(1).
[653] 42 U.S.C. §1490a (a)(1)(B) (West 2003).
[654] 42 U.S.C.A. § 1480(g) (West 2003). *United States v. White*, 429 F. Supp. 1245 (N.D. Miss. 1977), *aff'd* 536 F.2d 1386 (5th Cir. 1977) *vacated and remanded on other grounds*, 542 F.2d 1139 (5th Cir. 1977).
[655] RD/RHS at one time estimated that as many as 52 percent of all Interest Credit Agreements were incorrect at the time they were executed and that as much as $190 million in excess Interest Credit was extended to borrowers over the then two-year terms of the agreements. RHS AN No. 476 (444) (Dec. 5, 1980).
[656] 7 C.F.R. § 3550.164(a) (2009).
[657] *Id.* § 3550.164(b)(1).

recipient thirty (30) days to repay that amount. If the recipient makes the required payment, the RD/RHS may thereafter allow the loan to continue without the subsidy.[658]

3.8.4.2 Inaccurate Information

Inaccurate information is information that while incorrect, was submitted or omitted without intent to obtain benefits to which the recipient was not eligible.[659] If a recipient receives a subsidy based upon inaccurate information, RD/RHS will require the repayment of the subsidy within thirty (30) days or if the recipient cannot do so, the agency may reamortize the account. In either case, the loan may be continued.[660]

3.8.4.3 RD/RHS Remedies

In the case of either false or inaccurate information, the RD/RHS has the following options: 1) require the recipient to repay in a lump sum, 2) require the recipient to execute a promissory note, 3) seek a judgment if the recipient refuses to repay, 4) accelerate the loan if payment is not made within thirty (30) days[661] and seek an offset on any payment due to the borrower from the government.[662]

3.8.5 DEFAULT UNDER THE SUBSIDY AGREEMENT

A borrower has two primary obligations under the subsidy agreements (Agreement). First, under paragraph 5,[663] the borrower agrees to make periodic payments, the failure of which may lead to foreclosure.[664] In addition, under paragraph 8, the borrower agrees to submit a statement of the family income for any designated period upon request by RD/RHS.

Paragraph 9 gives RD/RHS the right to terminate the Agreement if the borrower has defaulted under any term or condition of the Agreement, promissory note, or security agreement.[665] Paragraph 9.a. expressly contradicts RD/RHS regulations. There is no regulatory authority for RD/RHS to cancel the Agreement if the borrower defaults under the agreement, promissory note, or security agreement.[666] With respect to any failure to meet loan obligations, RD/RHS' regulations authorize cancellation of an Agreement only if after entering into a delinquency workout agreement, the borrower becomes more than 30 days past due under its terms.[667] As for defaulting under any of the terms of the Agreement itself, the regulations authorize cancellation only for the occurrences set out in paragraphs 9.b. (sale or transfer of title without the consent of the RD/RHS)[668] and 9.c. (borrower has failed or ceased to occupy the property).[669] The regulations affirmatively provide that even in the case of acceleration, the subsidy will not be cancelled," but will not be renewed unless the account is reinstated."[670]

Since regulations have the force and effect of law[671] and the subsidy Agreement by its terms is subject to the agency's regulations,[672] the provisions of Paragraph 9.a. should be treated as void.

3.8.6 EFFECTIVE DATE OF CANCELLATION

RD/RHS may cancel a subsidy agreement only if the borrower is no longer financially eligible for assistance, does not occupy the dwelling or has sold the dwelling.[673] The cancellation takes effect

[658] *Id.* § 3550.164(b)(3).
[659] *Id.* § 3550.164(c)(1).
[660] *Id.* § 3550.164(c)(3).
[661] *Id.* § 3550.164(d), (e); *see also id.* § 1951.701 et seq. (2009) and § 3.10, *infra.*
[662] *Id.* § 3550.210.
[663] Form RD 1944-14 (Rev. 5-08). Note, the applicable paragraphs may vary depending on the revision date of the agreement and whether the agreement is a Payment Assistance Agreement (Form RD 1944-14 (Rev. 4-1-08)) or an Interest Credit Agreement (Form RD 1944-6 (Rev. 3-97).
[664] Form RD 1944-14, ¶ 12 (Rev. 5-08).
[665] Form RD 1944-14 (Rev. 5-08) and Form RHS 1944-6 (Rev. 3-97).
[666] *See United States v. Marshall,* 431 F. Supp. 888 (N.D. Ill. 1977).
[667] 7 C.F.R. § 3550.205(c) (2009).
[668] *Id.* § 3550.157(c).
[669] *Id.*
[670] *Id.* § 3550.211(g).
[671] *Rodway v. USDA*, 514 F.2d 809, 814 (D.C. Cir. 1975); *Berends v. Butz*, 357 F. Supp. 143, 151 (D. Minn. 1973).
[672] Form RD 1944-14, ¶ 14 (Rev. 5-08) and Form RD 1944-6, ¶ XII (Rev. 3-97).
[673] 7 C.F.R. § 3550.157(c) (2009).

upon RD/RHS notifying the borrower of the cancellation, which is subject to an appeal. The subsidy agreement will not be terminated upon acceleration, although RD/RHS may choose not to renew it when it expires.[674]

3.9 UNDEREXTENSION OF INTEREST SUBSIDY

Current regulations and handbooks do not address the case where the borrower has received a smaller subsidy payment than that to which he or she is entitled. Presumably, such a situation must be dealt with in the context of the receipt or denial of assistance, and any errors must be addressed through the appeals process.[675] The current regulations address only situations in which the recipient of the subsidy has received an overextension of interest subsidy.[676] You should review these regulations, and the underextension of credit must presumably be addressed by the borrower through the appeals process discussed *infra*.

3.10 RECOUPMENT OF UNAUTHORIZED SUBSIDY ASSSISTANCE

Whenever RD/RHS concludes that a borrower received unauthorized subsidy, it must notify the borrower of its determination.[677] The notice must specify in detail the reasons the amount was found to be unauthorized and the amount to be repaid. The notice must also advise the borrower that he or she has 30 days in which to consult with the CSC or dispute the claim[678] in accordance with the RD/RHS appeal procedure.[679]

If the borrower seeks a meeting with the CSC, he or she may request additional time to assemble needed documents, but must get CSC's approval. Otherwise, the original 30 day deadline applies.[680]

After the meeting with CSC or the passage of 30 days (if the borrower has chosen not to meet with CSC), RD/RHS must notify the borrower of the amount of assistance it has finally determined to be unauthorized and the actions that RD/RHS plans to take and must advise the borrower of his or her appeal rights.[681] RD/RHS may not take any action against the borrower until the appeal has been concluded or the time for requesting an appeal has expired without an appeal having been filed.[682]

If either before or after a meeting with RD/RHS, the borrower agrees that the assistance was unauthorized or the borrower is willing to pay RD/RHS the amount in question in a lump sum, RD/RHS will require the borrower to execute documents adjusting the status of the account and will provide the borrower up to 30 days to make the payment.[683]

Borrowers who fail to repay unauthorized assistance or enter into an agency approved repayment plan to repay the unauthorized assistance within 30 days after the borrower's appeal expiration date or final appeal determination will be assessed a $300 administrative cost plus any additional third party costs.[684]

3.10.1 INNOCENT RECIPIENT

If the borrower agrees with the RD/RHS or is willing to pay, but is unable to make a lump-sum payment within the 30 day period, RD/RHS will reamortize the loan to recoup the improper subsidy. However, the borrower must sign the reamortization agreement within 30 days of the final determination date.[685]

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[674] *Id.* § 3550.211(g). Note that the failure to renew the agreement is not significant because if the borrower prevails on the appeal, the agreement will be reinstated as of the expiration date of the last agreement.

[675] Interestingly, prior RD/RHS regulations specifically dealt with the issue of under extension of interest subsidy. *See* 7 C.F.R. § 1944.34(h)(2) (1994).

[676] 7 C.F.R. § 3550.164 (2009). For a more complete discussion of 'Unauthorized assistance', see § 3.10, *infra.*

[677] Handbook 2-3550 ¶ 7.4 A (Rev. 10/15/08).

[678] *Id.*

[679] 7 C.F.R. Pt. 11 (2009).

[680] Handbook 2-3550 ¶ 7 B (Rev. 10/15/08).

[681] *Id.* ¶ C.

[682] *Id.* ¶ D.

[683] 7 C.R. R. § 1951.709(a) (2009); *See* Ch. 5 for a discussion of RHS servicing options.

[684] Handbook 2-3550, ¶ 7.4. D (Rev. 10/15/08).

[685] *Id.* ¶ 7.6 A.

3.10.2 NON-INNOCENT OR RECALCITRANT RECIPIENT

If the recipient does not pay within 30 days, RD/RHS will accelerate the borrower's account.[686]

3.11 EXCEPTIONS

The RD/RHS Administrator may waive any interest subsidy eligibility requirement when the waiver is in the best interest of the government.[687] It is not known to what extent, if any, this exception has been used. Arguably, it could be used in any case in which he application of a rules would create a hardship to the borrower because it will hamper the government's meeting of its objective to provide decent housing to every American family.

3.12 PROCEDURAL ISSUES

3.12.1 NOTICE OF INITIAL INELIGIBILITY, REDUCTION, CANCELLATION, OR RECOUPMENT OF INTEREST SUBSIDY

When RD/RHS determines that a borrower is ineligible for a subsidy or when it takes any action that results in the reduction, cancellation, or recoupment of an interest subsidy, it must notify the borrower of the action, providing the reasons for the action and notification of his or her right to appeal the decision.[688]

The Handbook states that participants are to be informed in writing, that they may request informal administrative review of adverse decisions which are not appealable, and that they may write to the National Appeals Division (NAD) for a review of the accuracy of the RD/RHS determination that the issue cannot be appealed. It then gives examples of decisions that are either not within RD/RHS' control or are ministerial rather than discretionary.[689] If a borrower disagrees with any RD/RHS decision, the borrower may file a written request for either an administrative review or mediation.[690] with the person making the decision within fifteen (15) days of the date of the Agency's adverse decision The RD/RHS review or mediation is to be completed within 45 days. Such a request tolls, but does not restart, the 30 day period in which the borrower must file an appeal to the NAD. It is unclear whether this regulation contemplates such issues as the possibility of a mathematical error being made in the amount of interest subsidy to which the borrower is entitled. Thus, it may result in some borrowers not receiving a notice of their right to appeal an erroneous RD/RHS decision.

In reviewing subsidy determinations, always check whether the adjusted family income (AFI) was properly calculated, whether proper consideration was given to the client's insurance and tax expenses and finally, if all calculations are correct. If there are any questions about the way RD/RHS determined the subsidy, ask for a meeting with an RD/RHS staff person to review all the materials. If the RD staff person fails to provide the client with specific reasons for any action, you should consider an appeal.[691]

3.12.2 APPEALS

Notice of the right to appeal. The regulations require that RD/RHS give participants written notice of any adverse decision.[692] This notice must also inform participants of their right to a NAD hearing in accord with 7 C.F.R. Part 11. The regulation also provides that any decision, whether appealable or not, may be reviewed by the next-level RD/RHS supervisor.[693] While the term 'adverse decision' is not defined, it is quite possible that RD/RHS does not inform participants whose subsidy is increased or decreased, but not to the proper amount, of their right to an appeal. Since such persons may have been deprived of their statutory right to procedural due process,[694] they should not be precluded from appealing a decision within the 30-day period provided in the appeal procedure.

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[686] *Id.*
[687] 42 U.S.C. § 1490a(a)(1)(B) (West 2003). *Cf.* 7 C.F.R. § 3550.8 (2009).
[688] 7 C.F.R. § 3550.4 (2009); *see, also,* Handbook 2-3550 ¶ 1.9 (Rev. 4/1/08).
[689] Handbook 2-3550 ¶ 1.9. B (Rev. 4/1/08).
[690] Handbook 2-3550 ¶ ¶ 1.9. C, and § 1.9. D. (Rev. 4/1/08).
[691] *See* § 9.3.1, *infra* (discussion of appeal procedure).
[692] 7 C.F.R. § 3550.4 (2009); *see also* Handbook 2-3550 ¶ 1.9 (Rev. 4/1/08).
[693] *Id.* § 3550.4.
[694] 42 U.S.C.A. § 1480(g) (West 2003).

CHAPTER 4
CONSTRUCTION DEFECTS

4.1 INTRODUCTION

The purchase of an RD/RHS-financed home is probably the largest single expenditure a borrower will ever make. Yet surprisingly, the borrower will exercise little choice in making the purchase. Factors by which most ordinary home purchasers make the decision to buy, such as price, size, location, and appearance, are often dictated by RD/RHS regulations or the borrower's income. Furthermore, rarely will a purchaser have the knowledge or experience to judge the structural condition of a house or the adequacy of the electrical, plumbing and other mechanical systems. Consequently, borrowers usually purchase and occupy a house without an inspection and do not discover defects for weeks, months, or even years.

The likelihood of eventually discovering a major defect, particularly in a newly constructed home, is great. According to a 2003 estimate by a national building inspection firm, 15 percent of the homes constructed each year have at least two significant construction defects.[695]

In theory, RD/RHS has devised various ways to avoid or correct defects in RD/RHS-financed homes. It has adopted standards for new and existing homes, it requires inspection of all homes during construction or prior to purchase and in the case of newly constructed homes, it requires the builder to provide the homeowner with a warranty. In addition, the agency will disbar builders who fail to comply with RD/RHS' requirements or to honor the warranties made. It will also provide purchasers of newly constructed homes with compensation for defects the builder does not repair.

In fact, borrowers' homes often contain significant defects that neither the builder-seller nor RD/RHS will correct or provide compensation to the owner to correct. Consequently, many borrowers face repair bills and maintenance costs that are higher than anticipated and often beyond their means. They must also make time-consuming efforts to persuade the builder, seller, RD/RHS, or others to correct the defects. This chapter will discuss the ways in which RD/RHS attempts to avoid construction defects, steps that borrowers can take to protect themselves, and the various remedies available to the borrower for the correction of discovered defects.

4.2 CONSTRUCTION STANDARDS FOR RD/RHS HOUSING

The Housing Act of 1949 requires that all new buildings and repairs financed under Title V of the Act "shall be substantially constructed and in accordance with such building plans and specifications as may be required by the Secretary."[696] Pursuant to that authority, RD/RHS has adopted standards of construction for its various programs.

New construction under Section 502. All newly constructed or rehabilitated housing financed with Section 502 loan funds must meet or exceed one of several standards prescribed in RD/RHS regulations and must also comply with any applicable local or state codes or ordinances.[697]

Existing housing purchased with Section 502 loan funds. All housing purchased with RD/RHS funds must be structurally sound, functionally adequate, and either be in good repair or placed in that condition with loan funds,[698] and must meet the general requirements of a special RD/RHS Design Guide.[699]

Repairs and rehabilitation standards. Dwellings rehabilitated with Section 502 loan funds

[695] CRITERIUM ENGINEERS, CONSTRUCTION QUALITY SURVEY (Sept. 2003) (e.g., 21 percent had roof installation defects; 21 percent had improperly installed doors or windows; 18 percent had framing defects).

[696] 42 U.S.C.A. § 1476(a) (West 2003).

[697] 7 C.F.R. § 1924.5(d) (2009). Note, the RD/RHS regulations governing construction standards and practices as well as the compensation for construction defects program were adopted in 1991 and 1994, before the RD field structure was dramatically reorganized. As a result, the RD regulations refer to County Supervisors and District Directors, staff positions that have been restructured under the reorganization of RD. As a consequence, this chapter does not make specific references to RD field staff that is referenced in the regulations. Instead, it makes a more general reference to RD staff whenever the regulations refer to the County Supervisor or District Director.

[698] *Id.* § 3550.57(c).

[699] RD Instruction 1924-A, Guide 2, "Rural Development Design Guide" (5-12-87).

must be structurally sound, functionally adequate, and placed in good repair.[700] However, repairs made with a Section 504 loan and/or grant need not bring the dwelling up to RD/RHS-prescribed standards, but need only remove major hazards to the health of the occupants.[701]

4.3 PREVENTING DEFECTS IN NEWLY CONSTRUCTED OR REHABILITATED HOMES

Clients purchasing or rehabilitating homes with Section 502 assistance do not normally seek legal assistance before construction problems arise; hence, the opportunities to prevent construction defects are limited. Nevertheless, a brief discussion of the precautions available to prevent construction defects is useful for certain situations.

4.3.1 REVIEWING CONTRACT DOCUMENTS

Most RD/RHS borrowers do not have sufficient technical knowledge to review construction contracts and specifications. Borrowers should therefore review them with persons with expertise, such as architects, engineers, builders, or RD/RHS officials. Although architects and engineers are probably not accessible, builders and RD/RHS officials should be willing to review contract documents with the borrower. However, these parties will have their own interests, which may be different from those of the borrower.[702] When reviewing contracts and specifications, borrowers should be encouraged to question things they do not understand and should seek assurances that the specifications meet applicable standards.

If the materials specified in the contract are not satisfactory or contract provisions appear insufficient to protect the borrower's interests, insist upon changes. Although RD/RHS documents are convenient to use, they are not sacrosanct. They may be amended or replaced as long as RD/RHS approves the changes or substitutions.[703]

4.3.2 INSPECTING CONTRACTOR'S PREVIOUS WORK

An easy way to learn about the quality of a contractor's work is to inspect the contractor's previous jobs and talk to the occupants of the housing. Any contractor should be willing to share the names of previous clients whose homes may be viewed. If the contractor is not willing to do so, potential clients should be cautious about dealing with that contractor.

When inspecting a contractor's previous work -- which often will have been performed not by the contractor but by one or more subcontractors -- an evaluation should be made not only of the quality of the work, but also of his or her responsiveness to complaints and requests to correct deficiencies. Because problems and mistakes arise in almost any construction project, the contractor's attitude about and history of making repairs and corrections are as important as the quality of the initial work.

4.3.3 BONDING

RD/RHS does not usually require contractors to supply performance bonds on projects costing less than $100,000.[704] Nevertheless, borrowers may insist on contractors' providing performance bonds[705] and probably should insist on them for all new construction. If a payment and performance bond is not provided by the contractor, RD/RHS requires contractors to furnish (1) a corporate latent defects bond or a maintenance bond in the amount of 10 percent of the construction contract, (2) an unconditional and irrevocable letter of credit in the amount of 10 percent of the contract issued by a lending institution that has been reviewed and approved by the Office of General Counsel, or (3) a cash deposit into a supervised bank account in the amount of 10 percent of the construction cost.[706] Whichever form of security the contractor provides,

[700] 7 C.F.R. § 3550.57(c) (2009).
[701] *Id.* § 3550.106(b).
[702] *See id.* §§ 1924.5(f)(2)(iv), (v), (vii) and (viii) (directing RD/RHS staff to review plans and advise applicants, but further providing that such actions is "for the sole benefit" of the agency). Builders should be willing to review contract documents because of their interest in being awarded the contract.
[703] *Id.* § 1924.6(a)(2)(vi).
[704] *Id.* § 1924.6(a)(3).
[705] *Id.*
[706] *Id.* § 1924.6(a)(3)(iv).

it must remain in place for a period of one year from the date of final acceptance of the work by RD/RHS and the owner.[707]

4.3.4 PARTIAL PAYMENTS

If a contractor does not provide the borrower with a performance bond, the amounts paid the contractor during construction, known as draws, may not exceed 60% of the value of the work in place.[708] Even when a performance bond is provided, RD/RHS limits the contractor's draws to 90% of the work in place.[709]

All draws, including final payments, must be approved by the borrower before RD/RHS issues a check.[710] Therefore, if a borrower observes any nonconformance with the construction contract, he or she may withhold payment authorization until the contractor makes the corrections. A borrower who approves payment in the face of a known defect risks waiving his/her remedy regarding such defect. Borrowers should, therefore, act promptly with respect to any discovered defects.

4.3.5 INSPECTIONS

All newly constructed homes, except those covered by a 10- year warranty,[711] must be inspected by an RD/RHS staff person at least three times during construction.[712] Rehabilitation and repair projects must be inspected at least twice.[713] New construction covered by an RD/RHS-approved 10-year warranty plan need, generally, be inspected only once by an RD/RHS official.[714] The RD/RHS inspector is responsible for recording all construction deficiencies and following up on their correction by the contractor.[715]

Borrowers should not rely on these inspections and should visit the construction site periodically to inspect the quality of the work. If a borrower does not have the technical expertise to judge the work, he or she should seek assistance from other builders or architects, engineers or others with such experience. This may cost some money, but is likely to resolve a defect issue sooner and less expensively since the structure will not have to be opened up to discover the problem area.

A borrower who notices any defect or nonconformance with the contract should provide immediate written notice to the contractor and send a copy to RD/RHS. If the contractor is using construction draws, the borrower should not authorize further draws until the construction conforms to the contract.[716]

4.3.6 WARRANTIES

Warranties do not prevent defects in construction or nonconformance with contract provisions. They merely provide borrowers with a potential remedy for defective construction. RD/RHS requires contractors of newly constructed and rehabilitated homes to provide borrowers with a one-year express warranty.[717] In the alternative, some contractors may provide borrowers with an RD/RHS-approved insured 10-year warranty.[718] Borrowers' remedies under these warranties are discussed below.[719] It should be noted that the one-year warranty provisions required by RD/RHS are minimum requirements. Borrowers may attempt to negotiate more favorable provisions when negotiating a purchase or construction contract.

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[707] *Id.*

[708] *Id.* § 1924.6(a)(3)(iii)(C)(4). Exhibit A of 7 C.F.R. Part 1924 may be used to determine the amount of work in place at any time and to estimate the partial payment due. Note that although RD/RHS contracts provide for 60% draws, nothing in the regulations precludes borrowers from insisting on a lower percentage. A lower percentage must, however, be negotiated and included in the contract.

[709] 7 C.F.R. § 1924.6(a)(3)(iii)(C)(4) (2009).

[710] *Id.* § 1924.6(a)(12)(v).

[711] *See* § 4.6.1, *infra*.

[712] 7 C.F.R. § 1924.9(b)(1) (2009).

[713] *Id.* § 1924.9(b)(2).

[714] *Id.* § 1924.9(b)(3). An inspector from the warranty provider will usually conduct several inspections during construction.

[715] *Id.* § 1924.9(c).

[716] Unfortunately, RD/RHS officials and contractors often pressure borrowers into releasing funds to the contractor even when they are not satisfied with the work.

[717] 7 C.F.R. § 1924.12 (2009). This warranty must conform to Form RD 1924-19, "Builder's Warranty."

[718] 7 C.F.R. § 1924.12(b) (2009).

[719] *See* § 4.6.1, *infra*.

4.4 AVOIDING DEFECTS IN EXISTING STRUCTURES

4.4.1 INSPECTIONS

Purchasers of existing housing have fewer opportunities to discover and avoid construction defects than purchasers of newly constructed housing. Notwithstanding, unless the structure has recently been renovated, defects in existing structures are more readily apparent than they are in new construction. A thorough inspection of the home, including all of its major systems, is the best means to avoid purchasing a defective home.

While RD/RHS staff are responsible for inspecting existing structures to ensure that they meet RD/RHS loan criteria, they are not responsible for inspecting and certifying that the structure's electrical, plumbing, heat, water and sewage disposal systems are adequate and that no termite infestation exists. The purchaser must secure these certifications either from the seller or through other qualified agents.[720] When certifications are provided by sellers, borrowers should also conduct their own inspections or hire qualified inspectors. Builders, engineers, architects, or building inspectors should be consulted whenever the borrower does not have the technical expertise to judge the quality of the construction.

4.4.2 WARRANTIES

Purchasers of existing homes can obtain protection against defects by purchasing[721] a warranty or insurance against defects from a home warranty or insurance firm. The practice of obtaining home warranties for existing structures is well established. RD/RHS does not require borrowers to obtain either a warranty or insurance as part of the home purchase transaction.

[720] 7 C.F.R. § 3550.57(c) (2009).

[721] Borrowers may be able to negotiate with the seller to include a warranty service in the purchase contract.

4.5 PURCHASERS' REMEDIES FOR DEFECTIVE NEWLY CONSTRUCTED HOMES: INTRODUCTION

A borrower with a defectively constructed home should first look to the seller or contractor for correction of the defect or compensation. The contractor's or seller's obligation under the sales or construction contract, and/or under an express or implied warranty, should in most cases provide the homeowner with sufficient leverage to get the repair made or to gain compensation through the courts.

The homeowner dealing with an uncooperative or judgment-proof contractor or seller should look to RD/RHS for assistance. If the home is newly constructed, the borrower may be eligible for assistance under the Compensation for Defective Construction Program authorized under Section 509(c) of the Housing Act of 1949.[722] If the home is not newly constructed, the borrower should consider seeking compensation from one or more professionals who inspected the property and certified its adequacy or obtaining a supplemental loan from RD/RHS to correct the defect. Owners of defectively constructed homes may also consider bringing an action against RD/RHS under a tort or contract theory based on RD/RHS' statutory duty to assist the borrower through inspection and supervision of the construction.

4.6 PURCHASERS' REMEDIES AGAINST BUILDERS, CONTRACTORS, OR SELLERS OF DEFECTIVE NEWLY CONSTRUCTED OR REHABILITATED DWELLINGS

4.6.1 EXPRESS WARRANTIES

The one-year RD/RHS warranty.[723] RD/RHS requires all builders, contractors, or sellers of newly constructed homes to provide the purchaser with either a one-year or a 10-year express warranty.[724] Most use the one-year warranty contained

[722] 42 U.S.C.A. § 1479(c) (West 2003).

[723] Even though the RD/RHS' one-year warranty covers consumer products as defined by the Magnuson-Moss Warranty Act, 15 U.S.C.A. §§ 2301, *et seq.* (West, WESTLAW Current through P.L. 111-172 (excluding P.L. 111-148, 111-152, and 111-159) approved 5-24-10), it is not subject to the Act because of a specific exemption found in *Id.* § 2311(d).

[724] 7 C.F.R. § 1924.12 (2009).

in Form RD 1924-19 (Rev. 1/00). In it, the builder, seller, or contractor warrants that the building or improvements were constructed or made in substantial conformity with the drawings and specifications approved by RD/RHS. In addition, all plastic pipes are warranted for a period of five years.[725]

The 10-year insured warranty. Builders, contractors or sellers may, in lieu of the one-year warranty, provide the purchaser with an insured 10-year warranty plan that is approved by an appropriate regulatory agency of the state in which the property is located.[726] Such a warranty must be underwritten by an insurance company or backed by the full faith and credit of the state and cannot be canceled. The warranty must be prepaid by the contractor and be transferable to subsequent owners without additional costs. It must cover defects caused by faulty workmanship and defective materials for one year; cover wiring, piping, and duct work for electrical, plumbing, heating, and cooling systems through the second year of the warranty; and cover major structural defects for a full 10 years. In addition, the warranty must contain a system for handling and resolving disputes, which includes arbitration arranged by the American Arbitration Association or a similar body.[727]

Additional warranties. In addition to these warranties, manufacturers of appliances, heating or cooling systems, and/or other fixtures may provide the borrower with additional warranties or guarantees on products installed in the home.

4.6.2 ENFORCING THE ONE-YEAR RD/RHS WARRANTY

The one-year warranty cannot be judicially enforced without first meeting several procedural obligations.

4.6.2.1 Notice to the Builder, Contractor, or Seller

The one-year warranty requires the owner to promptly provide the builder[728] with written notice of the defect during the term of the warranty.[729] A copy of that notice should be forwarded to RD/RHS for its information and to obtain its assistance in any subsequent disputes with the builder.[730]

The builder must correct the defect within the number of days specified in the warranty or the borrower has the right to contract with another party to correct the defect. The builder is obligated to pay any expenses incurred by the borrower if the builder fails to correct defects covered by the warranty.[731] Note that the warranty does not make the builder absolutely liable for any expenses incurred by the borrower. Therefore, the borrower should not contract for the repair unless she is confident that the defect is covered by the warranty. The borrower who proceeds takes a risk that the builder will dispute the extent of the warranty's coverage.

Regardless of the time specified in the warranty, if the builder does not respond to the borrower's notice within 30 days, you should seek RD/RHS 's assistance. RD/RHS staff must attempt to resolve the complaint by notifying the builder of the borrower's complaint and of RD/RHS' intention to inspect the home on a specific date and time, at which the builder may be present. Unless the builder either corrects the defect or notifies the borrower that he or she intends to correct it within 30 days, RD/RHS will jointly inspect the home with the borrower to determine if the defect is covered by the contractor's warranty.[732] The results of the inspection report must be reported to the borrower, contractor and, if applicable, to the manufacturer.[733] If RD/RHS determines that the builder is responsible for correcting the deficiencies, RD/RHS must notify the builder and advise him or her that the repairs must be made within 30 calendar days or other time period agreed to by the borrower, builder and

[725] Form RD 1924-19 (Rev. 1-00).
[726] 7 C.F.R. pt. 1924, subpt. A, ex. L, ¶ IV (2009).
[727] *Id.* ¶ III.

[728] Hereafter, "builder" will be used in this chapter to designate any one of three warrantors: the builder, contractor, or seller.
[729] Form RD 1924-19 (Rev. 1-00).
[730] *See* 7 C.F.R. § 1924.259 (2009).
[731] Form RD 1924-19 (Rev. 1-00).
[732] 7 C.F.R. §§ 1924.259(c) and (e) (2009).
[733] *Id.* § 1924.259(e)(2).

RD/RHS.[734] RD/RHS must further advise the builder that unless the repairs are made, RD/RHS will consider compensating the borrower for the repairs, hold the builder liable to RD/RHS, and consider suspension or debarment proceeding against the builder.[735] If the builder declines or fails to make the necessary repairs after the findings are made, RD/RHS is required to promptly institute debarment proceedings against the builder.[736]

Since debarment is an extremely effective remedy against contractors who wish to continue to build under the RD/RHS programs, borrowers should insist upon RD/RHS' commencing such proceedings whenever a builder fails to correct defects or otherwise comply with the construction contract. If the contractor still fails to take corrective action, the borrower's only remaining recourse is through legal action. Before instituting a lawsuit, check whether the client is eligible for compensation under RD/RHS' Section 509(c) program. This may obviate an expensive and time-consuming lawsuit and provide the client with a remedy in case the builder is insolvent.[737]

4.6.2.2 Judicial Enforcement

If, after proper notice, the builder fails to correct a defect, the homeowner may commence an action against the builder under the warranty. The primary issue in such a case is factual: whether the home was "constructed or improved in substantial conformity with the drawings and specifications which have been accepted in writing" by RD/RHS. Note also that, by the terms of the builder's warranty, the warranty may not be waived or otherwise disclaimed in any instrument executed by the owner.[738]

If the defect is discovered outside the warranty period, the borrower may nonetheless have a cause of action against the builder under one of several theories of liability, including negligence, strict liability, implied warranty, or contract.[739]

4.6.3 ENFORCING THE 10-YEAR INSURED WARRANTY

4.6.3.1 Introduction

RD/RHS will accept the use of a 10-year insured warranty plan in lieu of the one-year express warranty, provided the plan meets certain requirements set out in RD/RHS regulations.[740] Because these warranties may vary from state to state, attorneys representing borrowers with claims under such plans should become thoroughly familiar with their particular plan.

4.6.3.2 RD/RHS Requirements

General Provisions. RD/RHS requires that the entire cost of a 10-year insured warranty plan be prepaid and that it automatically transfer to subsequent owners without additional cost. Plans must not be cancellable by the builder, warranty company or insurer.[741]

Coverage. Per RD/RHS requirements, a 10-year insured warranty plan must cover any defects caused by faulty workmanship or defective materials for an initial one-year period. During the second year, the plan must cover electrical, plumbing, heating and cooling systems, in addition to minor structural defects. During years three through ten, the plan must cover minor structural defects. A "minor structural defect" is "actual damage to the load-bearing portion of the home including damage due to subsidence, expansion or lateral movement of the soil (excluding movement caused by flood or earthquake) which affects its load-bearing function and which vitally affects or is imminently likely to affect use of the home for residential purposes."[742]

Dispute Resolution. Plans must provide a system for dispute resolution that includes conciliation and arbitration through the American Arbitration Association or other organization.[743]

Inspection. A 10-year insured warranty plan may provide for a construction inspection plan in lieu of the first two RD/RHS inspections.[744]

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[734] *Id.* § 1924.259(e)(2)(I).
[735] *Id.* § 1924.259(e)(2)(ii).
[736] *Id.* § 1924.259(e)(3).
[737] *See* § 4.7.1, *infra*.
[738] Form RD 1924-19 (Rev. 1-00).
[739] *See* §§ 4.6.5 and 4.6.6, *infra*.
[740] *See* 7 C.F.R. pt. 1924, subpt. A, ex. L (2009).
[741] *Id.* at ¶ III A, B.
[742] *Id.* ¶ III C.
[743] *Id.* ¶ III D.
[744] *Id.* ¶ III E.

Types of Companies. RD/RHS permits three types of warranty "companies:" a properly-licensed insurer, a properly-licenses risk retention group or an individual state warranty plan backed by the full faith and credit of the state government.[745] Companies must present their plans to RD/RHS for review and are subject to on-going oversight by RD/RHS.[746] RD/RHS has published a partial list of acceptable warranty companies.[747]

4.6.3.3 The 10-Year Warranty Program and the Magnuson-Moss Consumer Product Warranty Act

The Magnuson-Moss Consumer Product Warranty Act[748] is intended to make warranties on consumer products more readily understood and enforceable and to provide the Federal Trade Commission (FTC) with the means for better protecting the consumer.[749] Since the act is intended only to cover warranties on consumer products,[750] its applicability to home warranties is limited to those instances in which a single warranty covers both the home and consumer products such as appliances, fixtures and equipment.

The act exempts from coverage all warranties the "making or content of which is otherwise governed by Federal Law."[751] However, it further provides that "[i]f only a portion of a written warranty is so governed by Federal law, the remaining portion shall be subject to [the Act]."[752] Thus, where a warranty covers both the home and consumer products, the Act appears to apply to the portion of the warranty relating to consumer products.

Assuming that Magnuson-Moss applies to a warranty provided in connection with an RD/RHS-financed home, FTC regulations require that the warranty conform to certain disclosure standards, that it be made available to the consumer prior to the sale, and that a copy of it be given to the consumer when a sale is completed.[753]

A homeowner who is damaged by the builder's failure to comply with Magnuson-Moss, or to comply with a written warranty, implied warranty, or service contract, is given a cause of action under the Magnuson-Moss Act.[754] Jurisdiction in these cases is extended to state courts.[755] Federal courts' jurisdiction to hear cases under Magnuson-Moss is limited to claims involving at least $25 per plaintiff and $50,000 in the aggregate and to class actions involving 100 or more named plaintiffs.[756] The prevailing party in an action brought under the Act may be awarded costs and expenses, including attorneys' fees.[757]

4.6.4 IMPLIED WARRANTIES

Many states protect property owners through implied warranties of habitability and workmanlike construction that provide a means of obtaining remedies from builders for construction defects. Such warranties are often imposed by state statute and are subject to various notice requirements, a builder's right to repair and special statutes of limitation and repose.[758] Any detailed treatment of state implied warranty laws is beyond the scope of this manual.

RD/RHS' express warranty does not limit implied warranties. The RD/RHS one-year builder's warranty expressly states that it is in addition to, and in no way reduces, all other rights and privileges the borrower may have under any other law.[759]

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[745] *Id.* ¶ II.
[746] *Id.* ¶¶ IV, V.
[747] *Id.* at. 1.
[748] 15 U.S.C.A. §§ 2301 *et seq*. (West, WESTLAW through P.L. 109-279 (excluding P.L. 109-248, 109-270, 109-271) approved 08-17-06).
[749] H.R. REP. NO. 1107, 93d Cong., 2d Sess. 1, *reprinted in* 1974 U.S.C.C.A.N. 7702.
[750] 16 C.F.R. § 702.1(b) (2009). Consumer products are specifically defined to include products that may be categorized as fixtures under traditional property law analysis.
[751] 15 U.S.C.A. § 2311(d) (West, WESTLAW through P.L. 109-279 (excluding P.L. 109-248, 109-270, 109-271) approved 08-17-06).
[752] *Id.*
[753] 16 C.F.R. § 702.3 (2009).
[754] 15 U.S.C.A. § 2310(d)(1) (West, WESTLAW through P.L. 109-279 (excluding P.L. 109-248, 109-270, 109-271) approved 08-17-06).
[755] *Id.*
[756] *Id.* § 2310(d)(3).
[757] *Id.* § 2310(d)(2).
[758] *See generally* Wendy B. Davis, *Corrosion by Codification: the Deficiencies in the Statutory Versions of the Implied Warranty of Workmanlike Construction*, 39 CREIGHTON L.R. 103 (2005).
[759] Form RD 1924-19 (Rev. 1-00). *See also Sedlmajer v. Jones*, 275 N.W.2d 631 (S.D. 1979) (rejecting builder's arguments that FmHA express warranty abrogated implied warranty and that implied warranty claims were subject to the express warranty's one-year limitation).

4.6.5 BUILDERS' TORT LIABILITY

While beyond the scope of this manual, the purchaser of a newly constructed but defective home may have tort claims against the builder. Possible theories for such claims -- which may include negligence and strict liability -- will vary depending on state law and the circumstances of the individual case.[760]

4.6.6 BUILDERS' CONTRACT LIABILITY

If the builder fails to complete construction or the construction does not conform to the drawings or specifications, the borrower may pursue a contract claim against the builder for damages due to breach of contract. Under appropriate circumstances, the borrower may also have a right to rescind the transaction. The issues involved in maintaining a contract claim against a builder are beyond the scope of this manual. Several issues relating to the RD/RHS contract documents should, however, be noted.

Contract documents. Contractors usually use Form RD 1924-6 (Rev. 8-93) as the basic contract document for an RD/RHS-financed home. The few provisions that benefit the borrower are listed in nine paragraphs entitled "General Conditions." The contract normally incorporates a set of plans and specifications, which themselves are to include various RD/RHS forms. Change Orders,[761] which must be approved by the borrower and RD/RHS, may modify the contract. A borrower's RD/RHS file should always be checked for copies of change orders.

Although RD/RHS requires construction to be carried out in accordance with RD/RHS development standards as well as local codes and ordinances, the only mention of those standards is in Description of Materials forms supplied by RD/RHS.[762]

Borrowers seeking to enforce the construction contract and to incorporate the RD/RHS development standards or local codes should review carefully all agreements executed by the contractor. If the standards or codes are not specifically mentioned in the contracts, borrowers will have to rely on RD/RHS regulations to argue that they are the applicable standards.

4.7 PURCHASERS' REMEDIES WITH OR AGAINST RD/RHS FOR DEFECTIVE NEWLY CONSTRUCTED OR REHABILITATED HOMES

4.7.1 THE SECTION 509(c) PROGRAM

Purchasers of newly constructed Section 502 housing may obtain financial assistance from RD/RHS under Section 509(c) of the Housing Act of 1949 for the correction of construction defects.[763] This program, modeled after the HUD Section 518(a) program,[764] was enacted in 1977. It was designed to assist Section 502 home buyers who are unable to have their homes repaired by the contractor-seller or are unable to obtain damages from either the contractor, because he or she is judgment-proof, or RD/RHS, because the courts have not held the agency liable for defective construction.[765]

4.7.1.1 Eligibility for Section 509(c) Assistance

To qualify for compensation under the Section 509(c) program, the borrower must be the owner of a dwelling insured under the RD/RHS Section 502 program with a structural defect. In addition, the borrower must file the claim for compensation within 18 months of the time financial assistance was granted and must have first requested the builder-contractor to correct the defect. The builder-contractor must either have been unwilling or unable to make the corrections.

4.7.1.1.1 The Borrower Must Be the Owner of a Newly Constructed Dwelling

Only owners of newly constructed dwellings financed with Section 502 direct loans are eligible for assistance under Section 509(c).[766] A newly

[760] *See, e.g.,* THOMAS E. MILLER & RACHEL M. MILLER, HANDLING CONSTRUCTION DEFECT CLAIMS: WESTERN STATES (3d ed. & Supp. 2005).
[761] Form RD 1924-7 (Rev. 2-97).
[762] Form RD 1924-2 (Rev. 7-99).
[763] 42 U.S.C.A. § 1479(c) (West 2003).
[764] 12 U.S.C.A. § 1735b(a) (West 2001).
[765] *See* § 4.7.2, *infra* (discussion of RD's potential liability).
[766] 7 C.F.R. § 1924.265(a)(3) (2009).

constructed dwelling is one that is financed with a Section 502 insured loan, was not more than one year old at the time the loan was made, was constructed under the contract method or under a conditional commitment, was not previously occupied as a residence, and for which RD/RHS, VA or HUD conducted the required construction inspections.[767]

Newly constructed manufactured homes financed with Section 502 funds are eligible for compensation on the same terms as other dwellings, provided the manufactured home was built to Federal Manufactured Home Construction and Safety Standards and is properly certified.[768]

Insured loans. Under RD/RHS regulations, only borrowers with Section 502 loans made directly by RD/RHS, known as insured loans, are eligible for compensation.[769]

Guaranteed loans. Pursuant to RD/RHS regulations, borrowers with loans guaranteed under the Section 502 program are ineligible for assistance. The exclusion of guaranteed loans is not justified by the statute authorizing compensation for construction defects which authorizes RD/RHS to provide compensation for any unit "purchased with financial assistance authorized by [Title V of the Housing Act of 1949]."[770] Because guaranteed loans are authorized by the same provision authorizing insured Section 502 loans, there is no basis for distinguishing between insured and guaranteed loans.

Borrowers with guaranteed loans in need of compensation should consider challenging RD/RHS' exclusion of guaranteed loans from Section 509(c) assistance as being contrary to law.

Successors-in-interest. Provided other conditions of eligibility are met, the person seeking Section 509(c) assistance need not be the original owner of the home. Successors-in-interest in a newly constructed home are eligible for assistance.[771]

Construction under contract method or conditional commitment--self-help exclusion. Persons whose homes were built under the self-help ("sweat equity") method of construction are ineligible for compensation for construction defects except for work that was performed by a contractor or for systems that are covered by a manufacturer's warranty.[772]

It is questionable that the exclusion of self-help participants from the compensation program is either rational or statutorily justified. Presumably, the exclusion is predicated on the fact that borrowers who construct homes under this method either caused the defect or were in a position to observe the construction and prevent it. Unfortunately, neither is always true. Typically, 5 to 20 families form a self-help group and each helps in the construction of all the homes, not merely its own. Thus, defects in construction are likely to be caused by persons other than the owner. More importantly, self-help participants rarely have special construction skills or knowledge. Consequently, all construction is carried out under the direction of a technical assistance provider employed by a nonprofit organization that is usually funded by RD/RHS. Thus, to the extent that defects are introduced into the construction, they may come as a result of inadequate supervision or assistance by the technical assistance provider and not because of any failure on the part of the borrower-builder.

Lastly, the exclusion assumes that, in adopting Section 509(c), Congress intended to provide compensation only in instances where contractors were negligent and unable or unwilling to make correction. In fact, no such intention is evident from the face of the statute. Indeed, a reading of the statute suggests that, in passing Section 509(c), Congress intended merely to provide a mechanism to enable low-income borrowers to repair their homes when they were defectively constructed. Since borrowers using the self-help method of construction generally have lower incomes than other Section 502 borrowers, the exclusion does not appear consistent with the statute and is otherwise arbitrary. Therefore, if representing a self-help participant, consider challenging the exclusion.

[767] *Id.* § 1924.253(a).
[768] *Id.* § 1924.253(b).
[769] *Id.* § 1924.253(a)(1).
[770] 42 U.S.C.A. § 1479(c) (West 2003).
[771] 7 C.F.R. § 1924.265(b) (2009).
[772] *Id.* § 1924.253(a)(2). See, *In re* XXXXX & USDA, Rural Hous. Serv., No. 2006S00052 (USDA, Nat'l App. Div. Feb. 3, 2006)("RD/RHS did not properly determine whether defects, which were not structural, were caused by the contractor or the self help participant).

4.7.1.1.2 The Dwelling Must Have a Structural Defect

A structural defect has been defined broadly to include any defect in the dwelling or related facility, or a deficiency in the site or site development, that directly and significantly reduces the useful life, habitability, or integrity of the building.[773] The defect may be due to faulty material, poor workmanship, or latent causes that existed when the dwelling was constructed.[774] Structural defects include, but are not limited to, structural failures in the foundation, footings, basement walls, slabs, floors, framing, walls, ceiling, or roof;[775] major deficiencies in the utility components of the dwelling, such as faulty wiring, failure of sewage disposal or water supply systems located on the property securing the loan; serious defects in the design or installation of heating, cooling, or air conditioning systems; defects in or improper installation of safety and security devices such as windows,[776] external doors, or railings,[777] as well as failure to provide or properly install devices to aid occupancy of the dwelling by disabled individuals where such devices are required; or defects in or improper construction of protective materials,[778] such as insulation, siding, roofing material,[779] or exterior paint.[780]

RD/RHS' authority to compensate borrowers under the Section 509(c) program is not limited to defects that affect the structural integrity of the building, but extends to other defects that directly and significantly reduce the useful life or habitability of the structure.[781] This authority is a major departure from the HUD Section 518 program and provides borrowers with protection beyond that extended by the builder under either the one-year express warranty or the 10-year warranty programs. Therefore, any defects that will shorten the useful life of the dwelling should be compensable.

Ineligible defects. Defects in structures that were not approved and financed by RD/RHS or defects that exist in building additions to, or in remodeling work of, an RD/RHS-financed dwelling are not covered by the Section 509(c) program.[782]

RD/RHS , unlike HUD, has not specifically excluded other defects from coverage under Section 509(c). Defects resulting from improper maintenance by the borrower[783] -- presumably, as well as decorative or cosmetic defects -- are not compensable. However, because of Congress's specific inclusion of defects that reduce the useful life and habitability of the unit, the exclusions under the Section 509(c) program should not be as extensive as those excluded by HUD under the Section 518 program.[784]

4.7.1.1.3 Claims Must Be Filed Within 18 Months of the Time Financial Assistance Was Granted

Claims for compensation must be filed within 18 months of the time financial assistance was granted.[785] Financial assistance is granted on the date the Section 502 loan is closed for all loans made to purchase an already completed new dwell-

[773] *Id.* § 1924.253(d).
[774] *Id.*
[775] *In re XXXXX & Rural Dev.*, No. 2007S000282 (9/6/2007) (Absence of porch railings and porch posts and railings not properly anchored and or aligned are compensable defects; Repair of sinking roof in one spot is also compensable).
[776] *In re XXXXX & Rural Dev.,* No. 2007S000129 (7/29/2007) (defective window compensable).
[777] *In re XXXXX & Rural Dev.*, No. 2007S000282 (9/6/2007) (Absence of porch railings and porch posts and railings not properly anchored and or aligned are compensable defects).
[778] *In re XXXXX & USDA*, Rural Hous. Serv., No. 2006S000227 (USDA, Nat'l App. Div. Dec. 29, 2006) (Inadequate termite treatment is eligible for compensation).
[779] See, *id*. (Improperly constructed roof is eligible for compensation).
[780] 7 C.F.R. § 1924.253(d) (2009). *See also* HUD, THE CONSTRUCTION COMPLAINTS AND SECTION 518(a) and (b) HANDBOOK, HANDBOOK 4070.1, REV-2, ch. 3, ¶ 3-4 (Aug. 1981)(available at http://www.hud.gov/offices/adm/hudclips/handbooks/hsgh/4070.1/index.cfm (last visited 6.7.10) *But see In re XXXXX & USDA*, Rural Hous. Serv., No. 2005S000507 (USDA, Nat'l App. Div. June 10, 2005)("Examples of non-structural defects include, but are not limited to, cracks attributed to normal curing or settlement and cosmetic defects in cabinets, woodwork, floor covering wall covering ornamental trim, etc.").
[781] 7 C.F.R. § 1924.253(d) (2009); H.R. REP. NO. 634, 95th Cong., 1st Sess. 71, *reprinted in* 1977 U.S.C.C.A.N. 2965, 2991. *See In re XXXXX and Rural Housing Service*, Case No. 2007S000282 (5/25/07)(Improper drainage outside the house which has the potential of damaging the structure is compensable).
[782] 7 C.F.R. § 1924.266(b)(3) (2009).
[783] *See id.* § 1924.266(b)(8).
[784] HUD Handbook 4070.1, *supra* note 780, ¶ 3-6.
[785] 7 C.F.R. § 1924.265(a)(4) (2009).

ing.[786] For all other loans, such as Section 502 loans made to purchase land and construct a new dwelling, financial assistance is granted on the date of final construction inspection and acceptance by the borrower and RD/RHS.[787]

RD/RHS will accept claims filed after expiration of the 18-month period, provided the defects were documented by RD/RHS in the borrower's case file or on a form used by RD/RHS for documenting construction complaints and requests for compensation for construction defects[788] prior to expiration of the 18-month period.[789]

4.7.1.1.4 The Builder's Obligation to Correct the Defect Must Have Expired or the Builder Must Be Unable or Unwilling to Correct the Defect

RD/RHS will compensate a borrower for the correction of structural defects only if the builder's warranty obligation to correct the defect has expired or if the builder is unwilling or unable to correct the defect.[790] Where applicable, this requirement obligates the borrower to inform the builder of the defect, to request that he or she repair it, and, if necessary, to invoke RD/RHS' assistance in handling construction complaints.[791]

The builder must be asked to correct the defect unless the obligation to repair has expired. All borrowers who discover a defect during the first year after financial assistance is granted must ask the builder to correct it before becoming eligible for Section 509(c) assistance.[792] Borrowers with the RD/RHS express one-year warranty[793] who discover a defect later than one year after assistance is granted need not ask the builder to correct the defect since the builder's obligations under the warranty have expired.[794] Borrowers whose homes are covered by a 10-year warranty plan who discover a defect after the first year must ask the builder to correct the defect only if it is covered by the builder's warranty. Therefore, if the defect is a major structural defect,[795] or if the plumbing, electrical, heating or cooling system does not operate in accordance with the warranty's approved standards, the borrower must ask the builder to correct the defect. If the defect is not covered by the builder's warranty for the second year, the borrower need not comply with this requirement.

It should be noted that borrowers covered by a 10-year warranty will probably also have to seek compensation from the builder's insurer prior to obtaining Section 509(c) assistance, if the defect is covered by the warranty.[796]

Unwillingness or inability of the builder to correct the defect. A borrower who must ask a builder to correct a defect should follow certain procedures outlined elsewhere in this manual.[797] If, after RD/RHS determines that the defect is covered by the builder's warranty, the builder does not respond or does not correct the defect within the required time,[798] the borrower should insist on RD/RHS' processing his or her Section 509(c) claim.

RD/RHS' determination of whether a defect is covered by the builder's warranty is not material to the determination of a borrower's eligibility for compensation under Section 509(c). The only significance of the former decision is procedural. It determines whether RD/RHS can compensate the borrower immediately, or must await expiration of the 30-day period given the builder to correct the defect.[799] In most cases, this period will have expired long before the borrower's eligibility for compensation is determined.[800]

In preparing for cases involving construction defects for which compensation is sought under Section 509(c), carefully review the regulations on

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[786] *Id.* § 1924.253.
[787] *Id.* § 1924.265(a)(4).
[788] Form RD 1924-4 (Rev. 10/90).
[789] 7 C.F.R. § 1924.265(a)(4) (2009). *See In re XXXXX and Rural Housing Service*, Case No. 2007S000129 (April 19, 2007).
[790] 7 C.F.R. § 1924.265(a)(5) (2009).
[791] *See id.* §§ 1924.259, 1924.260, 1924.261; § 4.6.2.1, *supra*.
[792] *Id.* §§ 1924.259, 1924.260, 1924.261.
[793] Form RD 1924-19 (Rev. 1-00).
[794] *See id.*
[795] *See* § 4.6.3.2, *supra* (definition of major structural defect).
[796] *See* § 4.6.3, *supra* (discussion of 10-year warranty plan).
[797] *See* § 4.6.2, *supra*.
[798] *See* 7 C.F.R. § 1924.259(e)(2)(ii) (2009).
[799] *In re XXXXX & Rural Dev.*, Case No. 2009S000112 (4/8/2009). RD cannot compel borrower to extend period of time in which builder must make repairs and borrower's failure to extend the time does not justify denial of compensation request) (decision upheld on 6/4/2009) by NAD Director)(Case No. 2009S000112R).
[800] *See* § 4.7.1.4, *infra*.

handling construction complaints[801] and those dealing with compensation for construction defects.[802] Note that the regulations dealing with compensation do not apply to the decision of whether or not a defect is covered by a builder's warranty. Insist that RD/RHS treat all complaints and requests for compensation separately and strictly in accordance with the regulations.

4.7.1.2 Items Compensable with Section 509(c) Funds

4.7.1.2.1 Eligible Purposes

Section 509(c) funds may be used to compensate borrowers for the repair of the defect, damages resulting from the defect, emergency repair work, acquisition of the property, temporary living expenses, miscellaneous expenses, storage and moving expenses, and interest on loans obtained to repair the defect.

Repair of the defect. Section 509(c) funds may be used to compensate the homeowner for the cost of repairing the home.[803] This may be done before or after the borrower has made the repairs[804] or contracted for them.[805] All repairs must be made in accordance with plans and specifications approved by RD/RHS. The contractor making the repairs must be licensed and reputable and must provide the borrower with a warranty covering the repair for a period of one year.[806] When repairs have been completed before compensation is made, the borrower must provide reasonable evidence to establish the cost of the repairs.[807]

Professional assistance. If it is necessary to hire professional assistance to determine the cause of the defect or to determine the means of repair, RD/RHS may approve the use of Section 509(c) funds to compensate the professionals.[808]

Damages resulting from the defects. Borrowers may be compensated for damage to dwellings or related facilities that is the direct result of the defect.[809] Compensation will not be granted, however, for damage to improvements or remodeling not financed or approved by RD/RHS[810] nor to personal property or individuals.[811]

Emergency repairs. If the borrower makes emergency repairs of the dwelling to preserve its integrity, to prevent or limit damage to personal property, or to prevent or eliminate immediate health hazards, the costs incurred are reimbursable.[812]

Cost of acquiring the property. A borrower may reconvey a defective property to RD/RHS in lieu of making the repairs.[813] However, if the property is considered decent, safe and sanitary, the borrower must attempt to sell the dwelling before conveying it to RD/RHS.[814] If the property is sold, RD/RHS will reimburse the borrower for any loss of borrower contribution made at the time of loan closing; will pay the borrower's relocation expenses, including temporary living expenses as prescribed in the regulations; and will pay related sales expenses if the property is sold for less than the debt against it.[815]

If the property is not considered decent, safe and sanitary, RD/RHS will accept reconveyance without the borrower first having to attempt to sell it. Compensation in that case may not exceed the difference between the RD/RHS-appraised value of the property at the time of loan closing and the

[801] 7 C.F.R. § 1924.259 (2009).
[802] *Id.* § 1924.265.
[803] *Id.* § 1924.266(a)(1). *See In re* XXXXX & USDA, Rural Hous. Serv., No. 2006S000227 (USDA, Nat'l App. Div. Dec. 29, 2006)(Water supply fitting repair compensable).
[804] 7 C.F.R. § 1924.266 (a)(1) (2009).
[805] *Id.*
[806] *Id.*
[807] *Id.*
[808] *Id.* § 1924.266(a)(1)(ii).
[809] *Id.* § 1924.266(a)(1)(I). *In re* XXXXX & USDA, Rural Hous. Serv., No. 2006S000227 (USDA, Nat'l App. Div. Dec. 29, 2006)(Damages from water-supply fitting, including deductible on homeowner's insurance is compensable; moreover, replacing landscaping over damages sewage pump is also compensable).
[810] 7 C.R.R. § § 1924.266(b)(3) (2009).
[811] *Id.* § 1924.266(b)(5). Although nothing in the legislative history of the Section 509(c) program suggests that RD is precluded from compensating borrowers for personal injuries or personal property damage, to the extent that the program is modeled after the HUD/FHA Section 518 program, the legislative history of that program specifically precludes such compensation. S. REP. NO. 1265, 88th Cong., 2d Sess. 6 (1964).
[812] 7 C.F.R. § 1924.266(a)(2) (2009).
[813] *Id.* § 1924.266(a)(3).
[814] *Id.* § 1924.266(a)(3)(I).
[815] *Id.*

amount of the RD/RHS loan and any prior liens.[816] Borrower contributions that may be compensated include land, cash, construction work done by the borrower, attorneys' fees, and abstract or title insurance costs paid by the borrower in connection with the closing.[817]

Temporary living and other expenses. Under certain circumstances, the borrower is eligible for compensation for temporary living expenses, moving and storage and other miscellaneous expenses.[818] These expenses will be paid if the borrower's home is uninhabitable or if the borrower must vacate the home to make repairs. They will also be paid if RD/RHS determines that the severity of the defect prevents the property from being repaired and made suitable as a permanent residence and that it should be conveyed to RD/RHS.[819] All these expenses are subject to published limitations.[820]

Interest paid on loans. If the borrower obtains a loan to repair the defect, RD/RHS may compensate him or her for reasonable interest paid on the loan.[821] This authority may be important to borrowers when Section 509(c) funds have been temporarily exhausted in a given fiscal year and they seek to avoid delay in making repairs.

4.7.1.2.2 Ineligible Purposes

RD/RHS will not compensate borrowers to complete an uncompleted dwelling; for defective items that were completed under neither the contract for construction nor the conditional commitment; for damages caused by defects in design, workmanship or materials in making improvements to or remodeling the dwelling or related facilities that were not financed or approved by RD/RHS; for personal injuries, loss of wages, damage to personal property, death benefits, funeral expenses, medical or psychological treatment; for losses due to the borrower's negligence or failure to maintain the property; for losses caused by acts of nature that the structure was not designed to withstand; or for losses that are the result of war or civil disorder.[822]

4.7.1.3 Procedural Issues

Notice. RD/RHS must notify borrowers of the availability of Section 509(c) assistance within 30 days after loan closing or final inspection, whichever is later. In addition, borrowers are entitled to a notice anytime construction defects are apparent within the 18-month statutory eligibility period and the contractor is unwilling or unable to correct them.[823] Borrowers will be requested to make a written complaint to the contractor whenever they advise RD/RHS of construction defects.[824]

Borrowers who purchase existing dwellings for which the statutory period of eligibility for compensation has not expired must also be notified within 30 days after loan closing of the availability of compensation for construction defects.[825]

The notice must advise the borrower of the time frames for filing warranty claims with the contractor and compensation claims with the agency.[826] The sending of the notice must be documented in the borrower's case file.[827]

Filing claims. Persons seeking to file claims for compensation must submit Form RD 1924-4 (Rev. 10/96).[828] The form may be obtained on-line or in any RD Office upon request.

Timeliness. Claims must be filed with RD/RHS within 18 months of the time loan assistance was granted.[829]

Exhaustion. A Section 509(c) claim may be filed at any time during the statutory period. If the borrower's home is covered by a builder's warranty, RD/RHS will delay processing of the Section 509(c) application until the procedures governing the handling of construction complaints[830] have

[816] *Id.* § 1924.266(a)(3)(ii).
[817] *Id.* § 1924.266(a)(3)(iii).
[818] *In re* XXXXX & USDA, Rural Hous. Serv., No. 2006S000227 (USDA, Nat'l App. Div. Dec. 29, 2006)(Rental and storage expenses compensable when sewer system is not working).
[819] 7 C.F.R. § 1924.266(a)(4) (2009).
[820] *Id.* § 1924.266(a)(4)(ii).
[821] *Id.* § 1924.266(a)(5).
[822] *Id.* § 1924.266(b).
[823] *Id.* § 1924.258.
[824] *See id.* § 1924.259(a).
[825] *Id.* § 1924.258.
[826] *Id.*
[827] *Id.*
[828] *Id.* § 1924.271.
[829] 42 U.S.C.A. § 1479(c) (West 2003); 7 C.F.R. § 1924.265(a)(4) (2009). *See* § 4.7.1.1.3, *supra* (discussion of determination of date on which assistance was granted).
[830] 7 C.F.R. §§ 1924.259, 1924.260, 1924.262, 1924.263 (2009).

been exhausted.[831] To meet the 18-month statutory filing period, borrowers need not first exhaust their remedies under the regulations covering the handling of construction complaints.[832] In fact, borrowers should file their claims early to ensure that the statutory time limitation does not expire. This is particularly true of borrowers whose homes are covered by a 10-year warranty plan, since a claim under a warranty may not be resolved within the 18-month period authorized for filing Section 509(c) claims. These borrowers should preserve their claim by filing an application for assistance before expiration of the 18-month period and before their warranty claim has been resolved.

4.7.1.4 Processing by RD/RHS

Once a Section 509(c) claim has been filed, RD/RHS, with the assistance of the RD/RHS state architect/engineer and/or construction inspector, must determine that the construction is defective in workmanship, material or equipment, that the dwelling was not built in substantial compliance with the approved drawings or specifications, that the dwelling did not comply with RD/RHS construction standards at the time the loan was approved or the conditional commitment issued, or that the property does not meet code requirements.[833] RD/RHS must also determine that any obligation of the contractor to correct the defect under the contractor's warranty has expired, or that the contractor is unable or unwilling to make the correction.[834] If the builder's obligation has not expired, RD/RHS must notify the builder of the complaint and follow the required complaint procedure.[835] The application for Section 509(c) assistance remains dormant pending completion of the construction complaint procedure.

If the complaint procedure has been followed, or is not applicable because either the warranty does not cover the defect or the warranty has expired, the RD/RHS staff person will send the claimant's file to the approval official (who may be the next higher RD/RHS official, who must process the Section 509(c) application within 60 days of the date that the claimant signed Form RD 1924-4.[836]

A local RD/RHS official may approve or disapprove claims up to $2000. All other claims are approved by the State Director.[837] However, all claims for compensation must be submitted to the RD National Office for authorization of funds.[838] The reason for the National Office's approval is not clear; however, it is possible that it is to ensure that approvals for compensation do not exceed annual appropriations.

Unavailability of Section 509(c) funds. Despite a decrease in annual appropriations, RD has had ample funds to compensate all Section 509(c) claims throughout the program's operation. If in the future, claims exceed the amounts appropriated, RD will presumably advise borrowers that the request has been denied because of the unavailability of funds. In such a case, the borrower has several alternatives.

First, the borrower may simply defer repairing the defect until RD has funds available. Whether a borrower should wait depends on when and if funds will again be available for the program. The former may depend on the point during the fiscal year that the funds were exhausted. The latter will depend on the congressional appropriations process.

Second, a borrower may apply for a Section 502 or Section 504 loan to make the repairs with the understanding that, once Section 509(c) funds become available, RD/RHS will use them to repay the loan. Authority for this exists in the Section 509(c) regulations, which state that Section 509(c)funds may be used to pay for "reasonable interest paid on loans for the sole purpose of correcting structural defects or other approved purposes . . . ."[839] Therefore, the regulations clearly contemplate the borrower's obtaining a loan to make the repair and using Section 509(c) funds to repay the loan with interest. A borrower may also obtain a loan from other sources, provided the interest is reasonable. Regardless of the source of the loan, the borrower, by borrowing for repair of the defect, takes the risk that RD/RHS may not obtain further appropriations for

[831] *Id.* § 1924.252.
[832] *See id.* § 1924.265(a)(4).
[833] *Id.* § 1924.265(a).
[834] *Id.* § 1924.265(a)(5).
[835] *See id.* § 1924.259(c).
[836] *Id.* § 1924.273(a). *See In re XXXXX & Rural Dev.*, Case No. 2009S000447 (6/25/2009) (RD decision made after 60 days is reversible).
[837] 7 C.F.R. § 1924.273(a) (2009).
[838] *Id.* § 1924.272.
[839] *Id.* § 1924.266(a)(5).

the Section 509(c) program, in which case the borrower will remain obligated on the loan.

Right to appeal and notice of right to appeal. All decisions with respect to Section 509(c) claims are appealable in accordance with USDA's appeal procedure.[840] Whenever any RD/RHS official denies a claim, in whole or in part, that official must inform the borrower of the denial in writing, giving the specific reasons it and the right to appeal the decision.[841] Several issues with respect to appeals in construction defects cases are worthy of separate note and are discussed here.

Use of experts. The claimant has the burden on an appeal of showing that the denial of assistance was erroneous and that the defect for which he or she seeks compensation is one that directly and significantly reduces the useful life, habitability, or integrity of the building. To meet that burden, you will probably need an expert who has inspected the structure and who will testify to its deficiencies. Depending on the defect, the expert may be a builder, architect, engineer, building inspector, or contractor familiar with a particular system such as heating or cooling. Since RD/RHS is likely to counter a claimant's testimony with that of its own construction inspector, it may be advisable to engage more than one expert. An expert should be used for more than just presenting evidence on the defective condition. He or she should also be able to testify how the condition may be remedied and the cost involved. In addition, he or she should help you prepare to cross-examine RD/RHS' witnesses.

RD/RHS regulations do not directly provide for the compensation of expert witnesses, even if the claimant prevails on the appeal. Arguably, if RD/RHS approves, the expert could be compensated under the provision authorizing the use of Section 509(c) funds for professional reports needed to determine cause of the defect or means to repair it.[842] Since, but for the expert's testimony, the defect would not be recognized, the testimony may be considered a report for which compensation may be granted. One way to avoid the problem altogether is to ask the expert to prepare a report as to the cause of the defect and its remedy. Then, have the expert charge your client for the report but not for his or her participation at the appeal hearing. If your client prevails, RD/RHS should approve the full cost of the report.

4.7.1.5 Judicial Review of RD/RHS Decisions

By statute, the decisions of RD/RHS with regard to Section 509(c) compensation are not judicially reviewable.[843] Similarly, the terms and conditions under which claims are approved or disapproved are not judicially reviewable.[844] This does not mean, however, that all decisions with regard to the Section 509(c) program are judicially nonreviewable. The HUD Section 518 compensation for defects program has a proscription on judicial review similar to that contained in the RD/RHS program.[845] Despite this, the courts have reviewed various HUD decisions concerning operation of the Section 518 program. Those cases can be summarized by the following rule: courts will not review a final agency decision to compensate borrowers for particular defects[846] or the terms and conditions under which compensation is granted,[847] unless the agency fails to consider the request for compensation,[848] fails to follow its regulations,[849] or follows regulations that are contrary to the purpose or intent of the statute.[850] When the courts have reviewed the agency's actions, relief may be had by way of injunction[851] or declaratory judgment.[852] Mandamus should also be available, at least for applicants seeking to have the agency process their request.[853]

RD/RHS' obligations under the Section 509(c) program have been addressed in detail in only one case, *Neal v. Bergland*.[854] In that case, the plaintiff sought to force FmHA, the predecessor

[840] *See id.* pt. 11, subpt. A. See Ch. 9, *infra* (discussion of USDA Appeals Procedure).
[841] 7 C.F.R. § 1924.273(a) (2009).
[842] *Id.* § 1924.266(a)(1)(ii).
[843] 42 U.S.C.A. § 1479(c) (West 2003).
[844] *Id.*
[845] 12 U.S.C.A. § 1735b(c) (West 2001).
[846] *Pollard v. Romney*, 512 F.2d 295, 300 (3d Cir. 1975).
[847] *Owens v. Hills*, 450 F. Supp. 218, 221 (N.D. Ill. 1978).
[848] *Graham v. Caston*, 568 F.2d 1092, 1097 (5th Cir. 1978).
[849] *Id.*; *Owens*, 450 F. Supp. at 223-24.
[850] *Bailey v. Romney*, 359 F. Supp. 596, 601-02 (D.D.C. 1973).
[851] *Id.* at 598.
[852] *See Graham v. Caston*, 568 F.2d 1092 (5th Cir. 1978)
[853] *See id.* at 1095.
[854] 489 F. Supp. 512 (E.D. Tenn. 1980), *aff'd in part, rev'd in part*, 646 F.2d 1178 (6th Cir. 1981), *aff'd sub nom. Block v. Neal*, 460 U.S. 289 (1983).

agency of RD/RHS, to compensate her for defects in her Section 502 home after the contractor failed to correct defects that the agency concluded to have been covered by the contractor's warranty. The borrower argued that, once FmHA determined that the complaints were covered by the warranty, it was required to compensate her without further action. FmHA, on the other hand, argued that, even though the defects were justified, it could withhold compensation until the contractor was given another opportunity to correct the defects. The court ruled in FmHA's favor, misinterpreting the plaintiff's arguments, the statute and FmHA regulations.

The *Neal* court held that the plaintiff's claim failed for three reasons. First, erroneously believing that the plaintiff's home was financed under the FmHA guarantee program, it held that the plaintiff's claim could be denied because it fell within the FmHA regulations exempting guaranteed Section 502 loans from Section 509(c) coverage. Second, it held that defects covered by the warranty are the responsibility of the builder, not of FmHA, and that FmHA has total discretion on whether to compensate borrowers when the builder fails to correct the defect. Third, it held that mandamus may be granted only when the plaintiff seeks reimbursement for expenditures actually made, not when the repairs have yet to be made. The court reasoned that granting mandamus would be tantamount to ordering FmHA to pay damages, which would conflict with its earlier holding that there is no ground upon which damages may be assessed against FmHA. It concluded that, since the plaintiff had not made the repairs, FmHA could not be forced to compensate the claims.[855]

The *Neal* decision is wrong on numerous grounds. First, the plaintiff's home was financed with an insured Section 502 loan, not with a guaranteed loan. The regulatory exception for guaranteed loans was therefore not applicable.[856] Second, in relying on FmHA regulations then in effect to conclude that FmHA had no duty to compensate a borrower for defects covered by the warranty, the court misinterpreted the regulations and missed the basic purpose of the Section 509(c) program. The regulation cited by the court was a general policy statement in the introductory section of the regulations, covering both compensation for construction defects under Section 509(c) and the handling of construction complaints under an express warranty.[857] That policy statement simply reiterated FmHA's position, still in effect, that a borrower with a warranty claim against a builder was expected to exhaust the construction complaint procedure before the request for compensation under Section 509(c) will be processed.[858] It did not state that FmHA would not compensate a borrower whenever a defect was covered by a warranty.[859] It is clear that the court misinterpreted the policy statement because the balance of that statement provided that "the costs of repairing structural defects, in newly constructed dwellings not corrected by the builder may be paid by the Government . . . ."[860] Moreover, in stating, essentially, that FmHA was not required to compensate a borrower whenever the defect is covered by a warranty, even though the builder did not abide by his or her obligations, the court undermined the fundamental purposes of the Section 509(c) program. Those purposes are to repair defects or to compensate borrowers whenever the builder does not perform under the warranty.[861]

Third, to the extent the decision implied that FmHA had a duty to compensate borrowers only when they have made repairs and expended funds, it again misinterpreted the regulations, which specifically authorized compensation before a repair is made.[862] Similarly, the court's conclusion that forcing FmHA to make payment was tantamount to or-

[855] *Id.*, 489 F. Supp. at 515-16, *rev'd on other grounds*, 646 F.2d 1178, *aff'd sub nom. Block v. Neal*, 460 U.S. 289 (Section 509(c) claim was found moot on appeal because FmHA compensated plaintiff. 646 F.2d at 1180 n.3).

[856] The holding might also be incorrect concerning guaranteed loans, because it is questionable whether the regulatory exception is consistent with the statute. *See* § 4.7.1.1.1, *supra*.

[857] 7 C.F.R. § 1924.252 (1980). A similar statement appears in the most recent version of the regulations. *Id.* § 1924.252 (2009).

[858] *Id.* § 1924.260(c) (1980). *See id.* §§ 1924.252, 1924.265(a)(5) (2009).

[859] *Id.* § 1924.257(a)(5) (1980).

[860] *Id.* § 1924.252 (emphasis added). The most recent RD regulations are less ambiguous in that they state that if "the contractor cannot or will not correct the defect, the cost of correcting the defect may be paid by the government, or the borrower may be compensated for correcting the defect." *Id.* § 1924.252 (2009).

[861] *See* H.R. REP. NO. 236, 95th Cong., 1st Sess., *reprinted in* 1977 U.S.C.C.A.N. 2884, 2910-11.

[862] 7 C.F.R. §§ 1924.258, 1924.261(b) (1980); 7 C.F.R. § 1924.266(a) (2009).

dering it to pay damages[863] did not follow from the court's reasoning and misinterpreted the plaintiff's argument.

In addition to seeking mandamus under Section 509(c), the plaintiff had sought damages against FmHA for breach of contract and negligence. The district court held that the plaintiff did not have a claim against the government under either of these theories and that FmHA could therefore not have been made to pay her for the damages to her home.[864] The plaintiff's mandamus action was predicated on a different theory, however. In essence, she maintained that once FmHA had determined that the defect was compensable and that the contractor had failed to make the repairs under the warranty, she had a statutory and regulatory entitlement to compensation that a court could enforce through mandamus. While the court missed or ignored this argument, its conclusion was still not justified. The absence of a contract or a negligence claim did not preclude the borrower from receiving the same relief under a third theory of liability.[865]

In the over two decades since *Neal*, there appear to have been no decisions that address RD/RHS' obligations under Section 509(c) in any detail. Because RD/RHS may attempt rely on *Neal*, despite its reversal by the Sixth Circuit, should such a case arise in the future, persons seeking to challenge RD/RHS decisions on Section 509(c) claims should carefully review *Neal* and be prepared to point out its errors.

4.7.2 RD/RHS' TORT AND CONTRACT LIABILITY

Homeowners unable to obtain relief for the correction of construction defects from contractors or from RD/RHS under the Section 509(c) program may wish to consider bringing a tort or contract action against RD/RHS. The arguments underlying such claims are that RD/RHS has a statutory and contractual duty to provide borrowers with construction supervision and inspection or that it voluntarily undertakes such actions for the benefit of its borrowers. When the failure to provide, or the negligent provision of, either inspection or supervision is the cause of the defect, RD/RHS is liable to the borrower for the appropriate amounts under either a contract or tort theory of liability. Unfortunately, the courts have not reacted favorably to these theories, and with few exceptions,[866] have held that RD/RHS is not liable to borrowers for defective construction.[867] Moreover, current RD/RHS regulations expressly limit the scope and purpose of the inspections RD/RHS performs so as to undercut possible bases for agency liability.

The borrower will be responsible for making inspections necessary to protect the borrower's interest. Agency inspections are not to assure the borrower that the house is built in accordance with the plans and specifications. The inspections create or imply no duty or obligation to the particular borrower. Agency inspections are for the dual purpose of determining that the Agency has adequate security for its loan and is achieving the statutory goal of providing adequate housing.[868]

Unless RD/RHS departs from the inspection procedures set forth in its regulations and can be shown to have volunteered to perform some additional supervision of the construction or inspection on behalf of a borrower, it likely would be very difficult to sustain a negligence or contract action against the agency regarding its inspection of an RD/RHS-financed home.

4.8 ACTIONS BY PURCHASERS OF EXISTING STRUCTURES

Many or most of those who seek RD/RHS single-family home financing today are planning to purchase previously occupied homes. Purchasers of existing homes may also suffer losses as a result of

[863] *Neal v. Bergland*, 489 F. Supp. 512, 516 (E.D. Tenn. 1980).
[864] *Id.* at 514-15; the court was reversed on the tort theory of liability, 646 F.2d 1178 (6th Cir. 1981). Consequently, its conclusion on the Section 509(c) claim is also questionable.
[865] *See Bailey*, 359 F. Supp. at 599-600.
[866] *Luckinbill v. United States*, 735 F. Supp. 155 (M.D. Pa. 1990); *Creasy v. United States*, 645 F. Supp. 853 (W.D. Va. 1986); *Neal v. Bergland*, 646 F.2d 1178 (6th Cir. 1981); *Park v. United States*, 517 F. Supp. 970 (D. Or. 1981). In these cases, FmHA, the predecessor agency of RD, was determined, by its actions, to have volunteered to perform services, which were performed negligently.
[867] *Muniz-Rivera v. United States*, 326 F.3d 8 (1st Cir. 2003); *Moody v. United States*, 774 F.2d 150 (6th Cir. 1985); *Ortiz v. United States*, 661 F.2d 826 (10th Cir. 1981); *Reynolds v. United States*, 643 F.2d 707 (10th Cir. 1981).
[868] 7 C.F.R. § 1924.9(a) (2009).

defective construction. Although the remedies to purchasers of existing housing for defects in their homes are more limited than those available to purchasers of newly constructed homes, existing home purchasers do have several bases upon which to seek relief.

4.8.1 CLAIMS AGAINST THE BUILDER/CONTRACTOR

4.8.1.1 Contract Claims

Because purchasers of existing homes did not contract with the builder, there generally is no contract cause of action against the builder. If, however, the original construction contract was assignable or was enforceable by subsequent purchasers, a contract claim may exist.

4.8.1.2 Express Warranty Claims

RD/RHS one-year warranty. The RD/RHS one-year warranty, by its terms, extends to successor(s)-in-interest of the original purchaser. Purchasers of homes to which the original RD/RHS one-year warranty is applicable may therefore bring an action against the builder under the warranty. The procedures for bringing such a claim are identical to those applicable to claims brought by an original owner.[869]

Ten-year warranty. RD/RHS regulations require that any 10-year warranty used in connection with RD/RHS-financed homes be automatically transferrable to subsequent owners.[870] Therefore, second or subsequent purchasers of homes insured under a 10-year warranty plan may seek relief under that plan in the same manner as the original purchaser.[871]

Other express warranties. Purchasers of existing housing may bring actions on other express warranties of the builder or of a manufacturer of appliances, systems, or fixtures, if those warranties run to the successors in interest or assignees of the original purchaser. Review all warranties to determine whether your client may have a claim under them.

4.8.1.3 Implied Warranties

Since the development of the doctrine of implied warranties in housing has followed that of implied warranties in the sale of goods and products, implied warranties of habitability should not be limited to the original purchaser. Indeed, several states have specifically extended implied warranties to persons other than the original purchaser.[872] Purchasers of existing homes may therefore have a cause of action against the original builder for defective construction. It is beyond the scope of this manual to discuss the basis upon which implied warranties have been extended to second purchasers or to research the various states that have extended the doctrine. Review your state law to determine whether implied warranties have been extended to subsequent purchasers and if not, whether there is a basis for extending product liability developments to housing.

4.8.1.4 Tort Actions

Tort remedies for purchasers of existing homes against the builder/contractor may be available under conventional state doctrines of negligence or strict liability. These should be explored on behalf of your client.

4.8.2 REMEDIES AGAINST THE SELLER WHO IS NOT THE BUILDER

4.8.2.1 Private Seller

Purchasers of existing housing may also have various tort or contract remedies against the seller of an existing home arising out of representations, omissions, or warranties made in connection with the sale. Again, state law should be checked, as a discussion of these remedies is beyond the scope of this manual.

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[869] *See* § 4.6.2, *supra*.

[870] 7 C.F.R. § 1924.12 and 7 C.F.R. pt. 1924, sub pt. A, ex. L, ¶ III A (2009).

[871] *See* § 4.6.3, *supra* (discussion of procedure for seeking compensation under 10-year warranty plan).

[872] *See, e.g., Barnes v. Mac Brown & Co.*, 264 Ind. 227 (1976); *Schipper v. Levitt & Sons, Inc.*, 44 N.J. 70 (1965).

4.8.2.2 RD/RHS as Seller

When RD/RHS sells property to an individual, its obligations to the purchaser should be identical to those of any other seller, and the purchaser should be able to hold the agency to any warranties, express or implied, that it makes.[873] Ordinarily, RD/RHS will not make any express warranties in connection with the sale of an existing or rehabilitated structure.[874] In fact, until 1979, RD/RHS' predecessor agency quite often expressly disclaimed any warranties by disposing of property on an "as is" basis. In 1979, Congress restricted the agency's authority to dispose of properties on an "as is" basis to houses that will not be inhabited or that the purchaser agrees to bring up to decent, safe and sanitary standards.[875] Since this prohibition was intended to protect purchasers of existing housing and prevent RD/RHS from putting structures on the market that are not decent, safe and sanitary,[876] it may be used to bolster any available state law implied warranty claims against the agency.

Individuals who purchased existing homes from RD/RHS that were constructed prior to 1960 and that have lead-based paint on any of their surfaces that was not properly inspected or removed may have a tort cause of action against RD/RHS for failing to inspect or remove the paint. RD/RHS regulations require the agency to remove lead-based paint from all properties built before 1950.[877] Moreover, HUD regulations, promulgated pursuant to the Lead-Based Paint Poisoning Prevention Act,[878] require RD/RHS to inspect and perform appropriate lead abatement on properties constructed before 1960.[879] If RD/RHS has failed to comply with these requirements, such failure may be used to support any available negligence claims against the agency.

4.8.3 REMEDIES AGAINST RD/RHS

4.8.3.1 Section 509(c) Compensation for Construction Defects

The Section 509(c) program is generally not available to purchasers of existing housing. Nevertheless, transferees, including purchasers, of newly constructed RD/RHS-financed homes may file claims under the program if they do so within the statutory 18-month period.[880] All procedures and requirements imposed on the original purchaser must be followed by the transferee.[881]

4.8.3.2 Tort and Contract Liability

Purchasers of existing homes have the same potential tort and contract remedies against RD/RHS as the purchaser of a new home.

4.9 REMEDIES OF PERSONS WHOSE HOMES ARE REHABILITATED

4.9.1 REMEDIES AGAINST THE CONTRACTOR

With few exceptions, the homeowner who has his or her home rehabilitated has all of the remedies available against the rehabilitation contractor that the purchaser of a new dwelling has against the builder.[882] The remedies that are not usually available to persons whose home is rehabilitated are the express warranty causes of action under the one-year RD/RHS warranty and the 10-year insured warranty. Contractors are not required to provide

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[873] *Cf. Burroughs v. Hills*, 564 F. Supp. 1007 (N.D. Ill. 1983); *City of Philadelphia v. Page*, 363 F. Supp. 148 (E.D. Pa. 1973), *aff'd on reconsideration*, 373 F. Supp. 453 (E.D. Pa. 1974).

[874] When RD inventory property has a hazardous substance, as defined by the Comprehensive Environmental Response, Compensation and Liability Act, 42 U.S.C.A. §§ 9601 *et seq.* (West, WESTLAW through P.L. 109-279 (excluding P.L. 109-248, 109-270, 109-271) approved 08-17-06), it is obligated to remove the substance and expressly warrant that all remedial actions necessary to protect human health and the environment have been taken prior to sale of the property. FmHA AN 2177 (1955) (Nov. 20, 1990); 42 U.S.C.A. § 9620(h) (West, WESTLAW through P.L. 109-279 (excluding P.L. 109-248, 109-270, 109-271) approved 08-17-06).

[875] 42 U.S.C.A. § 1480(e) (West 2003).

[876] *See* H.R. REP NO. 154, 96th Cong., 1st Sess. 45, *reprinted in* 1979 U.S.C.C.A.N. 2317, 2361; S. REP. NO. 157, 96th Cong., 1st Sess. 4 (1979).

[877] RD Instruction 1924-A, ex. H, ¶ IV E (5-21-87); RD AN 4124 (1924-A) (Nov. 21, 2005).

[878] *See* 42 U.S.C.A. § 4822(a) (West, WESTLAW through P.L. 109-279 (excluding P.L. 109-248, 109-270, 109-271) approved 08-17-06).

[879] 24 C.F.R. § 35.210 (2009).

[880] *See* 7 C.F.R. § 1924.258 (2009).

[881] *See* § 4.7.1, *supra* (discussion of these requirements).

[882] *See* § 4.6, *supra*.

homeowners with either warranty when undertaking rehabilitation. This does not mean that the homeowner may not have a warranty cause of action against the contractor under some other express or implied warranties discussed previously.

4.9.2 REMEDIES AGAINST RD/RHS

The homeowner whose home is defectively rehabilitated may have a tort or contract cause of action against RD/RHS in special situations.[883] The RD/RHS Section 509(c) program is not available to borrowers whose homes have been rehabilitated.

4.10 OBTAINING OTHER RD/RHS ASSISTANCE TO CORRECT THE DEFECT

A borrower who is unsuccessful in obtaining relief from the builder or RD/RHS or who chooses not to seek this relief can always apply for a subsequent Section 502 loan to make the repairs.[884] If the borrower is eligible for an interest subsidy, that loan can be made with Payment Assistance. It is also possible, although not likely, that the borrower may obtain a Section 504 grant to correct the defect. To obtain a Section 504 grant, the borrower must meet the Section 504 eligibility criteria.[885]

[883] *See* § 4.7.2, *supra*.
[884] *See* 7 C.F.R. § 3550.53(d) (2009).
[885] *See* § 2.4.3, *supra*.

CHAPTER 5
MORATORIUM RELIEF PROGRAM
AND OTHER LOAN SERVICING TOOLS

5.1 INTRODUCTION

In 1949, concerned that the vicissitudes of an agrarian economy could periodically make it difficult for the farmer-borrower to meet monthly payments on farm construction or improvement loans, Congress directed FmHA to provide relief for farmer-homeowners threatened with loss of their Section 502 homes because of circumstances beyond their control.[886] In 1965, the Section 502 and Section 504 programs were amended to include all rural poor within the class of home loan beneficiaries. As a result, the moratorium relief provision, authorized in Section 505 of the Housing Act of 1949, was made applicable to rural nonfarmer-borrowers as well.[887]

The creation of alternatives to foreclosure is an integral part of the overall federal program to make home loans available to low-income persons. Twice before, in times of economic distress, our nation has resorted to wholesale national emergency relief for defaulting homeowners. . First, during the Great Depression, states enacted a wide variety of emergency measures. More recently, Congress responded to the alarmingly high rate of mortgage foreclosures by enacting the Emergency Homeowners Relief Act.[888] This Act provides standby authority for either direct federal government loans to defaulting mortgagors or federal insurance of emergency loans by lenders to defaulting homeowners. Its purpose is to prevent "widespread mortgage foreclosures and distress sales of homes resulting from temporary loss of employment and income. . ."[889]

Two threads run through these enactments. First, the concept is established that in certain circumstances, the mortgagor in default for reasons beyond his or her control should be given relief to avoid the oppressive results of foreclosure. Second, there is the recognition that the government has a significant interest in avoiding the ills that accompany substantial numbers of foreclosures, namely, community deterioration, social unrest, depressed real estate values as a result of low distress sale prices, and the consequent decline of local real property tax revenues.

Unlike the temporary depression measures and standby authority afforded under the Emergency Homeowners Relief Act, Section 505 makes moratorium relief permanently available and is an integral part of RD/RHS' overall statutory scheme. This probably reflects Congress's realization that persons who are unable to obtain credit from conventional credit sources because of their low-income are more likely to experience income fluctuations than other borrowers and should not lose their RD/RHS-financed homes when those fluctuations result from circumstances beyond their control.

In light of this manifest congressional concern that RD/RHS' government-assisted homeownership programs operate primarily to protect the homeowner, rather than in complete deference to traditional property law governing foreclosure, it is disturbing that for 25 years RD/RHS' predecessor, FmHA, simply ignored its statutory mandate to make moratorium relief available. It was only after an action in mandamus was filed[890] that FmHA promulgated the initial implementing regulations

[886] 42 U.S.C.A. § 1475(a)(West 2003). Parts of this introduction are excerpted from Comments on Proposed Amendments to Regulations on Moratorium on Payments of Principal and Interest on Section 502 and Section 504 Rural Housing Loans, 7 C.F.R. § 1861.10 (1977), submitted by David Madway and Frances Werner of the National Housing Law Project (Dec. 16, 1976).

[887] Pub. L. No. 89-117, 79 Stat. 451, 497 (1965).

[888] Pub. L. No. 94-50, 89 Stat. 249 (1975).

[889] 12 U.S.C.A. § 2701(b) (West, WESTLAW, Current through P.L. 111-191 (excluding P.L. 111-148, 111-152, 111-159, and 111-173) approved 6-15-10).

[890] *Yracheta v. Butz*, No. S74-255 (E.D. Cal. filed June 24, 1974).

for Section 505 on July 10, 1974.[891] These regulations so summarily restricted the availability of relief, however, that the FmHA statutory mandate was far from being fulfilled.

Additional litigation, administrative advocacy and the passage of legislation that forced FmHA to adopt an appeals process have improved administration of the moratorium program substantially in the intervening years. Notwithstanding these improvements, FmHA, and now RD/RHS, have maintained arbitrary regulatory restrictions in the moratorium program that have prevented hundreds, if not thousands, of RD/RHS borrowers from obtaining moratorium relief.

This chapter reviews eligibility for moratorium relief in both its substantive and procedural aspects, as well as RD/RHS' actions at the end of the moratorium period. It does not cover use of RD/RHS' failure to extend moratorium relief as a defense to foreclosure, which is discussed separately in the foreclosure chapter.[892] To better understand the use of that defense, you should review this chapter and generally become familiar with the moratorium relief program. In addition, this chapter discusses other ways in which RD/RHS can assist borrowers who are having difficulties meeting their loan obligations. This includes informal moratorium relief, entry into a delinquency workout agreement, reamortization, and refinancing.

RD/RHS regulations and instructions. As noted earlier, between 1970 and 1990, FmHA regulations published in the *Federal Register* and codified in the Code of Federal Regulations (C.F.R.) comprised all of the instructions that FmHA published with respect to the operation of its programs.[893] In 1990, FmHA began to edit the regulations that it published in the *Federal Register* to the point where they have often become generalized statements of the agency's obligations, lacking details about the operations of a program and the administrative obligation of agency staff. Those elements were incorporated only in materials distributed to agency staff in the form of FmHA Instructions. In 1996, the agency went back to conforming its instructions to the regulations published in the C.F.R. However, in doing so, it did not expand the regulations, but rather, published the additional staff instructions in two handbooks that are available on the RD website and are distributed to its staff.[894] Unfortunately, the handbooks are not published for review and comment and can be, and indeed are, periodically revised by the agency without any public notice.

Moratoriums and Leveraged 502 Loans. Just like any other Section 502 borrower, borrowers with RD leveraged or participation loans are eligible for moratorium relief. However, the moratorium applies only to the RD loan, and the borrower must continue to pay the private loan.[895]

Moratorium and loan servicing for mortgages held by the Rural Housing Trust 1987-1.[896] Loans originated by FmHA as Section 502 loans that were sold to the Rural Housing Trust 1987-1 (RHT) and are now serviced by Chase Mortgage, Inc., are eligible for moratorium and other loan servicing as if they continued to be RD/RHS loans.[897] Thus, no distinctions are made in this chapter between RD/RHS and RHT loans.

Moratorium and loan servicing for the Section 502 Guaranteed Loan Program. Like direct loans, RD/RHS guaranteed loans are authorized by Section 502 of the Housing Act of 1949.[898] Therefore, borrowers who obtained guaranteed loans were statutorily eligible for moratorium relief as well as other statutory servicing options available from RD/RHS.[899] Nonetheless, when the agency adopted its final loan guarantee regulations, it specifically rejected the right of borrowers with guaranteed loans to obtain moratorium relief and other loan servicing options.[900] Thus, the discussion in this chapter is inapplicable to guaranteed loans. The

[891] 39 Fed. Reg. 25,312 (July 10, 1974).
[892] *See* Ch. 6, *infra*.
[893] *See* § 1.6, *supra*, for a discussion of FmHA statutes, regulations and instructions.
[894] Handbooks 1-3550 DLOS Field Office and 2-3550 DLOS Centralized Servicing Center. Both Handbooks are available at http://www.rurdev.usda.gov/regs/hblist.html (last visited 5-27-09). These handbooks will be referenced throughout this chapter as Handbooks 1-3550 and 2-3550.
[895] Handbook 2-3550 ¶ 5.5 (Rev. 07-13-05).
[896] *See* § 1.2.5, *supra* (discussion of FmHA loans sold to the Rural Housing Trust 1987-1).
[897] RD/RHS appears to have removed all references to RHT loans from its regulations and handbooks. *See*, 7 C.F.R. § 1957.1 (1993).
[898] 42 U.S.C.A. § 1472(h) (West 2003).
[899] *See e.g., id.* § 1475(a).
[900] 56 Fed. Reg. 15,748, 15,752 (Apr. 17, 1991) (codified at 7 C.F.R. 1980.301 et seq. (2009)).

consequences of the agency's failure to provide moratorium relief to guaranteed loan borrowers are discussed in Chapter 6.

5.2 ELIGIBILITY FOR MORATORIUM RELIEF

Section 505 of the Housing Act of 1949[901] authorizes RD to grant a moratorium upon the payment of interest and principal on Section 502 and Section 504 loans during any time that such loans are outstanding. Under the statute, the borrower must first show that because of circumstances beyond his or her control, payments of such principal and interest cannot be made when due without unduly impairing his or her standard of living.[902] There is no statutory limitation on the length of a moratorium or number of moratoriums for which a borrower may qualify. The moratorium relief regulations[903] prescribe the conditions for eligibility, some of which are inconsistent with the statute.[904]

In particular, in one instance, the regulations require a threshold minimum loss of income, which is not indicative of whether the individual household's ability to make payments to RD has been unduly impaired.

5.2.1 DUE TO CIRCUMSTANCES BEYOND HIS OR HER CONTROL, THE BORROWER IS TEMPORARILY UNABLE TO CONTINUE MAKING SCHEDULED PAYMENTS

5.2.1.1 Circumstances Beyond the Borrower's Control

Under the regulations, the borrower must be temporarily unable to continue making scheduled payments due to circum- stances beyond the borrower's control.[905] RD/RHS has not defined the term "circum- stances beyond the borrower's control" except when the borrower has to pay unexpected and unreimbursed expenses. Its servicing handbook[906] states that the expenses must result from the illness, injury, or death of a borrower or a family member or from unreimbursed expenses resulting from damage to the security property in cases where adequate hazard insurance was not available or was prohibitively expensive.[907] These examples should not be treated as exclusive conditions for eligibility. The handbook does not have the force and effect of law because it was not published for review and comment. Accordingly, its examples are only guides and should not limit other circumstances where the borrower has experienced circumstances beyond his or her control.

A reduction in income.[908] Because RD/RHS has not defined what constitutes circumstances beyond the borrower's control in the context of a reduction in income, the RD Centralized Servicing Center has unfettered discretion to determine whether particular circumstances that caused the reduction in income are beyond the borrower's control.

Disputes with respect to whether particular circumstances make a borrower eligible for moratorium relief are not likely to arise when the loss of income is clearly outside the borrower's control. For example, borrowers should have no difficulty qualifying for moratorium relief when they are temporarily laid off, lose their job due to plant closings, injuries or illnesses, experience a reduction or delay in receipt of public or private benefits, lose support payments, or when they lose income due to the death of the borrower or co-borrower.

Disputes are likely to arise when the borrower has exercised some choice or somehow precipitated the circumstances that resulted in the loss of income. One such issue is divorce or separation. Historically, RD/RHS viewed separation or divorce

[901] 42 U.S.C.A. § 1475 (West 2003).
[902] *Id*.
[903] 7 C.F.R. § 3550.207 (2009).
[904] Handbook 1-3550 identifies moratorium as a servicing option. *See* ¶¶ 1.6, 13.4, except for nonprogram loans, (¶ 2.6) and defines it in the Glossary as "A period of up to two years during which scheduled payments for principal, interest and deposits to the escrow account are not required, but are subject to repayment at a later date."

[905] 7 C.F.R. § 3550.207 (a)(1) (2009).
[906] Handbook 2-3550 ¶ 5.5 (Rev. 7/13/05).
[907] *Id*.
[908] When there is a reduction in income, RD/RHS requires that the borrowers' income was reduced by at least 20% during the last year. *See* 5.2.1.2.1, *infra*.

as circumstances outside the borrower's control.[909] However, unless the borrower and spouse had commenced legal separation or divorce proceedings, neither was eligible for a moratorium until they had been living apart for six months or longer, and the separation was for reasons other than military service or work assignment.[910] RD/RHS has dropped the six months separation requirement, and in most cases, appears to have accepted the notion that separation and divorce are beyond the borrower's control. However, that policy is not applied uniformly. In at least one case, the National Appeals Division (NAD) hearing officer has concluded that a separation or divorce is within the borrower's control and denied the borrower a moratorium.[911]

Such a decision is arbitrary. Couples should not be required to remain in an unworkable relationship in order to retain their house. Divorces are very common in our society and are generally viewed as circumstances beyond the individual's control. RD/RHS' decisions to the contrary are inconsistent with the agency's current position, our society's view of separations and divorces, and HUD's view under the Assignment Program, which, until 1995, provided similar relief to borrowers under the HUD/FHA single family homeownership program.[912] Disturbingly, RD/RHS frequently views the loss of income from a divorce or separation as a permanent loss of income and refuses to extend a moratorium to borrowers because in its view, the loss is not temporary. Surprisingly, it has also taken the position that co-borrower couples that have separated have not suffered any loss of income.[913]

There are many other cases where it is not clear whether a circumstance is beyond the borrower's control, and RD/RHS has provided little guidance on the issue. In those instances, it is useful to look at how HUD and the courts have handled the issue of what constitutes circumstances beyond a borrower's control in the context of the HUD Assignment Program.[914]

For example, HUD advised its staff that participation in a strike is a circum- stance beyond a borrower's control unless the strike has been ruled illegal by a court. It also considered drug or alcohol dependency to constitute a circumstance beyond the borrower's control if a physician confirmed the dependency in writing and it was the cause of the borrower's inability to continue to make payments.[915]

Federal courts that have looked at the issue in the context of the HUD Assignment Program have generally agreed that HUD may not deny an assignment when the risk of not paying the mortgage and pursuing some other option is of "hardship" proportions or otherwise involves "Hobson's choices."[916] Thus, courts have held HUD to have acted arbitrarily when it denied an assignment to a borrower who has lost her job when there was no evidence that it was due to her willful misconduct,[917] but have upheld the agency's decision when the borrower lost his job because of dishonesty[918] or due to a personality conflict with his employer.[919] Leaving a job voluntarily has been held to be a circumstance beyond the borrower's control when the reason was emotionally based and due to "phantom pain,"[920] or when the borrower resigned after being told that he would be terminated for reasons beyond his control.[921] The failure to return to a job after an illness due to pregnancy,[922] as well as voluntarily quitting a job to take care of grandchildren whose parents were incarcerated,[923] have also been held to be circumstances beyond a borrower's control.

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[909] *See* 7 C.F.R. § 1951.313(e) (1994).

[910] *Id.* § 1944.5(d)(11).

[911] NAD, Case No. 2006S000426 (Aug. 29, 2006).

[912] HUD Handbook No. 4330.2 at 2-3 (1995).

[913] *See* §§ 5.2.1.2, *infra.*

[914] The Assignment Program was HUD's counterpart to the RD/RHS Moratorium Program. It was in existence until 1995 when Congress, at HUD's urging, terminated the program.

[915] HUD Handbook 4330.2 REV-2, MORTGAGE ASSIGNMENT AND PROCESSING SECRETARY-HELD SERVICING, Chap. 2, 2-4. E. 2.

[916] *See, e.g., In re Madison*, 60 Bankr. 837, 839-40 (E.D. Pa. 1986) (Clearinghouse No. 44,413).

[917] *Harris v. HUD*, 1986 WL 4331 (E.D. Pa. Apr. 9, 1986).

[918] *STM Mortgage Co. v. Anderson*, No. C-2-83-302 (S.D. Ohio Oct. 5, 1984) (Clearinghouse No. 45,017).

[919] *McCall v. HUD*, No. 85-1300 (E.D. Pa. Sept. 25, 1985) (1985 WL 2761). The court concluded that the borrower could have adjusted his attitude until alternative employment was secured.

[920] *Cronkhite v. Kemp*, 741 F. Supp. 822 (E.D. Wash. 1989).

[921] *Edwards v. Kemp*, 795 F. Supp. 856 (S.D. Ohio 1992).

[922] *In re Van Huderson*, 96 B.R. 541 (Bankr. E.D. Pa. 1989), *aff'd sub nom. Huderson v. HUD*, No. 89-2152 (E.D. Pa. Aug. 9, 1989) (Clearinghouse No. 45,100).

[923] *James v. HUD*, No. 4-81-457 (D. Minn. July 8, 1982) (1982 WL 1760). *See O'Neill v. HUD*, No. 85-1205 (E.D. Pa. Dec. 31, 1985) (bench opinion) (Clearinghouse No. 45,134).

Courts have also held that self-employed individuals are entitled to an assignment if their business is failing, provided they were self-employed when they obtained the HUD loan;[924] but they are not entitled to an assignment if the borrower chose to become self-employed after obtaining the HUD loan and the new business failed.[925]

In representing clients before RD/RHS, rely on these and other HUD cases as persuasive authority on the issue of what constitutes circumstances beyond the borrower's control.

You should also review the USDA NAD decisions. There may be cases where an issue facing your client has already been decided by an appeal. Be cautious about applying those decisions to your client's case. NAD hearing officers are bound by RD/RHS regulations, and unlike the courts, will not respond to an argument that a regulation is arbitrary or capricious or contrary to law. They will also not accept another hearing decision as a precedent for future decision.

The need to pay unexpected and unreimbursed expenses. A borrower may obtain a moratorium if he or she needs to pay unexpected and unreimbursed expenses resulting from the illness, injury or death of a family member or from damage to the security property if adequate insurance coverage was unavailable.[926]

It is not clear whether RD/RHS considers the listed situations as illustrative or exclusive. In an earlier version of the regulations, it considered the list exclusive.[927] It did not reiterate that position when it revised and republished the regulations in 1996. Even if RD/RHS considered the list to be exclusive, its position could be challenged as contrary to statute or otherwise arbitrary and capricious because other events beyond the borrower's control could unduly impair a borrower's standard of living.

The moratorium statute authorizes the extension of a moratorium whenever circumstances beyond the borrower's control preclude him or her from continuing to make mortgage payments without unduly restricting his or her standard of living. Any restriction on the kinds of events that disable the borrower from making payments is both contrary to statute and arbitrary and capricious if it denies moratorium rights when the circumstances are clearly beyond the borrower's control. Indeed, RD/RHS' predecessor, FmHA, authorized the inclusion of other expenses if they were considered essential and either resulted in or could result in a lien being placed on the borrower's dwelling that if not paid, would likely result in loss of the dwelling.[928]

Moreover, it appears that in one case considered under the language in the prior regulations, FmHA approved a moratorium to enable a borrower to pay her real estate taxes.[929]

In considering eligibility for the Assignment Program, HUD instructed its staff to consider as qualifying events unanticipated increases in reasonable expenses and an unanticipated increase in payments to a mortgage escrow account to compensate for past underestimates of escrow requirements if they were due to circumstances beyond the borrower's control.[930]

Also in the context of the HUD Assignment Program, one federal district court concluded that a borrower's need to make payments on a business loan secured by household goods was a circumstance beyond the borrower's control, when the borrower diverted income ordinarily used to pay the business loan to pay medical expenses.[931] Another court held that a borrower who paid bills incurred by a former spouse (who was not a co-borrower and

[924] *Brown v. Kemp*, 714 F. Supp. 445 (W.D. Wash. 1989) (Clearinghouse No. 44,707).

[925] *Miasel v. Pierce*, 650 F. Supp. 21 (D. Minn. 1986) (Clearinghouse No. 44,415).

[926] 7 C.F.R. § 3550.207 (a)(1)(ii) and (iii) (2009).

[927] *See* 52 Fed. Reg. 243, 244 (Jan. 5, 1987) (FmHA response to comments submitted to proposed regulations that were finalized in January of 1987. Those regulations first adopted the list of types of increased expenses that make a borrower eligible for relief.). The major rewriting of the regulations: Reengineering and Reinvention of the Direct Section 502 and 504 Single Family Housing (SFH) Programs 61 FR 59779, Nov. 22, 1996, as amended at 67 Fed. Reg. 78332 (Dec. 24, 2002), which recodifies certain sections of the regulations at 7 C.F.R. § 3550 *et seq*., does not comment on or offer any suggestion that the regulatory list is not exclusive.

[928] *See* 7 C.F.R. § 1951.313(a)(2)(ii) (1987) (rescinded.).

[929] *In re Spivey*, (Oregon, Mar. 23, 1987) (appeal decision of David T. Chen, State Director).

[930] HUD Handbook 4330.2, Rev. 2, *supra* note 912, ¶ 2-9 A 2. *See id.* ¶ 2-9 B 4.

[931] *In re Weigant*, No. 84-0839 (E.D. Pa. Sept. 29, 1986) (1986 WL 10796).

who had gone on a spending spree) had experienced circumstances beyond her control.[932] Yet another federal court has held that HUD must at least consider the need to pay legal expenses as a circumstance beyond a borrower's control.[933]

5.2.1.2 The Borrower's Standard of Living Must Be Unduly Impaired

The moratorium statute authorizes the extension of a moratorium whenever a borrower suffers a financial hardship that unduly impairs the borrower's standard of living.[934] Instead of interpreting this statutory provision broadly, as remedial statutes are typically interpreted, RD/RHS has defined this condition narrowly and arbitrarily. Contrary to statute, it does not make a determination of whether a borrower's individual circumstances unduly impair his or her standard of living. Instead, it considers that a borrower's standard of living has been unduly impaired when the borrower suffers a decrease in repayment income of at least 20% within the past 12 months; there is a need to pay unexpected and unreimbursed expenses resulting from an illness, injury or death of a family member; or there is a need to pay for damage to the dwelling and adequate hazard insurance was not available or was prohibitively expensive.

5.2.1.2.1 20% Reduction in Repayment Income

The borrower who seeks a moratorium due to a reduction in income must, as a threshold, show that his or her repayment income has been reduced by 20% in the past 12 months.[935] "Repayment income is the annual amount of income from all sources that is expected to be received by those household members who are parties to the promissory note. Student financial aid received by these household members for tuition, fees, books, equipment, materials, and transportation"[936] is exempted from Repayment Income.[937]

Prior to 1996, the reduction in income was calculated based on total household income. Today, it is based on repayment income. In other words, only if the borrowers' income is reduced by 20% or more will the household qualify for assistance. If a member of the borrower's family or a third party living in the household, but not on the promissory note, loses his or her income or moves from the household, the household will not qualify for a moratorium. This is not withstanding the fact that the entire household income is used to determine the level of payment subsidy that the household receives.

Because RD/RHS does not look at whether the individual borrower's capacity to make mortgage payments is unduly impaired, the 20% reduction in income test has been interpreted in an absurd manner. The RD/RHS regulations state that to be eligible for relief the "borrower's repayment income" must have been reduced by 20%. In one case, RD/RHS denied a moratorium to a borrower whose spouse left the household on the ground that the borrower, as opposed to borrower's household, did not suffer a 20% reduction in income.[938] Arguably, this rational can be used to deny all borrowers who separate or divorce the right to a moratorium.

Borrowers who meet the 20percent test should qualify for relief. Those who do not should consider challenging it on the grounds that the test is contrary to statute and otherwise arbitrary and capricious.

Challenging the use of the 20 percent test. The statute authorizes RD/RHS to extend a moratorium to individual borrowers "upon a showing by the borrower that due to circumstances beyond his control, he is unable to continue making payments. . . when due without unduly impairing his standard of living."[939] (emphasis added).

Clearly, the statute contemplates that the decision to grant a moratorium be individualized and that the determination be made with respect to each borrower's circumstances and standard of living. RD/RHS' regulations simply ignore the statutory mandate that the individual's standard of living is unduly impaired.[940] Obviously, some borrowers can

[932] *FNMA v. Rathgens*, 595 F. Supp. 552 (S.D. Ohio 1984).
[933] *Rickards v. HUD*, 623 F. Supp. 463 (E.D. Pa. 1985).
[934] 42 U.S.C.A. § 1475 (West 2003).
[935] *Id*. at (a)(1)(i).
[936] 7 C.F.R. § 3550.54 (a) (2009).
[937] *Id*.
[938] NAD Case No. 2005E000096 (Jan. 31, 2005).
[939] 42 U.S.C.A. § 1475 (West 2003).
[940] 7 C.F.R. § 3550.207(a)(1) (2009), 61 Fed. Reg. 59779 (Nov. 22, 1996) as amended at 67 Fed. Reg. 78332 (Dec. 24, 2002).

sustain a 20% reduction in income while others cannot. The determining factor is the relationship between the amount by which the borrowers' income has been reduced and the amount of the borrower's discretionary income. If discretionary income exceeds the reduction in income, the borrower's standard of living will not be impaired regardless of the size of the reduction. If, on the other hand, the reduction in income exceeds the borrower's discretionary income, the borrower's standard of living will be impaired.

RD/RHS has refused to adopt a case-by-case approach to determining moratorium eligibility. In 1991, the FmHA, RD/RHS' predecessor, rejected a case-by-case approach because "it would be more difficult to administer, would place an unnecessary burden on the county office staffs, and would introduce a higher degree of subjectivity."[941] In 1996, RD/RHS

"based [its refusal]upon the premise that for the Agency to completely stop requiring all payments from a customer for up to two years, a substantial reduction in income must have occurred. While it is true that our customers have very-low, low and moderate incomes, a homeowner should be able to adjust to *small* adjustments in income. Additionally, RD can provide customers with additional payment subsidies, work-out agreements, etc., in an effort to assist them in working through difficult periods. We believe the 20% reduction is reasonable."[942]

None of these reasons justifies RD/RHS' refusal to follow the moratorium statute. An agency may not simply ignore its statutory mandate in order to ease the operation of a program or its administrative burden. This is particularly true when the reasons FmHA and RD/RHS have given for rejecting a case-by-case approach for determining eligibility simply do not stand up to scrutiny.

RD/RHS has relied on family budgets to make loan eligibility decisions,[943] and in deciding servicing options at the end of a moratorium.[944] It also requires guaranteed lenders to use family budgets to decide servicing options.[945] Given the agency's reliance on family budgets, it is difficult to imagine how the use of the family budget will make it more difficult to administer the moratorium program.

It is also difficult to understand how using the family budget will create an unnecessary burden on RD/RHS staff. As already noted, if an administrative burden is created, it is mandated by statute and may not be ignored by the agency. Moreover, the burden is hardly "unnecessary." To the extent that the 20% test does not comport with the statute -- which provides moratoria for all borrowers temporarily unable to continue making payments -- the burden is not "unnecessary."

The fact that use of the family budget would introduce a higher degree of subjectivity does not justify RD/RHS' refusal to rely on it. While an objective, rather than a subjective, test may be desirable for determining moratorium eligibility, it is not justified when it produces irrational and inconsistent results. This is particularly true when the "subjective" method that the agency is rejecting -- the use of the family budget -- is apparently satisfactory for a myriad of other agency decisions.

As already noted, because it does not establish whether a reduction in a particular borrower's income would impair that borrower's ability to make payments to RD/RHS as is required under the statute, the 20% standard is arbitrary and capricious. The test is also arbitrary and capricious because RD/RHS has not articulated a rational reason for choosing the 20% standard over any other standard. When FmHA lowered the eligibility threshold from a 30% reduction in income to a 20% reduction, it conceded that the 30% requirement was excessive and adopted instead the 20% standard. According to FmHA, this was justified because a "20% reduction corresponds with the formula for Interest Credit assistance which is based on a borrower paying no more than 20% of their [sic] adjusted income for principal, interest, taxes and insurance."[946] Contrary to RD/RHS' contention, there is nothing about the

[941] 56 Fed. Reg. 6,939, 6,943 (Feb. 21, 1991).
[942] 61 Fed. Reg. 59762, 59775 (Nov. 22, 1996) (emphasis added).
[943] 7 C.F.R. § 3550.103(h) (2009); Handbook 2-3550 ¶ 5.5 F (Rev. 9/3/08).
[944] 7 C.F.R. § 3550.207(b) (2009).
[945] *See*, USDA Rural Development, Loss Mitigation Guide, Chapter 3, Section B, Part 1 1 f, and h, and 2 a (Dec. 1, 2007)(published as part of AN 4433 (April 17, 2009)).
[946] 56 Fed. Reg. 6,939, 6,943 (Feb. 21, 1991).

20% formula that RD/RHS uses to determine the level of subsidy that a family is receiving under the Interest Credit program that supports its requirement that a family incur a 20% reduction in income before its standard of living is unduly impaired and it becomes eligible for relief. Indeed, the opposite is true. Since the formula for the Interest Credit program suggests that a family should not pay more than 20% of its adjusted income for shelter, any reduction in income that causes the family to pay more than 20% of its income for shelter should qualify it for moratorium relief. Moreover, since RD abandoned the 20% of income test for all borrowers receiving an interest subsidy except those fortunate enough to have received the interest credit subsidy, there is no rationale for the 20% reduction in income requirement.

The 20% reduction in income test is arbitrary for other reasons. It establishes totally dissimilar standards for qualifying for moratorium relief depending on whether the borrower is seeking relief because of a decrease in income or an increase in expenses. Because there is no threshold in the amount of increased expenses that a borrower must incur before he or she can qualify for moratorium, it is possible for one family with an income of $10,000 to qualify for relief because it had incurred $500 in increased expenses while another family with identical income to be rejected because its income has "only" decreased by $1800. Such disparate results are irrational and not justified by the moratorium statute.

The fact that RD/RHS will not consider the loss of income by household members who are not borrowers in determining moratorium eligibility is also arbitrary. RD/RHS does not determine subsidy payments based on the borrowers' income, but on the total household income except for the income of a minor under 18.[947] Thus, borrowers are deprived of subsidy assistance based on a third party's income, but are denied a moratorium if that income is lost. Such an absurd result is arbitrary and capricious. It is even more absurd when as described above, a co-borrower moves from the house, but RD/RHS argues that the borrower who applies for a moratorium has not suffered a 20% loss of income.

The 20% reduction in income test is also arbitrary because its application operates in a manner that is contrary to the remedial nature of the moratorium statute. For example, a family with a gross income of $12,000 will not qualify for relief if it has a reduction in income of $2,300. It is hard to believe that many families, let alone very low-, low- and moderate-income families, can sustain a reduction in income of nearly 20% without unduly impairing their standard of living. To categorically deny families who sustain a substantial reduction in income merely because they do not meet RD/RHS' arbitrary 20% test, is contrary to RD/RHS' statutory authority.[948]

The 20% Loss of Income Must Have Occurred Within the Last 12 Months. The RD/RHS regulations require that the 20% loss of income must have occurred within 12 months of the borrower having applied for a moratorium.[949]

While this requirement appears innocuous, it can be quite disadvantageous to borrowers who are conscientious about paying their RD/RHS loan. For example, if a borrower who loses a job, accepts a lower paying job and continues to make payments is unable to continue to make payments after 12 months, because of the reduced income, RD/RHS would reject the application for a moratorium because the reduction did not occur within 12 months. The same may be true for borrowers who have savings or receive support from other family members to bridge a period of hardship.[950]

An argument can and should be made that the 12 months requirement is irrational, as well as arbitrary and capricious . There is no reason why RD/RHS staff cannot review the facts to determine whether the borrower suffered a loss of income over a period of time that ultimately prevented the borrower from continuing to make loan payments. There is nothing critical about the reduction having had to occur within the last 12 months.

5.2.1.2.2 The Need to Pay Unexpected and Unreimbursed Expenses

Neither RD/RHS regulations nor instructions state how the staff is to determine whether a borrower is unable to continue making scheduled

[947] *See* 7 C.F.R. § 3550.68 (c) (2009).

[948] *See United States v. Shields*, 733 F. Supp. 776, 785 (D. Vt. 1989).

[949] 7 C.F.R. § 3550.207 (a)(1)(i) (2009).

[950] *See* NAD Case No. 2006S000294 (June 18, 2006).

payments when the borrower has incurred unexpected and unreimbursed expenses. Notwithstanding this administrative failure, loan servicers should make the determination from a completed family budget form.[951] If the budget shows that the family is unable both to meet all its living expenses and make payments on principal and interest, the borrower should be found eligible for moratorium relief.

5.2.2 THE NEED FOR A MORATORIUM MUST BE TEMPORARY[952]

The moratorium relief regulations require that the circumstances that have caused the borrower's standard of living to be unduly impaired be temporary.[953] RD/RHS has not defined "temporary," but has determined that because a moratorium may be granted for up to two years,[954] the agency expects that the qualifying condition be cured within the two-year period.[955]

Historically, RD/RHS staff assumed that if a moratorium is justified, the borrower's inability to pay will not exceed two years. Since 1996, however, the staff has looked more closely at the "temporary" requirement and has frequently turned down applications when they do not believe that a condition is temporary.

One circumstance in which RD/RHS has repeatedly denied moratorium relief is when borrowers become separated or divorced. RD assumes that unless the borrower can show that he or she has taken affirmative steps to improve the borrower's income, the loss of income is permanent and does not qualify the borrower for a moratorium. This practice is disturbing in that it fails to take into account that borrowers may be employable and that they may be employed before the end of the moratorium period. Accordingly, advocates are urged to advise their clients to seek employment, training, or other assistance to show that they are likely to improve their financial condition within the two-year moratorium period.

When RD contends that the need for a moratorium is not temporary, various arguments and forms of proof may be available to rebut that position, depending on the circumstances that the borrower contends precipitated the need for the moratorium.

In unemployment cases, argue that RD/RHS must assume that the borrower will be reemployed whenever he or she has a favorable record of past employment, is not suffering from a disability that prevents reemployment, and is actively seeking work. These criteria were used by HUD to evaluate a similar eligibility requirement for its Assignment Program.[956] Application to or participation in a job training or rehabilitation program may also constitute grounds for suggesting that the need for relief is temporary.[957]

When representing an unemployed borrower, be aware that RD has often considered an individual who is frequently unemployed to be ineligible for moratorium relief on the grounds that the individual's unemployment is not temporary. This should not, however, preclude borrowers, such as construction workers, who have been working steadily for a variety of employers, from qualifying for relief if employment in their field suddenly becomes scarce. Moreover, even a borrower who has had frequent periods of unemployment, but who has been able to make payments on the loan during those periods, should qualify for relief if the period of unemployment becomes extended. This is particularly true for seasonal employees such as farmworkers.

If the borrower has a documented disability that prevents him or her from returning to work and he or she has applied for disability benefits, argue that the borrower is likely to receive disability benefits which would make the need for a moratorium temporary.[958]

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[951] Budget and/or Financial Statement, Form RD 1944-3 (Rev. 6/97) (Available at: http://www.rurdev.usda.gov/ga/1944-3budget.pdf (Last visited 5/27/2009).
[952] 7 C.F.R. § 3550.207 (a)(1) (2009).
[953] *Id*. § 3550.207(a)(1).
[954] *Id.* § 3550.1. *See id* § 3550.207. *See also* § 5.3.1, *infra* (discussion of two-year moratorium period).
[955] *See* NAD Case No. 2006E000663 (Dec. 5, 2006).
[956] HUD Handbook 4330.2, Rev-2, Ch. 2, *supra* note 912, ¶ 2-10 B 4 d. *See Grasty v. HUD*, 636 F. Supp. 912 (E.D. Pa. 1985) (HUD abused its discretion when it decided that unemployed mortgagor with previous work experience and no disabilities had no reasonable prospect of resuming payments).
[957] *See Cronkhite v. Kemp, supra* note 920.
[958] *See In re Armstead*, 97 B.R. 798 (Bankr. E.D. Pa. 1989). *But see Manufacturers Hanover Mortgage Corp. v. Chicago*

A favorable business forecast prepared by a consultant for a self-employed individual should also support the argument that the need for a moratorium is temporary.[959]

In cases where the borrower has had increased expenses, evidence should be presented showing that the borrower will pay off certain expenses during the moratorium, be relieved of other expenses, or have increased the household income because of a dependent obtaining employment, in order to support the argument that the need for a moratorium is temporary.[960] A promise of support from a family member may also be persuasive on this issue.[961]

If RD/RHS contends that the circumstances for which the borrower is seeking relief are not temporary, insist that the staff person fully articulate the basis for the decision in writing so that your client can appeal it.

5.2.3 THE BORROWER MUST OCCUPY THE DWELLING

To be eligible for a moratorium, the borrower must occupy the dwelling, unless RD/RHS determines that it is uninhabitable.[962]

This condition should not disqualify individuals who are not occupying the home for a temporary period of time, such as migrant farm workers, from qualifying for relief.[963]

5.2.4 THE BORROWER'S ACCOUNT MUST NOT BE ACCELERATED

According to RD/RHS regulations, an individual whose loan is currently accelerated is not eligible for moratorium relief.[964] In other words, an individual whose loan has been accelerated may not reinstate the loan by seeking and receiving a moratorium.[965] This regulation is contrary to the moratorium statute and should be challenged.

Challenging post-acceleration denial of moratorium. The moratorium statute states that RD/RHS is authorized to grant a moratorium "[d]uring any time that [a Section 502 or 504] loan is outstanding. . . ."[966] Two courts that have reviewed the statute have concluded that its language is clear and that prior agency policy and regulations prohibiting post-acceleration moratorium relief are invalid on grounds that they are contrary to the statute.[967]

Nonetheless, when FmHA revised the moratorium regulations in 1991, it continued to include a provision that prohibits post-acceleration moratorium relief.[968] FmHA justified its actions in a rather lengthy response to public comments, which was obviously written to support its future litigation position. In sum, the response states that FmHA is vested with the responsibility of interpreting and administering the moratorium statute; that the statute "authorizes" FmHA to grant a moratorium and that the term "authorized" "should not be read as requiring [FmHA] to consider granting a post-acceleration moratorium;" that it is reasonable for FmHA to draw the line and restrict the availability of moratoriums to the period prior to acceleration, because borrowers are advised of various servicing options that are available and given ample opportunity to apply for relief prior to acceleration; and that it is inappropriate to extend a moratorium to a

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Title & Trust Co., 1985 WL 3617 (N.D. Ill. Nov. 1, 1985) (HUD mortgagor's prospective recovery of personal injury damages is insufficient when no definite date for settlement or litigation of claim has been set).

[959] *See Brown v. Kemp*, *supra* note 924.

[960] *See* HUD Handbook 4330.2, Rev-2 (March 24, 1995), *supra* note 24, ¶ 2-10; *FNMA v. Rathgens*, *supra* note 932.

[961] *See Gray v. HUD*, No. 89-CV-71860 (E.D. Mich. Nov. 7, 1990) (Clearinghouse No. 45,473) (HUD abused its discretion when it failed to consider plaintiff's mother's pledge for financial assistance and plaintiff's ability to improve her employment status). *But see Howell v. Pierce*, No. 84-1424 (5th Cir. Oct. 25, 1984) (HUD did not act arbitrarily when it concluded that the borrower did not have a reasonable prospect to resume mortgage payments when child support payments upon which the borrower was relying were sporadic).

[962] 7 C.F.R. § 3550.207 (A)(2) (2009). *See Lamison v. HUD*, No. 83-766 (W.D. Pa. Apr. 1, 1983) (Clearinghouse No. 44,418) (under the HUD Assignment Program, uninhabitable house may be considered principal place of residence when mortgagor takes steps to rehabilitate it).

[963] 52 Fed. Reg. 243, 245 (Jan. 5, 1987) (FmHA response to comments on occupancy requirements in 1987 final rulemaking). Borrowers who are away from their home for job training, school, or who are employed in another locality on a temporary basis should also qualify for relief.

[964] 7 C.F.R. § 3550.207 (A) (3) (2009).

[965] This regulation does not preclude RD from granting a moratorium to a borrower whose loan is reinstated pursuant to a borrower's offer to cure a default.

[966] 42 U.S.C.A. § 1475 (West 2003).

[967] *United States v. Shields*, *supra* note 948, at 782-85; *United States v. Rodriguez*, 453 F. Supp. 21, 22 (E.D. Wash. 1978).

[968] 56 Fed. Reg. 6,939, 6,949 (Feb. 21, 1991).

borrower who was ineligible for relief prior to acceleration and only becomes eligible thereafter because such a borrower will not have the means with which to repay the loan at the end of the moratorium period. Specifically relying on *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,[969] FmHA concluded that the "restriction that moratoria cannot be applied for after acceleration is a reasonable exercise of the Agency's rulemaking discretion."[970]

FmHA's arguments were, for the most part, rejected by the court in *United States v. Shields*,[971] and should not prevail. There, the court specifically rejected FmHA's contention that the statute's use of the term "authorized" granted FmHA the discretion over whether to grant a moratorium to a qualifying borrower. "If a borrower qualifies for a moratorium, [FmHA] must grant one."[972] The court also rejected the argument that the agency is free to interpret the statute as it chooses.

The interpretation put on a statute by the agency charged with administering it is entitled to deference, but the courts are the final authority on issues of statutory construction. A plain reading of 42 U.S.C.A. § 1475 leads us to conclude that the blanket prohibition of post-acceleration moratorium relief embodied in 7 C.F.R. § 1951.313(b)(3) [1979] is invalid. Such a prohibition is contrary to the statutory mandate that the Secretary grant moratorium relief to a borrower who, at any time his or her loan is outstanding, can satisfy the requisite substantive grounds for relief.[973]

Indeed, it is doubtful that agency interpretation of the statute should be given any deference when the statute was enacted nearly 40 years prior to the interpretation; when no legislative history supports the agency's position; when, for nearly 25 years after enactment, the agency refused to implement the statute at all and thereafter did so in a restrictive manner; and when the statutory interpretation was adopted after litigation that resulted in decisions adverse to the agency's position.

The court in *Shields* also rejected FmHA's argument that its loan servicing prior to acceleration makes it reasonable to restrict post-acceleration moratoriums. Contrary to FmHA's contention, the court found it conceivable that a borrower whose loan was accelerated could demonstrate an ability to repay the loan in full or to resume scheduled payments after a temporary moratorium. The court referred to other FmHA regulations that recognize the possibility of post-acceleration rehabilitation and permit borrowers to make offers to cure delinquencies after acceleration has occurred.[974]

A post-acceleration moratorium may also be appropriate in circumstances where the borrower has not received the RD/RHS default notices and does not become aware of the default until after the acceleration. Such a case could arise when a husband and wife separate and one of them assumes the obligation for making the mortgage payment to RD/RHS.[975] If that person also controls the mail received by the former spouse, the borrower who is not making the RD/RHS payments will not learn of the default until a notice of sale is posted on the property or otherwise brought to the borrower's personal attention. Since that person will not have had notice of the default nor of the opportunity to apply for a moratorium, RD/RHS regulations would deprive that person from applying for a moratorium.

Notwithstanding the fact that RD/RHS' regulatory position is contrary to *Shields*, it has settled at least two Vermont cases that have challenged its failure to consider a post-acceleration moratorium.[976] Moreover, in several administrative appeal cases, RD/RHS has suspended the acceleration in order to give the borrower the opportunity to appeal the denial of the moratorium.

RD/RHS asserted the post acceleration rule in one case in which the borrower contended that the agency failed to respond to her request for a moratorium. The court rejected RD/RHS' assertion by stating that the borrower was not seeking a post-acceleration moratorium, but rather, a review of the

[969] 467 U.S. 837 (1984).
[970] 56 Fed. Reg. 6,939, 6,943-44 (Feb. 21, 1991).
[971] *Supra* note 948.
[972] *United States v. Shields*, *supra* note 948, at 783.
[973] *Id.*, at 784 (citations omitted).
[974] *Id.*, at 784 (referring to 7 C.F.R. § 1955.15(d)(3) (1994)).
[975] *See id.*, at 779.
[976] *United States v. Taylor*, No. 2:92CV-396 (D.Vt. April 29, 1994); *United States v. Cox*, No. 2:92CV 345 (D.Vt. Aug. 23, 1993).

agency's failure to consider a moratorium request before the acceleration.[977]

5.2.5 CONDITIONS UPON WHICH A MORATORIUM IS GRANTED

5.2.5.1 Agreement to Notify RD/RHS of Changed Circumstances[978]

Borrowers who obtain a moratorium agree to advise RD/RHS if there is a change in their circumstances that would justify cancellation of the moratorium.[979] It is not clear, however, what consequences other than cancellation of the moratorium would flow from the borrower's failure to notify RD/RHS.

5.2.5.2 Payment of Unreimbursed Expenses

Borrowers who obtain a moratorium because they incurred unexpected and unreimbursed expenses agree to apply at least an amount equal to the deferred mortgage payment toward those expenses during the moratorium period.[980] The failure to apply deferred mortgage payments toward the unreimbursed expenses may result in cancellation of the moratorium either at the annual review[981] or at such earlier time as the expenses were scheduled to be repaid.[982]

5.2.5.3 Obligation to Pay Taxes and Insurance

A borrower who obtains a moratorium agrees to pay real estate taxes or hazard insurance premiums during the moratorium period and agrees that if he or she is unable to make these payments, RD/RHS will do so and charge the amount to the borrower's loan account.[983]

5.3 PERIODS FOR WHICH MORATORIUM RELIEF MAY BE GRANTED

5.3.1 PROSPECTIVE RELIEF

A moratorium may be granted for a term not to exceed two years that would enable the borrower to resume mortgage payments.[984] A moratorium granted for a two-year term may be cancelled at anytime that the borrower's circumstances change to the point that the borrower no longer needs relief or the borrower breaches the conditions upon which the moratorium was granted.[985]

A borrower may qualify for a new moratorium at the expiration of any moratorium period, provided there are different grounds for the new moratorium.[986] For example, a borrower who obtained a two-year moratorium after she lost her job may obtain an additional two-year moratorium if due to an illness, she incurred unexpected and unreimbursed expenses that she must repay.

Challenging the two-year moratorium period. Borrowers who are in need of a moratorium longer than two years should consider challenging the two-year limitation on the ground that the agency did not publish the limitation for prior comment and did not provide an adequate explanation for its adoption.

Prior to 1987, FmHA granted moratoriums for six-month terms, renewable for up to three years.[987] When FmHA proposed to revise the regulations in effect prior to 1987, it did not propose to alter the term for which moratoriums could be granted.[988] It did propose to deny borrowers the right to appeal FmHA's failure to extend a moratorium if they did not supply FmHA with information that would justify an extension.[989] When commentators suggested that the proposal would violate bor-

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[977] *United States v. Childers*, 152 Ohio App. 3d 622, 628 (Ohio App. 4 Dist. 2003).

[978] Handbook 2-3550 ¶ 5.5 D (Rev. 7/13/05). Since, however, RHS has no means of determining whether the borrower will abide by the condition, it operates as a condition upon which assistance is granted.

[979] *Id*. *See* Form RD 1951-23 (Rev. 5/97).

[980] 7 C.F.R. §3550.207 (b)(iii) (2009); Form RD 1951-23, (Rev. 5/97).

[981] *See* § 5.5.4, *infra*.

[982] 7 C.F.R. §3550.207 (b)(iii) (2009); Handbook 2-3550 ¶ 5.5 D (Rev. 9/3/08).

[983] Form RD 1951-23, (Rev. 5/97).

[984] 7 C.F.R. §§ 3550.10 and 3550.207 (2009).

[985] *Id.* at § 3550.207 (b); Handbook 2-3550, ¶ 5.5 E (Rev. 9/3/08).

[986] *See* Box titled "Multiple Moratoriums" at Handbook 2-3550 ¶ 5.5 A (Rev. 7/13/05).

[987] *Id*. ¶¶ 1951.313(b)(4) and (b)(5) (1987).

[988] *See* 50 Fed. Reg. 38,663, 38,667-68 (Sept. 24, 1985).

[989] *Id*. at 38,668 (proposed ¶ 1951.313(e)(2)).

rowers' due process rights, FmHA decided that moratoriums would be granted for a term of two years and be subject to review and cancellation annually at the time of Interest Credit renewal, or if the borrower is not receiving Interest Credit, on the moratorium's anniversary date.[990] FmHA's decision to eliminate the renewable six-month terms in favor of a single fixed term, during which the moratorium is periodically reviewed and subject to cancellation, appears to be a rational and considered compromise between the agency's and commentators' positions. However, it did not necessitate nor justify the shortening of the total allowable moratorium term from three to two years. Thus, it is arguable that adoption of the two-year limitation was arbitrary and capricious because the decision was not published for prior rulemaking and because it failed to establish a rational connection between the need to reduce the administrative burdens on the agency and the shortening of the moratorium period.[991]

It is possible that the two-year limitation could also be challenged on the ground that it is simply too short, particularly at times of economic hardship when unemployment rates are high for prolonged periods of time.

5.3.2 RETROACTIVE RELIEF

RD/RHS does not grant a moratorium for any time prior to the borrower's application date except possibly in response to litigation.[992] This is true even if it can be shown that the agency failed to notify the borrower of the availability of a moratorium.

RD/RHS' failure to grant moratorium relief retroactively is significant only in a limited number of cases. This is due to the fact that at the end of the moratorium period, when a repayment plan is developed, RD/RHS does not distinguish between the arrearage that has accrued on the loan during the moratorium period and that which accrued prior to the moratorium. The agency typically recalculates the borrower's monthly payments based on the total arrearage on the loan.[993] Thus, the period for which a retroactive moratorium is granted will be significant only if the moratorium granted was for fewer than two years and the borrower, in order to cure the default, must have the interest that accrued during the moratorium cancelled.[994] Unfortunately, it is impossible to predict at the time a moratorium is granted whether a borrower will need this form of relief.

Regardless, it is doubtful that RD/RHS will extend retroactive moratorium relief unless it is engaged in litigation. If RD/RHS refuses to do so, argue that its failure to extend retroactive relief, particularly when the agency failed to inform the borrower promptly or properly of the availability of relief, illegally deprives the borrower of the program's benefits.

5.4 ACTIONS AT EXPIRATION OF THE MORATORIUM PERIOD

The extension of moratorium relief does not relieve a borrower of any obligations to RD/RHS. Payments excused during the moratorium period are merely deferred and unless partially cancelled at the end of the moratorium period, must be repaid by the borrower. The borrower additionally has an obligation to resume ordinary loan payments at the end of the moratorium.

Since borrowers ending a moratorium period are probably in worse financial condition than they were before becoming eligible for moratorium relief and since for most borrowers, payments at the end of the moratorium period are higher than payments before or during the moratorium period, it is crucial

[990] *See* 52 Fed. Reg. 243, 245 (Jan. 5, 1987).
[991] *See United States v. Garner*, 767 F.2d 104, 117-23 (5th Cir. 1985).
[992] *See United States v. Smith*, No. H-76-230 (D. Conn. Dec. 21, 1977) (stipulation for dismissal). FmHA agreed to settle a foreclosure case by granting moratorium relief to the borrower for all payments due and owing at the time of settlement. Actually, FmHA did not characterize the relief as a retroactive moratorium, but maintained that it was only prospective. It agreed, however, to a moratorium on all payments of principal and interest presently due and owing, which was five years' worth at the time of settlement. Effectively, FmHA granted the defendant a five-year retroactive moratorium.
[993] 7 C.F.R. S 3550.207(c) (2009).
[994] *See* § 5.4, *infra*. Indeed, when a borrower is likely to require a two-year moratorium, it may be disadvantageous to argue for retroactive relief because the period of the borrower's prior default will be included in the moratorium period.

that the rescheduling of deferred payments be realistic. RD/RHS has several servicing alternatives available to ease the borrower's obligations. These include the cancellation of interest, increased interest subsidy, and reamortization or rescheduling of payments. It is important to become familiar with each alternative to ensure that your client is receiving the proper and maximum assistance.

The type of assistance available depends on your client's ability to repay the loan and arrearage at the end of the moratorium period. Ability to repay is determined by completing a household Budget and/or Financial Statement form[995] and verifying the borrower's income.[996]

Once the borrower's ability to repay has been determined, the loan will be reamortized to include the amount deferred during the moratorium and the borrower will be required to escrow tax and insurance payments. In addition, annual borrowers will be required to change to monthly payments. If the new monthly payment, after consideration of the maximum amount of payment subsidy available to the borrower, exceeds the borrower's repayment ability, all or part of the interest that has accrued during the moratorium may be forgiven.[997]

Reamortization. Unless the borrower is able to pay the arrearage accrued before and during the moratorium, something which is likely to only occur rarely, the borrower's loan will be reamortized over the remaining term of the loan or if the original loan was not for the maximum term, the maximum term of the original loan less the number of years the loan has been outstanding. This extension may only be approved if the agency's security interest is not affected.[998]

Cancellation of interest accrued during the moratorium. If reamortization over the maximum permissible period still does not result in the payment coming within the borrower's repayment ability, the RD/RHS must consider cancellation of part or all of the interest that accrued during the moratorium period for borrowers whose payments, after all the interest subsidies for which they are eligible has been extended, exceed the borrower's repayment ability.[999] Interest will be cancelled only to the extent necessary to bring the resulting payments within the borrower's repayment ability.[1000]

Example. Mr. Jones, who had a $25,000 RD/RHS loan at 9-percent interest before interest subsidy, was unemployed for a period of two years, during which he was unable to make any mortgage payments. Mr. Jones was receiving Interest Credit and his monthly payments before obtaining moratorium relief were $88. When the moratorium period began, the loan servicer reduced the monthly payments to $75 by granting Mr. Jones the maximum amount of Interest Credit for which he was eligible. These payments were then deferred by the moratorium. At the beginning of the moratorium, Mr. Jones's loan had been in effect for seven years. At the end of the moratorium, RD/RHS determined that Mr. Jones continued to be eligible for the maximum amount of Interest Credit, leaving his payment at $75, and that his repayment ability was $79 per month. Mr. Jones's payments deferred by the moratorium totaled $1,800 ($75 multiplied by 24 months).

The remaining term of Mr. Jones's loan is 24 years (33 years minus nine years). After seven years of payments, the principal balance on his loan is $21,053.21. The total owed by Mr. Jones to RD/RHS after the moratorium period is $22,853.21 ($21,053.21 plus $1,800). This translates into a monthly PITI payment of $ 83.21. Since the monthly payment, based on Mr. Jones' income, is in excess of his ability to repay. RD/RHS must consider canceling part of the interest accrued during the moratorium period.

At the end of seven years, $17.54 of Mr. Jones's $75 payment to RD/RHS goes toward the principal, while $57.46 goes toward interest. RD/RHS may therefore cancel up to $1,379.04 ($57.46 multiplied by 24 months) of Mr. Jones's obligation. In fact, Mr. Jones's ability to pay $79 per month enables him to amortize a loan of $21,696.39, or $1,156.82 less than the amount due ($22,853.21). Therefore, RD/RHS must cancel $1,156.82 of the $1,379.04 in interest that accumulated during the moratorium period. Thus, after the moratorium, Mr. Jones will have a principal balance

[995] Form RD 1944-3 (Rev. 6/97).
[996] 7 C.F.R. § 355.207 (b)(2) (2009); Handbook 2-3550 ¶ 5.5 F (Rev. 9/3/08).
[997] 7 C.F.R. § 3550.207 (c) (2009).
[998] *Id.* §§ 3550.208 (a)(2) and 3550.207 (c).
[999] *Id.* § 3550.207 (c).
[1000] *Id.* Handbook 2-3550, ¶ 5.5 F (Rev. 9/3/08).

of $21,696.39 on his loan and his monthly payments will be $79.

Foreclosure. RD/RHS regulations state that if the borrower's repayment ability is so low that the borrower is still unable to resume making scheduled payments, even if the account were reamortized, all authorized interest subsidy granted, and accrued interest cancelled, the account must be liquidated.[1001] In other words, the borrower is given the option of selling the property and recovering any equity he or she may have or facing foreclosure.

5.4.1 CHALLENGING A FORECLOSURE FOR LACK OF REPAYMENT ABILITY

When representing a borrower who is facing foreclosure because he or she lacks repayment ability, consider a challenge to the foreclosure. There are three grounds upon which such a challenge may be based: (1) that RD/RHS may not foreclose on the loan because there has been a waiver of past defaults during the moratorium and there has not been a new default after the moratorium; (2) that the regulation authorizing the fore- closure without offering the borrower an opportunity to continue with the loan is arbitrary and capricious and contrary to the national housing goals; and (3) that RD/RHS' failure to consider refinancing the borrower's loan prior to foreclosure is contrary to Section 502 of the Housing Act of 1949.

Lack of default. When RD/RHS grants a moratorium, it reinstates the account such that the borrower is effectively current. In the alternative, you may argue that by granting a moratorium, the agency has waived its right to accelerate for defaults prior to the moratorium. In either case, RD/RHS should not be able to accelerate the loan unless the borrower has defaulted on a payment subsequent to the moratorium's expiration. The mere fact that the borrower does not "show" repayment ability is not a ground for accelerating the loan.

RD/RHS' failure to provide the borrower an opportunity to retain the home is arbitrary and capricious and contrary to the national housing goals. By refusing to set the borrower's payment at a level that effectively extends all the assistance available to the borrower after a moratorium and instead, proceeding to foreclose on the loan, RD/RHS deprives the borrower of the opportunity of becoming a successful homeowner. Basing its decision on a family budget form, RD/RHS in effect is denying the borrower the right to choose to default on other obligations or to forgo certain other expenditures in order to retain his or her home. Moreover, RD/RHS exacerbates the problem by not even advising the borrower what payment to make should he or she choose to make payments and by otherwise not offering the borrower the maximum assistance that could be extended after a moratorium.

There can be no question that RD/RHS' failure to provide the borrower with the maximum available assistance and instead, proceeding to foreclosure is simply inconsistent with the goal of providing a decent, safe and sanitary home for every American family and with the congressional admonition that RD/RHS exercise all of its authorities in a manner consistent with that goal.

Refinancing. Since 1974, RD/RHS has had statutory authority to use Section 502 loan funds to refinance loans made to its own borrowers whenever they cannot make loan payments for reasons beyond their control.[1002] Despite this statutory authority, RD/RHS has failed to make refinancing of Section 502 loans available to all but a limited number of its borrowers[1003] and has thus denied many otherwise eligible borrowers an extremely effective form of assistance.

Refinancing is crucial to borrowers who face foreclosure at the end of a moratorium period because they cannot make monthly payments equal to or greater than the monthly payment they would have made before the moratorium had they been receiving the maximum amount of interest subsidy authorized. Whether RD/RHS reamortizes the loan or cancels the interest due, under existing regulations it will seldom[1004] reduce the borrower's pay-

[1001] *Id.* §§ 3550.207 (d) and 3550.211.

[1002] 42 U.S.C.A. § 1471(a) (West 2003).

[1003] *See* § 5.6.4, *infra*.

[1004] Only one very small group of borrowers is eligible for potentially reduced payments. This group consists of borrowers whose Section 502 loans were not amortized over the maximum legal term prior to the moratorium. Because RHS authorizes the extension of these loans to the maximum legal term in connection with reamortization, 7 C.F.R. § 3550.208

ments to a level below that for which the borrower would have been eligible before the moratorium. Therefore, absent refinancing, RD/RHS will always foreclose on these borrowers' loans.

For example, if prior to obtaining moratorium relief, a borrower was making monthly payments of $75, the lowest payment possible for a $25,000 loan, under existing authorities, RD/RHS may not reduce that borrower's payments below $75 after the moratorium period. In fact, because RD/RHS may not cancel principal payments deferred during the moratorium period, the borrower's payments will always exceed $75.

If RD/RHS were to implement its refinancing authority, it could reduce the borrower's monthly payment to below that for which he or she was previously eligible. This could be accomplished by extending the term of the loan beyond the original term plus the period of the moratorium and by increasing the amount of interest subsidy provided.

Another example illustrates the advantages of refinancing. Assume the same facts as in the previous example of Mr. Jones,[1005] except that his monthly repayment ability after the moratorium period is $68 instead of $79. Even if RD/RHS cancels all of the interest that was due during the moratorium period ($1,379.04), Mr. Jones must still amortize $21,474.17 over a maximum of 26 years, which at best will reduce his monthly payment to $79 per month, or $11 in excess of his ability to repay. If RD/RHS were to use its refinancing authority, it could finance the total principal due ($21,053.21) plus the total arrearage due ($l,800)over a period of 33 years, reducing Mr. Jones's monthly payment after the moratorium to $68.

The validity of an earlier FmHA regulation prohibiting the use of refinancing as a servicing tool was successfully challenged on procedural grounds in *United States v. Garner*.[1006] In that case, FmHA borrowers argued that the regulation prohibiting FmHA from refinancing Section 502 loans was contrary to statute and not reasonably adopted and that FmHA should be enjoined from foreclosing on their loan until it considered their request to refinance their Section 502 loan. The District Court agreed with the defendants and enjoined the foreclosure.[1007]

The Court of Appeals for the Fifth Circuit affirmed the injunction and held that the regulation prohibiting the refinancing of Section 502 loans was not a product of reasoned decision-making and that the procedure used to adopt the regulation violated the Administrative Procedure Act because no general concise statement of basis and purpose was published when the regulation was adopted.[1008] The court did not, however, affirm the district court's conclusion that FmHA was obligated as a matter of statutory law to implement a refinancing program for Section 502 borrowers. Instead, it held that FmHA has a duty to implement some form of refinancing program and that in implementing such a program, FmHA does not enjoy unfettered discretion, but instead must conform to the objectives of the Section 502 program in a way that encourages borrowers to manage their finances and fully meet their loan obligations.[1009]

In 1987, when FmHA revised its refinancing regulations, it permitted the use of refinancing as a servicing tool for two types of Section 502 loans in order to enable borrowers who were previously ineligible for Interest Credit to qualify for assistance. Specifically, it authorized borrowers who obtained FmHA loans prior to August 1, 1968 to refinance their loans after a moratorium, when the borrowers were in need of Interest Credit to retain their homes. It also permitted borrowers who had purchased FmHA inventory property on a Non-program[1010] basis to refinance the loan as a Section 502 loan with Interest Credit if the borrower became eligible by virtue of changed circumstances.[1011] FmHA, however, again refused to use refinancing as a loan servicing tool for borrowers already eligible for moratorium relief and Interest Credit.[1012] These limited refinancing opportunities have been extended to regulations currently in effect.[1013]

(b) (2006), it is possible that reamortization will reduce these borrowers' monthly payments.

[1005] *See* § 5.4, *supra*.

[1006] *Supra* note 991.

[1007] *United States v. Garner*, 567 F. Supp. 313 (N.D. Miss. 1983).

[1008] *United States v. Garner*, *supra* note 991, at 123.

[1009] *Id.* at 104.

[1010] A Non-program (NP) loan is a loan made to an individual ineligible for an FmHA Section 502 loan for the purchase of FmHA inventory property.

[1011] 7 C.F.R. § 1951.315 (1994).

[1012] 52 Fed. Reg. 243, 245-46 (Jan. 5, 1987).

[1013] 7 C.F.R. § 3550.204 (2009).

In refusing to authorize the use of refinancing as a loan servicing tool for other Section 502 borrowers, FmHA stated that it believed that under the new regulations, the payment levels for shelter for most borrowers coming off a moratorium are likely to be within an acceptable percentage of income.[1014] While effectively admitting that the payment level for some borrowers would be excessive, the agency glossed over its refusal to allow for refinancing by stating that such borrowers "would receive a moratorium until normal income was restored or two years passed."[1015]

In appropriate circumstances, RD/RHS' continued refusal to use refinancing as a post-moratorium loan servicing tool can and should be challenged on the grounds that the agency has not engaged in a reasoned decision-making process. The fact that the percentage of income that a borrower devotes to shelter payments is within RD/RHS' "acceptable range" is irrelevant if the borrower does not have sufficient disposable income to make such a payment. In other words, if a borrower does not have adequate ability to repay a loan with, for example, 25 percent of his or her adjusted income, it is irrelevant that RD/RHS considers 25 percent to be a reasonable percentage of income to devote to shelter payments. Indeed, RD/RHS instructs its staff to foreclose on a borrower's account not on the basis of the percentage of income that the borrower would devote to shelter payments, but rather on whether or not the borrower has sufficient disposable income to repay the loan.[1016]

With respect to those borrowers whose payments are likely to exceed RD/RHS' acceptable range, the agency's assumption that their income at the end of a moratorium would in all cases return to a normal level is without support. It is unquestionable that some borrowers, through no fault of their own, will experience long-term reductions in income or increases in necessary living expenses that will not be altered during a two-year moratorium.

In short, RD/RHS' rulemaking process has ignored the rationality test that the Court of Appeals in *Garner* suggested must be met before the agency's refusal to use refinancing as a loan servicing tool can be considered the product of a reasoned decisionmaking process. As stated by the court:

A moratorium functions essentially only to provide the borrower with a short-term breathing spell, not reduced monthly payments. A moratorium cannot help the rural homeowner who, through no fault of his own, is suffering a long-term reduction of income or an increase in necessary living expenses. Refinancing, in contrast, appears uniquely suited to help such a borrower. By spreading the debt over a new amortization term, refinancing, although extending the duration of the obligation, can reduce the amount of the regular monthly installments, possibly significantly. In response to the government's own question, therefore, we cannot say, based on what is before this court, that refinancing would fail to save eligible FmHA borrowers in jeopardy of losing their homes when existing tools would be to no avail.[1017]

5.5 PROCEDURAL ISSUES

5.5.1 NOTICE OF AVAILABILITY OF MORATORIUM RELIEF

RD/RHS must notify borrowers of the availability of moratorium relief at the initial interview prior to loan closing[1018] and must provide borrowers with a moratorium application form whenever they become aware of circumstances beyond a borrower's control that may entitle the borrower to a moratorium or when the borrower requests a moratorium without filing a form.[1019] RD staff or contractors must also notify borrowers of the availability of moratorium relief in the course of servicing

[1014] *Id*. at 246. The hypothetical examples relied on by FmHA resulted in borrowers paying between 20% and 26% of their income for shelter.
[1015] *Id*. at 245-46.
[1016] "*Policy. When RHS determines* that a borrower is *unable* . . . to meet loan obligations, RHS may accelerate the loan and, if necessary, acquire the security property." 7 C.F.R. § 3550.211 (2009) (emphasis added). "If RHS determines that foreclosure is in the best interest of the Government, RHS will [initiate] acceleration. . .". *Id*. § 3550.211 (c).

[1017] *United States v. Garner*, *supra* note 991, at 122.
[1018] *See* Handbook 1-3550 ¶ 8.6 (Rev. 12/19/07) and Applicant Orientation Guide: Form RD 3550-23 (Rev. 04-07)
[1019] Handbook 2-3550 ¶ 5.5 B (Rev. 9/3/08).

the loan after the borrower has missed one or more payments.[1020]

Because RD/RHS has incorporated the notice of availability of moratorium relief into most of its loan servicing guide letters,[1021] the agency rarely fails to at least notify borrowers at some time of the availability of moratorium relief.[1022] Borrowers who have not received a notice of the availability of moratorium relief at any of the prescribed times should assert their right to apply for and if found eligible, receive moratorium relief as of the time they should have received the notice, notwithstanding the restriction denying moratorium relief after loan acceleration.[1023] RD/RHS may not deny borrowers retroactive relief when it has failed to notify the borrower of its availability in the first place.[1024]

Although careful not to characterize the settlement of *United States v. Smith* as retroactive moratorium relief,[1025] FmHA effectively provided the borrower with moratorium relief extending retroactively for nearly five years.[1026]

Adequacy of the notice. When RD/RHS informs borrowers of the availability of moratorium relief, the notice is often either extremely brief or highly technical. It provides the borrower with little information other than that he or she may be eligible for something called "moratorium relief." One expert has concluded that it takes the average reading level of a college freshman to understand the simplest RD/RHS moratorium notice and that the more complex notices require a postgraduate reading level.[1027] Since many RD/RHS borrowers have a limited educational background[1028] and limited reading skills, and since RD/RHS has actual knowledge of each borrower's education level,[1029] it is arguable, at least for borrowers of limited education, that the RD/RHS notice is insufficient to provide adequate notice.[1030] The restriction on receiving a moratorium after acceleration should thus not be applicable to them.[1031]

5.5.2 DUTY TO PROVIDE A MORATORIUM APPLICATION FORM TO BORROWER

CSC has an affirmative obligation to provide borrowers with a moratorium application form whenever it becomes aware of circumstances that may make a borrower eligible for relief or when the borrower requests a moratorium without filing a moratorium form.[1032] The failure to provide borrowers with the application form has been held a violation of servicing regulations and is grounds for terminating a foreclosure.[1033]

[1020] *See* Handbook 1-3550 ¶ 13.4 H (Rev. 1/23/03); 7 C.F.R. § 3550.202(b) (2009).

[1021] *See e.g.*, FmHA Guide Letter 1951-G-9 (11/24/93).

[1022] *But see Lee v. Bergland*, No. 78-1222 (D. Idaho filed Aug. 23, 1978), 13 CLEARINGHOUSE REV. 311 (Aug. 1979) (No. 26,896); *Rau v. Cavenaugh*, No. 78-5105 (D.S.D. filed Dec. 8, 1978), 14 CLEARINGHOUSE REV. 1193 (Mar. 1981) (No. 30,749).

[1023] *See* § 5.3.2, *supra*. *United States v. Childers*, 152 Ohio App. 3d 622, 628 (Ohio App. 4 Dist. 2003).

[1024] *See United States v. White*, 429 F. Supp. 1245 (N.D. Miss. 1977) (on remand); *United States v. Roberts*, No. 79-78 (D.V.I., July 3, 1979) (stipulation).

[1025] *Supra* note 992 (stipulation for dismissal).

[1026] *See supra* note 992.

[1027] Affidavit of Jane L. Davison, Ph.D., *United States v. Rice*, No. 79-2291-2 (D.S.C. filed Mar. 11, 1980), 14 CLEARINGHOUSE REV. 172 (June 1980) (No. 28,869).

[1028] A 1979 study by USDA's Economics, Statistics and Cooperative Service, "Mortgaged Rural Homes, Characteristics of Housing Units and Occupants," study disclosed that nearly 20percent of all borrowers whose loans were closed before 1974 had fewer than 8 years of education.

[1029] RD/RHS' initial application form requires borrowers to indicate their educational level. Form RD 410-4 (Rev. 10/06).

[1030] *See United States v. Gomiller*, 545 F. Supp. 17, 21 (N.D. Miss. 1981). *See also Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 314 (1950). Indeed, RD acknowledges as much when it states, in its servicing handbook, that "although some borrowers may be knowledgeable enough to request a moratorium, more typically CSC will recognize that a borrower is a candidate for a moratorium and propose it to the borrower." Handbook 2-3550 ¶ 5.5 B (05-27-98 Rev. 09-03-08).

[1031] *But see United States v. Ford*, 551 F. Supp. 1101, 1106 (N.D. Miss. 1982) (borrowers with limited education waived their right to a moratorium when they failed to request a moratorium after receiving a notice advising them of the program's availability).

[1032] Handbook 2-3550 ¶ 5.5 B (Rev. 9/3/08).

[1033] In *United States v. Childers*, 152 Ohio App. 3d 622 (Ohio App. 4 Dist. 2003), a foreclosure action, the court denied RD/RHS' motion for summary judgment for failure to provide the borrower an opportunity to apply for moratorium relief when she requested assistance. NAS Appeal Decision (Calif. June 9, 1989 (Blackburn)); NAS Appeal Decision (Virginia, Aug. 30, 1988 (Crutchfield)).

5.5.3 APPLYING FOR MORATORIUM RELIEF

Borrowers seeking a moratorium must complete a Moratorium on Payment application.[1034] CSC should assist borrowers who need help in completing the application. If the borrower meets the moratorium eligibility requirements, he or she, with the assistance of the CSC, must also complete a Budget and/or Financial Statement form[1035] to enable RD/RHS to determine whether given the new circumstances, the borrower is unable to make the scheduled payments.[1036]

There is no deadline by which CSC must approve or disapprove a request for moratorium relief. RD/RHS regulations previously required a decision within 15 days after a completed written request for relief was filed with the County Office,[1037] However, that requirement was removed in the 1996 rewriting of the regulations. Regardless when CSS acts, the eligible borrower should be able to obtain relief retroactively to the date the application was filed.[1038]

The CSC official reviewing the moratorium request must record his or her decision on the borrower's application form.[1039] If the request is denied, CSC must notify the borrower in writing. This notice must inform the borrower of the action taken, the facts upon which the decision is based, and the specific reasons for denial of the requested relief. The notice must also invite the borrower to request an informal review of the decision, which may take place by phone or in-person, at which the borrower may be represented by another person. The notice must also advise the borrower of the right to request mediation and of the right to appeal the decision in accordance with USDA's appeal procedure.[1040]

RD/RHS staff has been known to have discouraged applicants from applying for moratorium relief or to have informally advised them that they are ineligible for assistance. Both practices violate borrowers' procedural and substantive rights and are grounds for terminating or reversing acceleration of the loan or a foreclosure sale.[1041] Specifically, the practice violates the borrower's right to apply for assistance, the right to notice of an adverse decision and to notice of an opportunity to appeal, the right to mediate, and the right to appeal an adverse decision.

5.5.4 REVIEW OF CONTINUED ELIGIBILITY FOR A MORATORIUM

CSC may periodically review borrowers' continued eligibility for moratorium relief and must do so at least every 6 months.[1042] Prior to the review, RD/RHS should write to the borrower and request that he or she provide the agency with appropriate financial information supporting the continued need for a moratorium.[1043] If the borrower fails to submit the requested information, the agency receives information that the borrower is no longer eligible for relief, or when the moratorium was granted on the basis of the borrower needed to pay unexpected and unreimbursed expenses, the borrower does not submit information showing that those expenses are being met during the moratorium period, CSC will terminate the moratorium. CSC must notify the borrower of its decision, and if the borrower then submits the required information within 30 days, it must continue with the moratorium.[1044]

It is unclear whether the borrower has a right to seek a new moratorium on the same grounds when he or she has failed to promptly respond to RD/RHS' initial request for additional information and the moratorium has been in effect less than two years. In the interest subsidy program, a borrower who fails to promptly recertify income loses the assistance until such time as he or she completes the recertification process.[1045] No similar provision ex-

[1034] Form RD 1951-23 (Rev. 5/97).
[1035] Form RD 1944-3 (Rev. 6/97).
[1036] Handbook 2-3550 ¶ 5. C (Rev. 9/3/08).
[1037] 7 C.F.R. § 1951.313(d) (1994).
[1038] Handbook 1-3550 ¶ 1.9 E (Rev. 11/7/07).
[1039] Form RD 1951-23 (Rev. 5/97).
[1040] Handbook 2-3550 ¶ 5.5 C (Rev. 9/3/08).

[1041] *United States v. Gomiller*, *supra* note 1030; *see Higgins v. Block*, Civ. No. 84-257 (D.Vt. Apr. 2, 1985) (stipulation of settlement).
[1042] 7 C.F.R. § 3550.207(b) (2009); Handbook 2-3550 ¶ 5.5 D (Rev. 9/3/08).
[1043] *Id*.
[1044] 7 C.F.R. § 3550.207 (b)(1) (2009); Handbook 2-3550, ¶ 5.5 E (Rev. 9/3/08).
[1045] 7 C.F.R. § 3550.157 (2009).

ists in the moratorium regulations. However, the Handbook suggests that only one moratorium may be granted in response to a single precipitating event.[1046] It is unclear whether RD/RHS intended this restriction to apply in cases where the borrower has not had a full two-year moratorium and cancellation was caused by the borrower's failure to promptly respond to the recertification request. One way of addressing the issue is to request that RD/RHS make an exception to the regulations under the RD/RHS Administrator's exception authority.[1047]

If at the time of the review, a borrower who obtained a moratorium because of a decrease in household income has not had a change in circumstances that enables that borrower to resume making payments on the loan, the borrower's moratorium continues in effect until the next review period or the expiration of two years, whichever is earlier.

A borrower who obtained a moratorium because of unexpected and unreimbursed expenses may have his or her moratorium continued if the circumstances that precipitated the moratorium have not changed and if the borrower has paid an amount at least equal to the deferred mortgage payments towards the incurred expenses.[1048] The borrower's failure to make payments on the debt is grounds for cancellation of the moratorium.[1049]

5.5.5 CANCELLATION OF MORATORIUM RELIEF

A moratorium may be cancelled for three reasons. First, it may be cancelled if the borrower does not respond to a request for financial information.[1050] Second, it may be cancelled if the moratorium is no longer required. Thus, if the borrower's repayment ability has increased or the expenses that the borrower had incurred were repaid, the moratorium may be cancelled.[1051]

Third, if the moratorium was granted to enable the borrower to repay unexpected and unreimbursed expenses, a moratorium may be cancelled if the borrower fails to make payments towards those expenses that were at least equal to the deferred mortgage payments.[1052]

With several exceptions, borrowers whose moratoriums are cancelled must be informed of the cancellation and invited to an informal telephone, or in-person, review. The borrower must also be informed of the right to appeal the decision.[1053]

5.5.6 ACTIONS AT END OF MORATORIUM PERIOD

CSC has the burden of reviewing the borrower's repayment ability and deciding which of the various servicing alternatives, including cancellation of interest, may be used to reinstate the borrower's loan.[1054] *See* § 5.6, *infra,* for a discussion of other servicing alternatives.

5.5.7 APPEALS

Borrowers must be advised in writing of any decision denying a moratorium, cancelling a moratorium, a refusal to cancel interest that accrued during the moratorium, or a decision not to continue with a loan at the end of a moratorium. All of these decisions are adverse and appealable decisions.[1055] The letter advising the borrower of RD/RHS' decision must specify the basis for the decision and must advise the borrower of his or her appeal rights.[1056]

Current regulations provide a broad definition of 'adverse decision'[1057] and the Handbook identifies relevant unappealable decisions as those made by parties outside of the Agency, determination of interest rates, and the refusal by the field office to request a waiver.[1058]

[1046] Handbook 2-3550 ¶ 5.5 A (Rev. 9/3/08).
[1047] *Id.* ¶ 5.5 E.
[1048] *Id.*
[1049] *Id.;* 7 C.F.R. § 3550.207 (b)(iii) (2009).
[1050] 7 C.F.R. § 3550.207.(b)(i) (2009).
[1051] *Id.* § 3550.207(b)(ii).
[1052] *Id.* § 3550.207 (b)(iii).
[1053] *Id.*; Handbook 2-3550, ¶¶ 5.5 C (Rev. 9/3/08) and 1.9 (Rev. 11/7/07).
[1054] *See* 7 C.F.R. 3550.207 (c) (2009); Handbook 2-3550 ¶ 5.5 D (Rev. 9/3/08).
[1055] 7 C.F.R. §§ 3550.4 and 11.3 (2009), Handbook 2-3550, ¶ 1.9 (Rev. 11/7/07). Note that while the Handbook requires the RD/RHS to properly inform the participant of his or her appeal rights, the regulations put the burden on the participant to seek review. *See particularly* §§ 3550.4 and 11.5.
[1056] *See* Handbook 2-3550, ¶ 1.9, Exhibit 1-2, Sample Adverse Decision Letter.
[1057] 7 C.F.R. § 3550.11.1 and 7 C.F.R. Part 11 (2009).
[1058] Handbook 2-3550, ¶ 1.9 (B) (Rev. 11/7/07).

5.6 OTHER LOAN SERVICING TOOLS

Borrowers unable to make their loan, real estate tax, or insurance payments or who have failed to make such payments, may be eligible for other forms of assistance in addition to interest subsidy or moratorium relief. These may include rescheduling delinquent payments, reamortization, payment by RD/RHS of taxes or insurance, refinancing, the extension of an informal moratorium on payments, provision of additional interest subsidy, or credit counseling.

5.6.1 RESCHEDULING DELINQUENT PAYMENTS (DELINQUENCY WORKOUT AGREEMENTS)

Borrowers (either program or non- program) who have missed payments, on whose behalf RD/RHS has advanced tax or insurance payments, or who are ineligible for moratorium relief, may make-up missed payments by entering into an agreement to pay the arrearage over an extended period of time.[1059] RD/RHS refers to the formal repayment agreement as a Delinquency Workout Agreement (DWA).[1060] Arguably, even borrowers whose loans have been accelerated should qualify for a DWA if they have repayment ability, although reinstatement of the loan would have to be approved first.

RD/RHS has no guidelines about who is eligible for a DWA. At the very least, any borrower who has sufficient income to repay the delinquency either in a single payment or the shorter of two years or the life of the loan should be eligible for assistance.[1061] Arguably, RD/RHS' refusal to enter into a DWA with any borrower who has repayment ability may be challenged as being contrary to the purposes of the Section 502 loan program and the national housing goals.

With approval from a supervisor, CSC staff or a servicer may approve more than one agreement with the same borrower within a two-year period.[1062]

Borrower's ability to repay. When a borrower enters into an agreement to repay missed mortgage payments, CSC or the servicer may not set the period of repayment in an arbitrary manner.[1063] If the borrower has funds to make a lump-sum payment, a highly unlikely occurrence, he or she is obligated to do so.[1064] If the borrower does not have such funds, however, the period over which repayment is to occur must be established based on the borrower's ability to repay, provided the term of the agreement does not extend beyond the shorter of the remaining term of the loan or two years.[1065]

If the borrower will require more than 60 days to repay a delinquency, CSC will conduct an analysis of the borrower's financial circumstances, and if the borrower is found eligible, will require him or her to execute a DWA[1066] If repayment can be made in less than 30 days, the file will reflect a reaffirmation, and if more than 30 but less than 60 days, the borrower is simply required to receive a confirmatory letter.[1067]

The regulations provide that if the borrower becomes more than 30 days past due under a DWA, the RD/RHS "may" cancel the agreement.[1068] The Handbook states that in such circumstances, "the agreement is automatically cancelled."[1069] Since the Handbook does not have the force and effect of law, you should advocate that CSC exercise its discretion before terminating the DWA, particularly if your client can make the DWA account current.

Review of DWAs. To assist in oversight, borrowers seeking DWAs must agree to escrow accounts and annual payment borrowers with monthly income must convert to a monthly payment sched-

[1059] 7 C.F.R. § 3550.205 (2009).
[1060] Form RD 1951-37 (Rev. 5/97). Earlier versions of this form have been called Additional Payment Agreement, Additional Partial Payment Agreement or Supplemental Payment Agreement. Borrowers' rights varied somewhat under each of these agreements.
[1061] Arguably, even borrowers whose loans have been accelerated should qualify for a DWA if they have repayment ability, although reinstatement of the loan would have to be approved first. 7 C.F.R. § 3550.205 (2009). *See* § 6.3.2.2, *infra*.
[1062] Handbook 2-3550, ¶ 5.2. A (Rev. 7/13/05).
[1063] *Id.*, ¶ 5.2. C.
[1064] 7 C.F.R. § 3550.205 (a) (2009).
[1065] *Id.* Handbook 2-3550, ¶ 5.2 (Rev. 7/13/05).
[1066] Handbook 2-3550 ¶ 5.2 (Rev. 7/13/05).
[1067] *Id.*
[1068] 7 C.F.R. § 3550.205 (c) (2009)
[1069] Handbook 2-3550 ¶ 5.2. C. 4 (Rev. 1/9/08).

ule.[1070] Although the regulations do not detail authorized modifications, borrowers should be able to request a reduction in the DWA payment if circumstances justify it.

RD/RHS' servicing of DWAs and the consequences of a default under a DWA are also discussed in Chapter 6.[1071]

5.6.2 REAMORTIZATION[1072]

RD/RHS will consider reamortizing a loan to assist delinquent borrowers under a variety of circumstances including those enumerated at 7 C.F.R. § 3550.208 (2009). Aside from reamortization after a moratorium,[1073] RD/RHS may reamortize a loan to accomplish a variety of servicing actions, including, but not limited to: (1) repay unauthorized assistance due to inaccurate information;[1074] (2) repay principal and interest accrued and advances made during a moratorium;[1075] (3) bring current an account under a delinquency workout agreement;[1076] (4) to bring a delinquent account current in the case of an assumption where the due on sale clause is not triggered as described in 7 C.F.R. §3550.163(c) (2009);[1077] (5) to cover the remaining debt when a portion of the security property is being transferred but the acquisition price does not cover the outstanding debt;[1078] and (6) to bring an account current where the National Appeals Division (NAD) reverses an adverse action.[1079]

RD/RHS has the ability to reamortize loans after acceleration.[1080] This is particularly significant for borrowers whose loans were accelerated without RD/RHS having complied with its loan servicing obligations. Because RD/RHS normally does not accept payments after a loan has been accelerated, the borrower's delinquency will usually increase substantially in the period between acceleration and completion of a successful appeal. By authorizing a reamortization in order to reinstate the account, any increase in the borrower's monthly payment is minimized. However, if the borrower does not pay or request a hearing within 30 days of the acceleration notice, then a cure is nearly impossible, and after acceleration, none of the special servicing actions of Handbook 2-3550 described in Chapter 5 are available.[1081]

5.6.3 PAYMENT OF REAL ESTATE TAXES OR INSURANCE

RD/RHS regulations allow, but do not require, borrowers to establish escrow accounts.[1082] Despite this discretion, in recent years, RD/RHS has required most borrowers to escrow taxes and insurance after their loan is closed.[1083] Existing borrowers, who were not previously required to escrow taxes and insurance after their loan was closed, may escrow their taxes and insurance but are not required to do so except when the borrower's account becomes subject to special servicing options.[1084] For

[1070] *Id.* ¶ 5.2. A.
[1071] *See* § 6.4.5.4, *infra*.
[1072] When a loan is reamortized, the loan delinquency is added to the principal amount due and the new balance is amortized over the remaining term of the loan, provided the loan was originally amortized over the maximum allowable period. If it was not, servicing officials are authorized to extend the loan term in connection with a reamortization to the maximum loan term. 7 C.F.R. § 3550.208 (2009).
[1073] *See* ¶ 5.4, *supra*.
[1074] 7 C.F.R. § 3550.208 (a)(1) (2009).
[1075] *Id.* ¶ 3550.208 (a)(2).
[1076] *Id.* ¶ 3550.208 (a)(3) (The regulation requires that the borrower has demonstrated a willingness and ability to meet the terms of the loan and DWA and it is in the government's best interest. The Handbook further requires that the remaining term of the DWA be at least 12 months and that the borrower has made required payments for at least six months. Handbook 2-3550 § 5.2. C. 5 (Rev. 7/13/05)).
[1077] 7 C.F.R. § 3550.208 (a)(4) (2009).
[1078] *Id.* § 3550.208 (a)(5). The remaining balance will be reamortized for a period not to exceed ten years or the final due date of the note being reamortized, whichever is sooner. *Id.*
[1079] *Id.* § 3550.208 (a)(2). Where the borrower has adequate repayment ability and RD/RHS determines the reamortization is in the best interests of the Government and the borrower. *Id.*
[1080] Handbook 2-3550 ¶ 6.5. B. 1 (Rev. 11/26/01). The acceleration notice gives the borrower 30 days to pay in full or request a hearing.
[1081] *Id.* ¶ 6.5. B. 3.
[1082] RD/RHS is required by statute to implement a tax and insurance escrow system, 42 U.S.C.A. §§ 1471(e) and 1472(a)(1) (West 2003), and it has adopted regulations authorizing it to do so, 7 C.F.R. § 3550.60 (2009). *See also*: Real Estate Settlement and Procedures Act of 1974 (RESPA) (12 U.S.C. 2601, *et seq.*). The Rural Housing Trust 1987-1, has required borrowers whose loans are held by the Trust to escrow taxes and insurance.
[1083] *Id.* ¶ 3.5 (Rev. 6/21/06).
[1084] 7 C.F.R. § 3550.60 (2009). *See also* Handbook 2-3550, ¶ 3.5 (Rev. 6/21/06) which provides exceptions to the escrow requirements.

a variety of reasons, borrowers who do not escrow taxes and insurance often fail to pay their real estate taxes or insurance when due. This commonly results from their experiencing financial hardship, not knowing that RD/RHS may be able to provide assistance through the interest subsidy or moratorium relief programs, and choosing to make payments to RD/RHS instead of to the local tax assessor.

Assistance in making tax payments. RD/RHS will pay property taxes on behalf of practically all borrowers who have failed to make their annual property tax payment and will, thereafter, require that the borrower maintain an escrow account. [1085] It will also require the borrower to pay back the advance over time.

Taxes paid by RD/RHS are charged to the borrower's account and bear interest at the rate in effect on the borrower's initial loan.[1086] Tax advances must be repaid in installments amortized over the term of the loan less ten years.[1087]

Assistance in paying insurance. RD/RHS may force place insurance payments on behalf of borrowers who are not required to escrow for insurance or who fail to maintain insurance required by the agency.[1088]

All insurance advances are charged to the borrower's account. It is not clear from RD/RHS regulations or handbooks how the advance is repaid by the borrower.

5.6.4 REFINANCING

As an alternative to providing moratorium relief, RD/RHS has statutory authority to refinance Section 502 loans.[1089] In this manner, missed payments may be refinanced and the borrower's monthly payments may possibly be reduced, depending on the number of years the loan has been in effect, the old and new loan interest rates and the delinquency that has accrued. As noted earlier,[1090] RD/RHS has chosen not to implement this authority except in the three aforementioned cases.

RD/RHS will refinance loans only of borrowers who are not eligible for subsidy assistance and who, as a result of the refinancing, will become eligible for such assistance. Thus, it will refinance (1) loans that were originated prior to August 1, 1968, when the Interest Credit program was first authorized; (2) loans that were made as above moderate-income loans; and (3) loans that were made for the purchase of inventory property on a non-program basis.[1091] In each case, the borrower must be eligible to receive a loan with payment assistance; the borrower must be in danger of losing his or her home due to circumstances beyond his or her control; and the property must be RD/RHS program eligible.[1092]

Relying on the same rationale, RD/RHS should also consider refinancing loans of borrowers who, after their income increased to the above moderate-income level, failed to recertify their income, and consequently, had their payment assistance terminated;[1093] yet the RD/RHS regulations fail to authorize refinancing under such circumstances. If you represent such a borrower, you should consider challenging the regulations on the grounds that they violate Section 501(a)(4) of the Housing Act of 1949.[1094]

If you represent other clients who may benefit from refinancing, *see* § 5.4.1, *supra*.

5.6.5 ADDITIONAL INTEREST SUBSIDY

Borrowers who cannot make their loan payments in a timely fashion, pay taxes or insurance when due or otherwise meet their loan obligations may qualify for interest subsidy assistance. Whether a borrower is eligible for such assistance and RD/RHS' obligation to extend the assistance are discussed elsewhere in this manual.[1095]

[1085] Handbook 2-3550 ¶ 3.2 B (Rev. 9/18/02) and, generally, 7 C.F.R. § 3550 Subpart E (2009).
[1086] *Id.*
[1087] *Id.*
[1088] *Id.* ¶ 3.3.
[1089] 42 U.S.C.A. § 1471(a)(4) (2003).
[1090] *See* § 5.4.1, *supra.*
[1091] 7 C.F.R. § 3550.204 (2009). Handbook 2-3550 ¶¶ 4.2 B.3.and 4.5 A. *See note* 1010, *supra*, for definition of Non-program loans.
[1092] 7 C.F.R. § 3550.204 (2009); Handbook 2-3550 ¶ 5.3. A. *See* § 5.2.1.1 (discussion of circumstances beyond the borrower's control).
[1093] *See* § 3.8, *supra*.
[1094] 42 U.S.C.A. § 1471(a)(4) (2003).
[1095] *See* § 3.2.4, *supra*.

5.6.6 CREDIT COUNSELING

Credit counseling is not a loan servicing tool previously discussed in this section. Nevertheless, it is an important form of assistance to borrowers who are having trouble meeting their obligations to RD/RHS. CSC should provide credit counseling to borrowers throughout the terms of their loans to assist them in meeting their RD/RHS obligations and in planning use of other credit.[1096] This service should also be made available to borrowers who are delinquent in their payments, have requested moratorium relief, or have experienced other difficulties. It should be used to assist borrowers in overcoming these problems and in planning to graduate from the RD/RHS loan programs. Although counseling will usually be provided by an RD/RHS employee, RD state directors are required to make an assessment of the availability of certified homeowner education in their respective states and to maintain an annually updated listing of providers and their reasonable costs.[1097] New applicants for Section 502 loans are required to complete training in nine areas of home buying (including financing, operation, budgeting, etc.) and be provided with a letter or certification of completion from an approved entity.[1098] Check with the local RD/RHS office to see if such a counseling agency operates in your client's area.

[1096] 7 C.F.R. § 3550.11(2009), Handbook 1-3550 ¶¶ 3.3, 3.3 B. and D., 3.4. A., 4.10, 4.22, 4.24, 13.4, Handbook 2-3550 ¶¶ 2.4 (5/27/98) and 5.1 (Rev. 7/13/05).

[1097] 7 C.F.R. § 3550.11(a) (2009).

[1098] *Id.* §3550.11(c) and (d). The entities are: HUD, NeighborWorks America, the National Federation of Housing Counselors, the National American Indian Housing Council, and the state housing finance agency or other entity approved by the state director.

CHAPTER 6
FORECLOSURES AND RECONVEYANCES

6.1 INTRODUCTION

Even though its regulations counsel to the contrary, RD/RHS staff often considers that its obligation to help low- and moderate-income persons obtain decent, safe, and sanitary housing ceases once the loan is made. As a result, RD/RHS acts like any commercial lender, responding to borrowers who fail to make payments with threats of foreclosure and suggestions to sell the property in lieu of foreclosure. When these warnings are unsuccessful, foreclosure follows.

To the RD/RHS borrower, foreclosure is a nightmare. It results in the loss of his or her home, loss of equity, loss of decent and affordable housing, and a return to an increasingly costly renter's environment that often forces the borrower to devote a substantially greater portion of his or her income to housing and a lesser amount to food, clothing and other necessities of life. Given these consequences, RD/RHS should not foreclose until all alternatives have been explored and exhausted.

Both the statute and the regulations direct RD/RHS employees to explore all alternatives to foreclosure, avoiding it whenever possible. Both provide the agency with ample authority for servicing loans in a manner that will avoid foreclosure in all but the most extreme cases. Unfortunately, RD/RHS has not implemented all of its statutory obligations. In addition, some RD/RHS staff is either unaware of or chooses to ignore those obligations that the agency has implemented.

This chapter reviews the RD/RHS foreclosure and reconveyance procedures and practices. It also reviews the agency's obligations to avoid foreclosure and the defenses, both practical and judicial, that borrowers may raise to avoid foreclosure. Alternatives that may be available to borrowers when foreclosure cannot be avoided are also discussed. Finally, this chapter also discusses defenses to foreclosures by the Rural Housing Trust 1987-1 and by private lenders with RD/RHS guaranteed loans.

6.1.1 RD/RHS' OBLIGATIONS UNDER STATE LAW

Until 1990, the question of whether RD/RHS is subject to state laws when dealing with its borrowers had been in substantial flux. Prior to 1979, it was generally believed that RD/RHS, like the Federal Housing Administration (FHA), was not subject to state laws in its dealings with borrowers. This belief was fostered by two lines of cases. One line held that federal law governs questions involving the rights of the United States arising under nationwide programs;[1099] the other held that absent specific congressional direction, courts will apply a uniform federal rule of law to national programs, if subjecting the programs to the vagaries of the varying state laws would impair the fiscal interests of the United States.[1100]

The Supreme Court's decision in *United States v. Kimbell Foods, Inc*.[1101] changed that perception. In deciding, *inter alia*, whether an FmHA farm loan lien took priority over a state-created repairman's lien, the Court held that absent any act of Congress to the contrary, when a federal agency performs a federal function, the applicable law is federal.[1102] Nevertheless, the mere fact that federal law governs the controversy does not inevitably require resort to uniform federal rules. Whether to adopt state law as the applicable federal rule or to fashion a national federal rule "is a matter of judicial policy 'dependent upon a variety of considerations always relevant to the nature of the specific governmental interests and to the effects upon them of applying state law.'"[1103] The Court then proceeded to identify three factors that must be considered in determining the applicable law: whether the federal programs, by their nature, are and must be uniform; whether specific objectives of

[1099] *See, e.g., Clearfield Trust Co. v. United States*, 318 U.S. 363, 367 (1943).
[1100] *See, e.g., United States v. View Crest Garden Apts., Inc.*, 268 F.2d 380 (9th Cir. 1959).
[1101] 440 U.S. 715 (1979).
[1102] *Id.* at 726.
[1103] *Id.* at 728 (citation omitted).

the federal program would be frustrated if the state law were to be made applicable; and the extent to which application of uniform federal rules would disrupt commercial relationships predicated on state law.[1104]

Applying these factors, the Court found that the FmHA farm loan programs were already tailored to some state laws and to the specific needs of individual borrowers and therefore need not be uniformly administered. The Court also found that state law, if applied, would not frustrate any specific objectives of the FmHA farm loan program and that application of a uniform federal rule would disrupt commercial practices because creditors, who justifiably rely on state laws, would have their expectations of a superior lien thwarted whenever a federal contractual security interest unexpectedly appeared and took precedence.[1105] The Court therefore concluded that state law must be the applicable federal rule of decision.[1106]

Because the FmHA (now RD/RHS) housing programs, much like the agency's farm programs, are tailored to individual needs, the agency's loan instruments are drafted to conform to applicable state laws. Because no statute directed the agency to establish a uniform federal foreclosure procedure, one would have expected the lower courts to follow *Kimbell Foods* and to require RD/RHS to follow state law when it foreclosed on individual home loans. In fact, however, very few did.[1107] To the contrary, most courts have practically ignored *Kimbell Foods* and have held that FmHA, and now RD/RHS, need not follow state laws when foreclosing on individual home loans.[1108]

Reacting to the courts' failure to follow state foreclosure laws, in 1990, Congress enacted legislation requiring RD/RHS to follow the foreclosure procedures of the state in which the property is located, to the extent that such procedures are more favorable to the borrower than the foreclosure procedure that would otherwise have been followed by FmHA and now, RD/RHS.[1109] Thus, whenever state foreclosure laws provide your client with protections not afforded by RD/RHS regulations, the agency is now required to follow the state foreclosure procedure.

RD/RHS has successfully limited the application of 42 U.S.C. § 1475 (b) in the 8th Circuit by drawing a distinction between state procedural and substantive laws. In several cases in that circuit, it has successfully argued that the legislation only extends to borrowers' state procedural rights and not substantive rights such as redemption or the protection from deficiency judgments.[1110] Moreover, some of these decisions explicitly uphold RD/RHS' required borrower waiver of those rights in its mortgage instruments[1111] even though no regulations have ever been published advising the public of RD/RHS' intention or policy to include such a waiver in the mortgage.[1112]

[1104] *Id*. at 728-29.
[1105] *Id.* at 729-40.
[1106] *Id.* at 740.
[1107] *See*, *e.g.*, *United States v. Hargrove*, 494 F. Supp. 22 (D.N.M. 1980) (FmHA Section 502 loan).
[1108] *See United States v. Mikolaitis*, No. 88-5650 (3d Cir. Feb. 14, 1989), *rev'g* 682 F. Supp. 798 (M.D. Pa. 1987); *United States v. Spears*, 859 F.2d 284 (3d Cir. 1988); *United States v. Black*, 622 F. Supp. 669 (W.D. Pa. 1985). Strangely, in the context of farm foreclosures, some courts have specifically refused to apply the state right of redemption to an FmHA loan, but have then, contrary to the intent of *Kimbell*, fashioned an equitable federal right of redemption. *See, e.g.*, *United States v. Elverud*, 640 F. Supp. 692, 696 (D.N.D. 1986).
[1109] 42 U.S.C.A. § 1475(b) (West 2003).
[1110] *United States v. Larson*, 2003 WL 21999148, at 5 (8th Cir. 2003)(Unpublished); *United States v. Jacobsen*, 319 F.3d 323 (8th Cir. 2002)(*per curium)*; *United States v. Lowe*, 655 F.Supp. 2d 925, 927 (S.D. Iowa 2009).
[1111] United States v. Jacobsen, *supra*, note 1110. *See also United States v. Birchem*, 100 F.3d 607 (8th Cir.1996).
[1112] RD/RHS loan instruments, even those used after enactment of the 1990 legislation, include various express waivers of borrowers' state-created rights. *See e.g.* Deed of Trust for Missouri, ¶ 25 (RD 3550-14 MO (Rev. 6-02))(Borrower agrees that RD/RHS will not be bound by any present or future prescribed state laws, including, prohibition of deficiency judgment, right of redemption, and proscribing a statute of limitations.) These waivers should have no legal consequences, as they are contrary to the 1990 legislation and were adopted without benefit of rulemaking. *See Rodway v. USDA*, 514 F.2d 809 (D.C. Cir. 1975). They may also be attacked on the grounds that state-created rights may not be waived under various state laws (*see United States v. Marshall*, 431 F. Supp. 888, 892 (N.D. Ill. 1977) (Small Business Administration mortgage is subject to Illinois redemption law, which does not permit waiver of the right)); that they are inapplicable in particular cases (*see United States v. Johansson*, 467 F. Supp. 84 (D.Me. 1979)); that they are unconscionable (*see United States v. Hargrove*, *supra* note 1107); or that they were illegally extracted from borrowers as a condition of obtaining a federal benefit (*see Frost v. Railroad Comm'n*, 271 U.S. 583, 593-94 (1926)).

It is questionable whether the right of RD/RHS to insist upon a waiver of state procedural or substantive rights is enforceable. Applying the *Kimbell Foods* test to determine whether a uniform federal rule is applied or whether state law is adopted as the applicable federal rule, the 1990 legislation enunciates a clear congressional policy of adopting state laws in RD/RHS foreclosure cases. RD/RHS should therefore be prohibited from including waivers of state rights in its mortgage instruments.[1113]

It is beyond the scope of this manual to attempt to set forth all rights granted borrowers under state foreclosure laws. Certain rights common to many states and significant in the foreclosure process are reviewed here briefly; however, you will have to determine whether any additional protections are available under the laws of the state in which you practice. The rights that may be available are redemption, homestead, valuation, appraisal, mediation, possession after foreclosure sale, prohibition against deficiency judgment, or limitation on amount of deficiency judgment.[1114]

In response to the national foreclosure crisis that began to manifest itself in 2007, Congress, as part of the Emergency Economic Stabilization Act of 2008,[1115] directed the Secretary of the Treasury, working with other federal agencies, to implement various foreclosure mitigation efforts to assist defaulting homeowners.[1116] Pursuant to that authority, the Department of Treasury announced guidelines for the Homeownership Affordable Modification Program (HAMP) on March 19, 2009.[1117] Those guidelines were directed at private financial institutions that were holding and servicing single family home loans and borrowers who were experiencing hardships in continuing to pay those loans. The guidelines made it clear that the HAMP program did not apply to RD/RHS loans, Veterans Administration, and Federal Housing Administration loans. The guidelines stated that these agencies will address the statutory directive through stand alone modification programs. HUD Secretary Donovan announced the FHA-HAMP program in July of 2009.[1118] The VA announced its program in January of 2010.[1119] RD/RHS has yet to announce its program. As a consequence, neither RD/RHS direct nor guaranteed loan borrowers can benefit from the program as of this writing.[1120]

6.1.2 CENTRALIZED SERVICING CENTER

In the mid-1990, RD/RHS set up the Centralized Serving Center (CSC), which is located in St. Louis, Missouri. It has assumed all loan servicing functions after loan closing from the local Rural Development offices. Hence, all servicing notices, including notices of delinquency, default and acceleration are generated and sent out by CSC. All the CSC notices invite borrowers to contact CSC by phone using a toll free number. On certain occasions, which will be discussed later, CSC will initiate a phone call to the borrower. On other occasions, it may ask field staff assistance in dealing directly with borrowers.

While RD/RHS believes that the CSC servicing system works well, that conclusion is not always shared by borrowers. They have complained that they have had problems reaching a representative directly at CSC,[1121] which is only open between 7 a.m. and 5 p.m. Central Standard

[1113] On the other hand, it is possible to draw an inference from the 1990 legislation that federal law is applicable to RD/RHS foreclosures and that Congress required the agency to follow state law only when it was more favorable to the borrower.

[1114] You may gain some insight into the types of rights available in your state by reviewing the waiver clause in your client's mortgage instrument.

[1115] Pub.L. 110-343 (Oct. 3, 2008).

[1116] *See id*. §§ 109 and 110.

[1117] *See Relief for Responsible Homeowners One Step Closer Under New Treasury Guidelines* (March 4, 2009) (available at http://www.makinghomeaffordable.gov/pr_030409.html (last visited March 25, 2010).

[1118] HUD, Making Home Affordable Program: FHA's Home Affordable Modification Loss Mitigation Action; Mortgagee Letter 2009-23 (July 30, 2009)(available at http://www.hud.gov/offices/adm/hudclips/letters/mortgagee/2009ml.cfm (last visited March 25, 2010).

[1119] Department of Veterans Affairs, VA Making Home Affordable Program, Circular 26-10-02 (January 8, 2010).

[1120] As of June 2010, RHS has indicated that it plans to adopt a HAMP program shortly. Accordingly, advocates should check the Federal Register to determine whether the agency has adopted any new regulations that may be applicable to clients.

[1121] *See*, e.g. *United States v. Martinez*, 2004 WL 2827045 (E.D. Pa. 2004)(Slip op. 2); *United States v. Childers*, 152 Ohio App. 3d 622 (Ohio App. 4 Dist. 2003).

Time;[1122] that there are various communication problems, including language access problems for persons who do not speak English; and that borrowers talk to different persons each time they call, thereby hampering clear communications.

Frequently, borrowers are not capable of reading or understanding RD/RHS correspondence. This is clearly a problem that was frequently resolved in earlier days through the personal contacts between FmHA staff and borrowers. Unfortunately, even then, the fact that a borrower was not able to understand an agency notice was not deemed to be a defense to a foreclosure.[1123] One court has held that a borrower who is incapable of reading has an obligation to seek assistance from a person who can read when receiving a notice about her home loan. Otherwise, the court reasoned, RD/RHS would stop making loans to individuals who do not read.[1124]

It is not clear the extent to which CSC staff has capacity to communicate in languages other than English or whether the agency has servicing letters in languages other than English.[1125] Arguably, its failure to notify non-English speaking borrowers in languages other than English is a violation of the Civil Rights Act of 1964.

6.2 DEFAULT

The right to foreclose is triggered by the borrower's failure to perform one or more covenants of the mortgage instrument,[1126] promissory note, or other agreement(s) entered into with RD/RHS that specifically grant the agency the right to accelerate the note and to foreclose on the security when the borrower fails to pay the obligation in full.

6.2.1 BASIS FOR DEFAULT

There are at least 15 obligations under an RD/RHS mortgage instrument that, if breached by the borrower, will constitute a default. Additional covenants are contained in other documents, such as the promissory note, Subsidy Agreement, and Delinquency Workout Agreement. These covenants, however, are usually repeated in the mortgage instrument. A brief review of several of these covenants follows.

Covenant to pay. Both the promissory note and the mortgage instrument obligate the borrower to pay promptly when due either the annual or monthly installment specified in the promissory note. The borrower is also obligated to pay any late charges that are due under the promissory note.[1127] This promise to pay may be modified in one or more agreements executed by RD/RHS and the borrower. For example, borrowers receiving subsidies are obligated to pay, on a monthly or annual basis, the amounts specified in the Interest Credit or Payment Assistance Agreement and not in the promissory note.[1128] The failure to pay that amount authorizes the agency to accelerate the promissory note, thereby making the entire loan due.[1129]

Borrowers who have been in arrears or who have obtained moratorium relief and have executed a Delinquency Workout Agreement[1130] (DWA) may have their payment obligations modified by those agreements. The failure to pay in accordance with the DWA also authorizes RD/RHS to cancel the agreement and accelerate the loan.[1131]

Covenant to pay taxes and Insurance. The mortgage instrument obligates the borrower to pay RD/RHS, on a monthly basis, 1/12 of all taxes and insurance amounts due as well assessments that may be due that take priority over the RD/RHS security interest.[1132] For security instruments

[1122] *See*, *How can I contact the CSC about my home loan?*, available at http://www.rurdev.usda.gov/RHS/sfh/bor_sfh.htm# When can I talk to a customer service representative? (last visited March 25, 2010).
[1123] United States v. Gomiller, 545 F. Supp. 17 (N.D. Miss. 1981).
[1124] *Id*.
[1125] RD has translated a number of its forms into Spanish. *See* e.g. Formulario RD 3550-1S (Rev. 07-06).
[1126] The term "mortgage instrument" is used throughout this chapter to refer to RD mortgages, deeds of trust, or other deeds and instruments used to secure RD loans. Whenever the text refers to a specific form of instrument such as a mortgage or deed of trust, the discussion is limited to that particular form.
[1127] *See* Form RD 3550-14 MO, Deed of Trust for Missouri, ¶ 1 (Rev. 6/02).
[1128] Interest Credit Agreement, ¶ IV, V and XI (Form FmHA 1944-6 (Rev. 3/97)).
[1129] *Id.* ¶ X.
[1130] Form FmHA 1951-37 (Rev. 5/97).
[1131] *Id.* ¶ E. *See* § 6.4.4.4, *infra* (discussion of Delinquency Workout Agreement).
[1132] *See* Form RD 3550-14 MO, Deed of Trust for Missouri, ¶ 2 (Rev. 6/02).

entered before the agency started to escrow taxes and insurance, the instrument requires the borrower to deliver promptly to RD/RHS, without demand, receipts evidencing these payments when made.[1133] Further, those instruments authorize the agency to collect each month from the borrower 1/12 of the estimated annual taxes, assessments, or insurance premiums. In cases where the security instrument did not actually require the borrower to escrow taxes and insurance payments, the agency has not required borrowers to escrow those payments except in cases where the borrower has defaulted on the loan or received a moratorium.[1134]

Covenant to pay charges and liens. The mortgage instrument requires borrowers to pay all taxes, assessments, charges, fines and impositions attributable to the mortgaged property that may attain priority over the RD/RHS mortgage instrument.[1135] Moreover, the borrower agrees to discharge promptly any liens that have priority over the RD/RHS security interest, unless RD/RHS agrees in writing to such a lien and the borrower agrees to pay for the lien in a manner that is acceptable to RD/RHS. Unless the borrower pays for these liens directly, in which case the borrower must provide RD/RHS receipts evidencing payments, the borrower must pay the agency the agreed amount due with the monthly mortgage payment.

Covenant to insure. The mortgage instrument obligates the borrower to keep the property insured. The agency's regulations require borrowers to maintain standard hazard and flood insurance policies.[1136] In addition, borrowers must obtain the policy from an approved insurer, include a mortgagee clause and name RD/RHS as the mortgagee, and deliver the policy, or declaration page, to RD/RHS.[1137] The failure to obtain or maintain such a policy is a default under the mortgage instrument.

Covenants authorizing RD/RHS to protect the security and requiring the borrower to reimburse the agency. The mortgage instrument reserves to RD/RHS the right to pay at any time any amounts required to be paid by the borrower that have not been paid when due. It also authorizes the agency to pay any costs necessary to preserve its lien. All payments made are advances that bear interest at the promissory note's market rate of interest.

Another mortgage instrument clause makes all advances and interest due and payable immediately upon demand. Failure to pay constitutes a default.

Covenant to maintain property. The mortgagor agrees to maintain the property in good repair, not to abandon it, and not to commit waste or without the agency's permission, remove, lease, cut any timber or extract minerals except for ordinary domestic purposes.

Bar against sale, lease, or encumbrance. The borrower may not lease,[1138] assign, sell, transfer, or encumber the property, or any part of it, without written consent of RD/RHS.

Covenant to use the loan only for authorized purposes. The mortgagor agrees to use the loan only for the purposes authorized by RD/RHS.[1139] These purposes, among other things, restrict the use of the property to housing for the borrower. At one time, the agency relied on this clause to prohibit borrowers from renting RD/RHS-financed housing to others for any period of time.[1140] Borrowers may now lease a property and are required to notify RD/RHS if they lease the property.[1141] However, if the lease is for a term in excess of three years or contains an option to purchase, RD/RHS may liquidate the loan.[1142] Moreover, during the lease period the borrower is not eligible for a payment subsidy.[1143] Thus, a borrower may rent or lease RD/RHS-financed property for any term, but if the

[1133] It is not clear whether RD ever enforces this obligation.

[1134] *See* § 5.6.3, *supra* (discussion of tax and insurance servicing). Unlike RD, the Rural Housing Trust 1987-1 is requiring borrowers to escrow taxes and insurance payments. *See id.*

[1135] *See* Form RD 3550-14 MO, Deed of Trust for Missouri, ¶ 4 (Rev. 6/02).

[1136] 7 C.F.R. § 3550.61(a)(2009).

[1137] RD Handbook 1-3550 ¶ 7.13 (1-23-03).

[1138] But s*ee* note 1142, *infra*, and accompanying text.

[1139] *See* 7 C.F.R. § 3550.52 (2009) (enumeration of authorized purposes).

[1140] *See, e.g., id.* Part 1861, Subpart D (1981).

[1141] RD Handbook 2-3550 ¶ 2.16 (5/27/98).

[1142] *Id.*

[1143] 7 C.F.R. § 3550.159(d) (2009). Note, however, that if a borrower is receiving any interest subsidy, RD may terminate the assistance if the applicant fails to reside in the home. *Id.* § 3550.68(a)(1)(2009).

borrower executes a lease in excess of three years or a lease containing a purchase option, the loan may be liquidated.[1144]

Obligation to refinance. To protect its status as lender of last resort,[1145] RD/RHS obligates the borrower to refinance the loan whenever it appears to RD/RHS that the borrower is able to obtain a loan from a private credit institution at reasonable rates and terms for a loan of similar purposes and duration. The mortgage instrument binds the borrower to apply for and if eligible, to accept credit to pay off the agency's loan.

A breach of any of the above covenants authorizes RD/RHS to accelerate the note, and if the breach is not cured or the note is not paid in full, to foreclose on the security. Nevertheless, RD/RHS usually takes these actions only upon breach of one of three covenants: the covenant to pay; the covenant against sale, lease, or encumbrance of the premises; and the covenant to refinance the loan. Indeed, CSC staff is not authorized to accelerate an account without first receiving concurrence from the Office of General Counsel when the borrower has not had a monetary default on the loan.[1146] Nevertheless, breach of other loan covenants by the borrower will typically be asserted in conjunction with a breach of one or more of these three primary covenants. RD/RHS deems these three covenants to be the most important for protecting its security interest and for achieving its program objectives. The agency therefore focuses on the borrower's actions with respect to each of these covenants in deciding whether to foreclose on the loan. Since borrowers who have failed to pay taxes, failed to insure the home, or who have abandoned the property will almost invariably have also failed to make mortgage payments, the agency rarely needs to rely on these remaining covenants to enforce a borrower's obligations. Defaulting borrowers also often will not have maintained their property or will have otherwise committed waste. Similarly, borrowers who have leased their homes for periods of three or more years, or who have leased the property for any term under a lease agreement containing a purchase option, will usually have breached several other covenants, including that against using the loan proceeds for unauthorized purposes and possibly, that against refinancing the loan.

Later sections of this chapter discuss the defenses a borrower may assert upon foreclosure based on any of these defaults. First, however, this chapter discusses curing defaults and the procedure followed by RD/RHS when it proceeds to accelerate and foreclose on a borrower.

6.2.2 NOTICE OF DEFAULT

RD/RHS has a systematic method of servicing delinquent loans that CSC must follow when a borrower misses one or more payments. Through a series of letters and phone calls, it is intended to advise borrowers of their default, of available servicing options, as well as to warn them of the consequences of their failure to cure the default.

Unfortunately, the servicing method that RD/RHS currently uses is not made public, and it varies depending on the contacts that are made between the borrower and CSC staff. Prior to the establishment of the CSC, the RD/RHS servicing letters were specified in the RD/RHS instructions and regulations. That is no longer the case.

If more than one person is obligated on the RD/RHS loan, copies of all servicing letters must be sent to each person obligated on the note, including co-signers, if the obligors are not married or are married but not living together. If married and living together, a joint servicing letter may be sent to the co-borrowers.[1147] Copies of all loan documents and servicing letters should be uploaded to MortgageServ**,** a mainframe-based application that is used by CSC to service agency loans and monitor loan performance. The RD/RHS handbook instructs CSC staff to record every action taken by CSC regarding an individual borrower's account in MortgageServ.[1148] The CSC staff will also scan documents and enter them into MortageServ. [1149]

Since borrowers' initial loan contacts are with the RD/RHS field office when the loan is first made, the field office is required to inform borrow-

[1144] RD Handbook 2-3550 ¶ 2.16 (5/27/98).
[1145] *See* § 1.2.5, *supra*; § 7.1, *infra* (discussions of RD as lender of last resort).
[1146] RD Handbook 1-3550 ¶ 13.20A (1-23-03, Rev. 7-8-09).
[1147] Handbook 2-3550 ¶ 6.5 (Rev. 11/26/01).
[1148] *Id.* ¶ 1.7 B (Rev. 11/07/07).
[1149] *Id.* ¶ 2.2 B (Rev. 01/09/08).

ers that all dealings with RD/RHS after loan funds are fully disbursed will be with the CSC. Moreover, once the permanent loan is closed, CSC must contact the borrower in writing to explain the role of the CSC and to provide the borrower with toll free numbers that the borrower can use to contact CSC staff.[1150]

6.2.2.1 Delinquency Loan Servicing Instructions

When a borrower first misses a payment, CSC will send the borrower a one page Notice of Payment Default thirty-one days after the payment has been missed. The notice advises the borrower that he or she has missed a payment and that the delinquency has been reported to a credit bureau, and urges the borrower to send a check to the agency. It further states that if the borrower is unable to make the payment, RD/RHS may be able to assist through payment subsidy, moratorium, or a delinquency workout agreement. These options are each described in very short sentence and the borrower is simply urged to ask about them when contacting CSC. Lastly, the letter lists toll free phone numbers to the CSC and states the hours during which CSC staff may be contacted.

Surprisingly, the notice does not advise the borrower of late fees that have been assessed against the account, which accrue the day after the original payment was due and equal 4% of the principal and interest that were due.[1151]

Second contact. Assuming that the borrower has not contacted CSC in response to the initial delinquency notice, CSC sends out a second notice when the loan payments are 60 days past due. The notice is very similar to the initial delinquency notice except that a higher amount, equal to two payments, is recited to be due and payable, and the borrower is advised that unless the account is brought current at once, RD/RHS will begin acceleration or foreclosure, which means that the borrower may lose the house. In all other respects, the letter is identical to the initial default notice.

Third contact. Assuming the borrower has still not contacted RD/RHS, CSC sends a third notice, Final Notice Before Foreclosure Review, one day after sending the borrower the second notice of default. The third notice is again identical to the first two notices except that the opening paragraph advises the borrower that CSC has already written the borrower several times to advise him or her that it had not received the amount due on the loan, that the account is seriously past due, and that the borrower must take steps to bring the account current. There is no elaboration in the letter as to its title, in other words, what it means that the letter is a final notice before foreclosure review. Significantly, the letter does not advise the borrower that if he or she fails to contact CSC, the opportunity to secure a moratorium is foreclosed after the loan is accelerated.

RD/RHS regulations or handbooks do not specify what other efforts CSC staff must make in order to contact the borrower and discuss servicing options. It is, however, clear from the handbooks that CSC staff must make at least three attempts to contact the borrower within 60 days before requesting assistance from field staff in servicing the loan.[1152] It is not clear, however, when calls must be initiated or how frequently they are made when the borrower does not answer or respond to the calls.

Pre-acceleration Personal Contact. When a borrower does not respond to any of the CSC letters or phone calls, CSC may request RD/RHS field staff to contact the borrower either by phone or in person in order to service the loan.[1153] RD/RHS field staff must make an effort to contact the borrower within 30 days of the request from CSC.[1154] The field office may attempt to contact the borrower by phone, but must visit the borrower's home and leave a door hanger or business card if the borrower is not at the property. The borrower is given an additional 15 days to respond to the notice left at the home. If in that time frame, the borrower does not contact the field office or CSC and has not

[1150] *Id.* ¶ 2.3 (5/27/98).
[1151] 7 C.F.R. § 3550.153 (2009); Handbook 2-3550, ¶ 2.10 (5/7/98).
[1152] Handbook 1-3550, ¶ 13.4 H and Exhibit 13-1 (1/23/03).
[1153] *Id.*
[1154] The RD field staff may decide that a personal contact is unnecessary and that the account should be accelerated. This may be the case if the property has been abandoned. In such a case, the field staff must document why a personal contact is unnecessary and must recommend acceleration of the loan. *Id.*

brought the account current, the borrower's account is passed on to the CSC acceleration unit.

Abandonment. RD/RHS field staff need not make personal contact with the borrower in cases where the borrower has abandoned the dwelling and the account is delinquent.[1155]

It is not known how rigorously CSC staff and RD local office staff follow the RD/RHS servicing instructions. Consequently, when representing a borrower who is facing foreclosure, ask for and review the borrower's file carefully to determine whether the proper letters were sent at the appropriate intervals, whether they contained the required information, whether RD/RHS made the required efforts to contact your client, and whether the appropriate servicing options were discussed and considered.

CSC's or RD/RHS' failure to strictly follow the handbooks can and should be asserted as a basis for setting aside a foreclosure either in the appeals process or in judicial proceedings. For example, an early National Appeals Division hearing officer has set aside an acceleration of the loan on the ground that the loan servicing letters were sent to the borrower at intervals that were shorter than those prescribed in the regulations.[1156] Accelerations have also been set aside because the notices advised the borrower of erroneous or inconsistent amounts due.[1157]

6.2.2.2 State Notice of Default

Some state statutes require mortgagors to give borrowers a notice of default that contains certain specified information before they may accelerate the loan. If that information is not contained in the RD/RHS standard servicing letters, RD/RHS must comply with these statutes by either sending additional letters or incorporating the required information in the servicing letters.[1158]

6.2.3 CURING A DEFAULT BEFORE ACCELERATION

6.2.3.1 Payment of Past Due Amount

Since the purpose of loan servicing is to bring the borrower's account current, a borrower may cure a default by tendering the full past due payments at any time before RD/RHS accelerates the note. In ordinary mortgage financing situations, a tender before the mortgagor's unequivocal election to accelerate the loan is a good defense to a foreclosure action or a basis for enjoining a nonjudicial foreclosure.[1159]

Since RD/RHS has instituted late fees for a borrower's failure to make timely payments, RD/RHS may be able to foreclose on the loan for failure to make late payments. Note that the right to foreclose for failure to make only late payments will depend on whether the obligation to make the late payments is included in the note and deed of trust or mortgage, whether it gives the agency the right to foreclose, and state law. Advocates should check all three issues in every case because the RD/RHS promissory notes and deeds of trust and mortgages have varying provisions depending on when they were entered into.

6.2.3.2 Payment of Full Loan Amount

Sale or transfer. Borrowers may also cure the default by selling the property to a third party and paying the loan in full. RD/RHS encourages sales as a last resort when a borrower is unable to cure a default and resume payments because it enables borrowers to recoup any equity that they may have in the property and from RD/RHS' perspective, avoids foreclosure proceedings and the possibility of RD/RHS having to take the property into inventory and subsequently dispose of it.[1160]

The CSC staff is instructed to discuss sale of the property with the borrower whenever, in the

[1155] Handbook 1-3550, ¶ 13.4 H (1/23/03).

[1156] NAS Appeal Decision (Fla. Dec. 5, 1988) (Nelson); NAS Appeal Decision (Fla. Jan. 4, 1989) (Nelson). *But see* 5 NAS NOTES 5-6 (Jan. 1989). (NAS Director advises that decision to overturn acceleration on grounds that one letter was sent eight days after the first letter instead of 10 days was improper. Obligation under regulations is for systematic servicing and a mere technicality should not be used to overturn acceleration. On the other hand, it is unacceptable to send the guide letters on the same day or 18 months apart.).

[1157] *See* NAS Appeal Decision (Fla. Jan. 4, 1989) (Nelson); NAS Appeal Decision (Okla. Apr. 17, 1989) (Webb).

[1158] *See* 42 U.S.C.A. § 1475(b) (West 2003); RD Handbook 1-3550 ¶ 13.20 (12/7/05).

[1159] Madway, *A Mortgage Foreclosure Primer*, 8 CLEARINGHOUSE REV. 146, 168 (July 1974).

[1160] RD Handbook 2-3550, ¶¶ 6.1 A 1 and 13.5 (4/20/05).

process of servicing a delinquent loan, it becomes clear that the borrower is not eligible for a moratorium or additional subsidy and the borrower is unwilling or unable to continue to make mortgage payments to the agency.[1161]

It is important to remember that when a borrower pays the loan in full, the amounts owed RD/RHS may be more than the mere mortgage balance. If the borrower received interest subsidy during the term of the loan, RD/RHS is also entitled to recapture a portion of that subsidy. You should review Chapter 7, *infra*, for a discussion of recapture.

Net Proceeds Sale. If a borrower decides to sell the home and use the proceeds to fully satisfy the RD/RHS loan, CSC will allow the borrower to complete the sale even after the loan has been accelerated. While there is nothing in the regulations or handbooks about timing, it is likely that the borrower will be given a reasonable amount of time to enter into a sales agreement, close the loan and pay RD/RHS in full. Clearly, advocates should encourage their clients to sell or transfer their home and recover some equity when the present market value of the property exceeds the borrower's obligation, including the recapture amount.[1162]

Short Sale. If the sale of the property will not cover the RD/RHS debt, the agency will only consent to the sale if it is in its best interest.[1163] This means that the sale will result in the greatest net recovery to the agency.[1164] RD/RHS field offices are placed in charge of reviewing and approving or denying short sales.

RD/RHS regulations and handbooks do not state the criteria that are used to determine whether a short sale is in the government's best interest. Generally, it is in the government's best interest to authorize a short sale when it will result in the greatest net recovery to the agency.[1165] Accordingly, a short sale is in the government's interest when the property is sold for its market value and junior liens are removed, preferably at less than full value. When it is in the government's best interest to authorize a short sale, the RD Field Office may facilitate the sale by authorizing and advancing certain selling expenses, such as real estate commissions, credit fees, real estate taxes, junior liens and closing costs.[1166]

When RD/RHS approves or rejects a property sale, it will do so in writing by sending the borrower a letter incorporating its decision.[1167] When it denies the borrower the right to sell the property, it must give the reasons for the denial and the right to appeal the decision. Unfortunately, the form letter set out in the Handbook does not include a statement regarding the borrower's right to appeal the decision. Arguably, the agency will contend that the decision is discretionary, and therefore, not subject to review.[1168] That position is not defensible. A decision that a short sale is in the government's best interest has to be supported by facts which show that alternative procedure will reduce the loss to the government.[1169] That decision is not subjective and must be reviewable. Moreover, even if the decision is not appealable, the decision that it is not appealable is itself reviewable[1170] and the borrower should be advised of this fact.[1171]

When RD/RHS approves a short sale, it does not release the borrower from liability for the balance owed to the agency on the loan or for recapture. It agrees only to release its lien from the property when it is paid the expected net proceeds from the sale. The balance, if any, owed on the loan remains payable, and the agency will pursue collection or offsets if the debt is not otherwise settled or the borrower is released from liability.[1172]

RD/RHS is required to determine whether a borrower is going to be released from liability before a short sale closes.[1173] Unfortunately, agency staff has authorized short sales without advising the borrower whether he or she will be released from liability. The decision is based on the borrower submitting Debt Settlement Package to CSC. It consists of an Application for Settlement of

[1161] *See* i*d.*, Chapter 6.
[1162] See Chapter 7.2, *infra* (discussion of recapture of subsidy).
[1163] Handbook 2-3550.
[1164] *Id.*, Chapter 6 (4/20/05) (Introduction).
[1165] *Id.*
[1166] *Id.*, ¶ 6.1.
[1167] *Id.*, Handbook Letter 115.
[1168] Handbook 2-3550, ¶ 1.9 B (11/7/07).
[1169] *Id.*, ¶ 6.1 (5/27/98).
[1170] 7 C.F.R § 11.6(a)(2)(2009).
[1171] Handbook 2-3550, ¶ 1.9 B (11/7/07).
[1172] *Id.*, ¶ 6.1 (5/27/98).
[1173] *Id.*

Indebtedness,[1174] a Payment Subsidy Renewal Certification,[1175] copies of bank statements for all the borrower's accounts for the past two months, a Verification of Income, a copy of the borrower's most recent Federal Income Tax Return, a copy of Net Recovery Worksheet, if applicable, and Estimated Selling Expenses.[1176] Neither RD/RHS regulations nor its handbooks disclose the basis of the agency's decision to release a borrower from liability after a short sale. Presumably, the decision will depend on whether the borrower has assets or income from which a debt can be collected or the borrower has gone through the debt settlement process with the agency.[1177]

6.2.3.3 Voluntary Conveyance to RD/RHS in Lieu of Foreclosure

RD/RHS will accept a deed in lieu of foreclosure after a loan has been accelerated if the agency will realize a greater net recovery value from the subsequent sale then would be obtained if foreclosure proceedings are allowed to continue. As with a short sale, a deed in lieu of foreclosure will not release the borrower of any remaining debt unless the borrower has gone through the debt settlement process with the agency.[1178] Reportedly, the agency does not accept very many voluntary conveyances in lieu of foreclosure.

6.2.3.4 Voluntary Conveyance as Part of Bankruptcy

RD/RHS will generally accept title to property if it is offered as part of a bankruptcy proceeding and the title is free and clear of encumbrances other than the agency's lien.[1179] Indeed, in such a case, the agency may pay any necessary and proper fees approved by the Bankruptcy Court in connection with the conveyance.[1180] In these cases, the borrower is likely to be relieved of any further debt to the agency as part of the bankruptcy proceeding.

6.3 ACCELERATION AND FORECLOSURE PROCEDURE

The RD/RHS regulations regarding acceleration and foreclosure are codified at 7 C.F.R. § 3550.211 (2009). The regulations are written in a very summary fashion and provide little guidance as to the agency's policies with respect to acceleration and foreclosure. The topic is covered in greater detail in three chapters of the RD/RHS Handbooks,[1181] parts of which are rather repetitive. Advocates are urged to review all the handbooks when representing a client facing foreclosure.

6.3.1 ACTIONS PRIOR TO ACCELERATION

Acceleration decisions on RD/RHS single-family home loans are made by CSC staff. After the acceleration notice has been sent out and all appeals conducted, or the time for appeals has lapsed, the foreclosure is carried out under the direction of RD State Offices.[1182]

6.3.1.1 Acceleration Decision[1183]

When a borrower becomes delinquent on a loan, a CSC counselor begins to compile a problem case report,[1184] which is designed to record information about the status of the loan, taxes and insurance, servicing options offered to and discussed with the borrower, and borrower household income and assets. If the delinquency leads to a decision to accelerate and foreclose, the problem case report is supposed to reflect the basis for the decision and provide guidance on how

[1174] Form RD 3550-20 (10-96).
[1175] Form RD 3550-21 (Rev. 3-06).
[1176] Handbook 2-3550, ¶ 6.1 (Rev. 5/27/98).
[1177] The RD/RHS debt settlement regulations are codified at 7 C.F.R. Part 3550 Subpart F (2009). A review of those regulations is beyond the scope of this manual.
[1178] *Id.*
[1179] Handbook 2-3550, ¶ 6.1 A 3 (Rev. 9/27/06).
[1180] *Id.*
[1181] Handbook 1-3550, Chapter 13; Handbook 2-3550, Chapters 5 and 6.
[1182] Handbook 1-3550, ¶ 13.6 (5/16/07).
[1183] RHS refers to the forced termination of a loan -- whether through sale, transfer, or foreclosure -- as a loan liquidation. 7 C.F.R. § 3550.211(a) (2009). It triggers the process by accelerating the loan.
[1184] The problem case report is a computer based report form. Advocates should seek a copy of the problem case report as part of discovery when representing a borrower before the National Appeals Division or in a judicial foreclosure process.

subordinate liens, if any, will be handled.[1185] The CSC counselor must submit the problem case report to his or her supervisor for review and approval of a decision to accelerate.[1186]

CSC counselors are authorized to recommend acceleration when they have determined that further special loan servicing will not achieve the loan objectives or that the borrower is refusing to cooperate with CSC by entering into a delinquency workout agreement or making payments on an agreement previously entered into.[1187]

It is not clear from the regulations or handbooks what role the counselor's supervisor plays in reviewing and approving the acceleration decision. Presumably, the supervisor ensures that all special servicing options have been fully explored and discussed with the borrower and that the loan objectives cannot be met. Clearly, if the supervisor does not concur with the decision, the case file should be returned to the counselor for further servicing.

Failure to meet the loan objectives. The regulations and handbooks do not explicitly state how a CSC counselor is to determine that continued servicing will not accomplish the loan's objectives. However, it is clear from the handbooks that if the borrower has failed to make regular loan payments, the loan's objectives will not be met because the borrower is not meeting his or her loan obligations. Thus, CSC will usually proceed to foreclosure when a specified number of payments are past due and all required servicing actions have been undertaken.

6.3.1.1.1 The loan must be at least three payments delinquent

As a general rule, the account of a monthly payment borrower, or of an annual borrower whose account has been converted to monthly payments, must be at least three full payments past due before RD/RHS may accelerate the loan.[1188] This means that an account may be accelerated on the first day after a third payment becomes past due. For example, if a borrower, whose payments are due on the first of the month, misses the July, August and September payments, RD/RHS may accelerate the loan on September 2. If the borrower had made a partial payment between July and September 1, the account would not be at least three payments past due and the agency would not be able to accelerate the account until and unless the borrower failed to make the October 1 payment.

The account of annual payment borrowers may not be accelerated until at least one annual payment, or a portion thereof that equals at least $3/12^{ths}$ of the annual installment, is 90 days past due and arrangements have not been made to bring the account current.[1189]

Exception: Chronic delinquency. CSC may accelerate loans of borrowers whose accounts remain two full payments past due for three consecutive months.[1190] If, however, at any time during the three months, the borrower is less than two full payments delinquent, the loan may not be accelerated.[1191] The following payment schedule for a borrower whose monthly payment of $200 is due on the 1st of each month and past due on the 16th will illustrate the point.

Date		Balance Due
December 31		Current
January 1	No payment	$200
January 16	Late payment fee assessed (4% of $200 = $ 8)	$208
February 1	No payment	$408
February 16	Late payment fee assessed (4% of $200 = $8)	$416
February 21	Payment of $200	$216
March 1	No payment	$416
March 16	Late payment fee assessed (4% of $200 = $8)	$424
March 21	Payment of $200	$224
April 1	No payment	$424
April 16	Late payment fee assessed (4% of $200 = $8)	$432
April 30	Payment $224	$208

[1185] Handbook 2-3550, ¶ 5.1 (Rev. 7/13/05).
[1186] *Id.*
[1187] *Id. See also* ¶ 5.6 (7/13/05).
[1188] 7 C.F.R. § 1951.312 (2009); FmHA AN 2567 (1951) (June 22, 1992).
[1189] 7 C.F.R. § 1951.312 (2009).
[1190] *Id.*
[1191] FmHA AN 2567 (1951) (June 22, 1992).

Even though the borrower was at least two payments behind on three loan payment due dates, the February and March payments reduced the past due amount to the point that the borrower's account was not two full payments past due every day during three consecutive months. Thus, RD/RHS may not accelerate this account under the chronic delinquency exception[1192]

Borrowers who have entered Delinquency Workout Agreements. Borrowers who default while a Delinquency Workout Agreement (DWA) is in effect are treated differently. RD/RHS will cancel the agreement if a borrower becomes more than 30 days past due under the terms of a DWA.[1193] The delinquency notice must advise the borrower that a payment has been missed and that the DWA will be voided if the payment becomes 30 days or more past due. Once the payment becomes 30 days past due, the agency voids the agreement, and if the borrower is more than three payments delinquent on the loan, it will begin the acceleration process unless the borrower has become eligible for special servicing.

6.3.2 ACCELERATION AND FORECLOSURE

Foreclosure is a two-step process: first, acceleration of the note, and, second, if the borrower fails to repay the note in full, sale of the property. Depending on state law and the agreement between the parties, a sale may be conducted with or without judicial supervision.

6.3.2.1 Acceleration

Acceleration of the note is authorized by the mortgage instruments and the promissory note whenever the borrower has breached a covenant in either instrument. Acceleration is a demand for the entire outstanding sum of the loan. If the borrower fails to pay, the instruments authorize the lender to sell the home.

When the default is monetary, the decision to accelerate a loan and authorize foreclosure is exclusively that of the CSC.[1194] When an acceleration of the loan is based solely on a nonmonetary default, CSC must obtain the concurrence of the USDA Office of General Counsel (OGC).[1195] OGC concurrence must also be secured when a borrower secured a loan while a civilian and subsequently entered the military.[1196] When representing clients, advocates should check that the OGC concurrence, when applicable, was obtained. If it was not, the failure to do so should constitute a defense to the foreclosure.

Typically, when RD/RHS accelerates a loan for a monetary default, it will list all nonmonetary defaults as additional grounds for the acceleration. In such cases, CSC need not get the approval of the OGC. However, should the borrower successfully challenge the monetary default, the agency may not proceed with the loan acceleration on the nonmonetary default grounds because the OGC approvals for the acceleration have not been obtained.[1197]

When RD/RHS decides to accelerate an account, a notice of acceleration must be sent to each borrower and any cosigner.[1198] The notice must be sent by regular and certified mail, return receipt requested, to the last known address of each borrower and co-borrower, and if the address of any borrower is different from the address of the security property or the address on file with CSC, a copy of the acceleration notice must also be sent to the property address.[1199] The failure to send a notice to each obligor is grounds for reversing an acceleration.[1200]

Unless state law permits borrowers to cure defaults after an acceleration, the notice of acceleration gives the borrower 30 days from the date of the notice in which to pay the balance of the loan in full.[1201] If state law permits a cure after acceleration, the acceleration notice should also

[1192] FmHA AN 2567 (1951) (June 22, 1992); 27 NAS NOTES 4 (June 1992). *Cf. United States v. LaCasse*, No. 83-141 (D. Vt. May 9, 1985) ($300 default on FmHA loan is insufficient grounds to accelerate).
[1193] 7 C.F.R. § 3550.205(c) (2009).
[1194] Handbook 1-3550, ¶ 13.20 A (Rev. 7/13/05).
[1195] *Id. ¶ 13.20 A 1.*
[1196] *Id.* Borrowers who are in the military are protected against foreclosure by Section 3 of the Servicemembers Relief Act of 2003, P.L. No. 108-189, 117 Stat. 2835 (2003).
[1197] NAS Appeal Decision No. 91 002817 TN RH (Tenn. Oct. 28, 1991) (O'Bryan).
[1198] RD Handbook 1-3550 ¶ 13.20 B 1 (Rev. 3/19/08).
[1199] *Id.*
[1200] NAS Appeal Decision No. 92002321 GA RH (Ga. Sept. 23, 1992).
[1201] Handbook 1-3550, ¶ B 1 (Rev. 3/19/08).

advise the borrower of the state law right to cure.[1202] The failure to advise the borrower of the right to cure a default is a defense to the foreclosure.[1203] The notice must also inform the borrower of the reason for the acceleration, the amount due, method of payment, an opportunity for an informal discussion with the CSC decision-maker, and the right to a hearing before a hearing officer of the National Appeals Division.[1204]

A borrower wishing to have an informal meeting must file a written request with the decisionmaker within 15 days of receipt of the letter of acceleration.[1205] Thereafter, if the matter is not resolved, the borrower may request mediation and/or an appeal hearing before the NAD. The borrower may request a NAD appeal hearing without first having an informal meeting with CSC. To do so, the borrower must file a written request for a hearing within 30 days of the mailing of the letter of acceleration.[1206]

When a borrower requests a hearing, RD/RHS should automatically postpone the due date of the accelerated payment until all appeals have been exhausted.[1207]

6.3.2.2 Right to Cure After Acceleration

After loan acceleration, CSC will generally not accept payments from borrowers that are not the balance demanded in the acceleration notice unless state law gives borrowers the right to cure defaults after acceleration.[1208] Where state law gives borrowers such a right, CSC must accept such payment as is permitted by state law,[1209] usually the amount necessary to bring the account current, and reinstate the account. RD/RHS must also accept an offer to cure a default after acceleration if required to do so by a National Appeals Division decision.[1210]

RD/RHS also allows borrowers to cure a default after acceleration if the borrower has not cured the account within the last two years.[1211] Moreover, the CSC Director is authorized to waive the two-year limitation if it is in the government's best interest.[1212] Such a waiver may be grated upon request from the RD field staff and must be accompanied with a cure proposal, a financial statement showing household wages or other income, and a profile credit report showing that the borrower has the ability to continue to make the mortgage payments.[1213] In addition, when such an offer is made, the borrower must establish an escrow account for the amount due and agree to cure the default within 30 days.[1214] In judicial foreclosure states, an offer to cure may be granted up to the time the case has been referred to the United States Attorney for foreclosure.[1215]

Since the discretion to accept a cure offer after acceleration lies with the CSC Director, it is arguable that the RD field staff's failure to communicate an offer to cure a default to the CSC director is a basis for stopping a foreclosure.[1216]

The CSC director is authorized to reinstate an account by accepting less than the amount necessary to cure a default.[1217] From the handbook, it is not clear under what circumstances such an offer will be accepted. If it is, however, a cure and financial statement must be completed, and the account will be reamortized if the borrower is unable to pay the remaining delinquency within 30 days of the account being reinstated.[1218]

Given the purposes of the Housing Act of 1949, it would appear that any tender that fully cures the default must be accepted by CSC unless it

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[1202] *See* § 6.3.2.2, *infra*.
[1203] *United States v. Henderson*, 707 F.2d 853 (5th Cir. 1983). *See* 42 U.S.C.A. § 1475(b) (West 2003).
[1204] Handbook 1-3550 ¶ B 1 (Rev. 3/19/08).
[1205] Handbook 2-3550, ¶ 1.9 C (11/7/07).
[1206] *Id.*, ¶ C (3/19/08).
[1207] *See Id.* ¶ D. *See also* Ch. 9, *infra*.
[1208] Handbook 2-3550, ¶ 6.5 B 5 (11/26/01).
[1209] *See* 42 U.S.C.A. § 1475(b) (West 1994). *Cf. United States v. Henderson*, *supra* note 1203 (FmHA's failure to advise borrower of the right to cure so misrepresented Mississippi law that FmHA may not complete foreclosure proceedings).
[1210] RD Handbook 2-3550, ¶ 6.5 B 5 (11/26/01).
[1211] *Id.*
[1212] *Id.*
[1213] *Id.* In these circumstances, the borrower's total debt ratio may not exceed 41% of income.
[1214] *Id.*
[1215] *Id.* Presumably, in states that RD uses private attorneys to conduct the foreclosure, the deadline is the submission of the file to the private foreclosure attorney.
[1216] NAS Appeal Decision (Okla. Jan. 6, 1988) (Webb); NAS Appeal Decision (Fla. Jan. 4, 1989) (Nelson).
[1217] Handbook 2-3550, ¶ 6.5 B 5 (Rev. 11/26/01).
[1218] *Id.*

can be shown that the borrower is likely not to continue making loan payments. Any decision to the contrary should constitute an abuse of discretion. Moreover, in the past, RD/RHS staff was known to accept offers to cure even when the borrower did not propose to pay the full past due amount, provided the borrower made a substantial payment and presented RD/RHS with a plan for repaying the balance, by entering into a Delinquency Workout Agreement, seeking a moratorium, or seeking a loan reamortization.[1219]

Unless there is state law to the contrary, RD/RHS has, in the past, contended that mistaken acceptance of any payment less than the full amount of the loan may not be asserted as a waiver of the agency's right to foreclose or otherwise operate to prejudice its rights.[1220] By contrast, any acceptance of payment made at the direction of the CSC should constitute a waiver. NAD hearing officers have reversed acceleration decisions when FmHA staff has continued to service a loan after it was accelerated.[1221] Arguably, the same should hold true to CSC servicing after acceleration.

After acceleration of the note, a borrower may still liquidate the loan by sale, transfer, or conveyance to RD/RHS. The agency may authorize additional time for a borrower to sell or transfer the property or to voluntarily reconvey it to the agency in lieu of foreclosure.[1222]

Voluntary reconveyance. Starting in 1992, FmHA ceased to accept a deed in lieu of foreclosure unless the loan had been accelerated and it was in the government's interest to do so.[1223] Moreover, RD/RHS has ceased to automatically release borrowers from liability when it accepted deeds in lieu of foreclosure. Instead, it now negotiates debt settlements, which may include debt cancellation, pursuant to published instructions.[1224] RD/RHS will not, however, seek a deficiency or debt settlement from a borrower who obtained a moratorium if the borrower faithfully tried to meet his or her loan obligations after receiving the moratorium.[1225] You should review Section 6.6 below for other instances where RD/RHS will not seek a deficiency judgment.

The RD/RHS handbook states that the determination of whether acceptance of a deed in lieu of foreclosure is in the government's best interest is based upon the estimated net recovery value.[1226] The handbook does not, however, elaborate on what considerations are made based on the net recovery value. Presumably, a deed in lieu of foreclosure will be accepted when it is likely to yield a higher return to the government than other alternatives such as foreclosure.

It is important to realize that RD/RHS will generally not accept a deed in lieu unless the borrower first satisfies liens, real estate taxes, and assessments.[1227] In addition, the borrower is required to provide a title insurance policy or a final title opinion from an agency-approved title company or attorney. In some circumstances, the agency may elect to satisfy or settle these debts if it is in the government's best interest.[1228] Moreover, the agency's acceptance of a deed in lieu will not automatically release the borrower from liability to the agency. Indeed, all costs related to the conveyance that are paid by the agency are added to the debt owed by the borrower.[1229]

Because of the difficulties, costs and remaining borrower obligations, the actual number of reconveyances accepted by RD/RHS in recent years is reportedly relatively low.

6.3.2.3 Foreclosure Sale

If the borrower does not prevail on an appeal of the acceleration decision and is unable to pay the loan in full by the due date, RD/RHS will proceed

[1219] *Cf.* 7 C.F.R. § 1955.15(d)(4) (1994) (receipt of payment without accompanying offer to cure the default is not considered a viable cure offer).
[1220] *See id.*
[1221] NAS Appeal Decision (Cal. June 9, 1989) (Blackburn).
[1222] *See*, Handbook 2-3550 ¶ 6.4 (Rev. 5/27/98).
[1223] 7 C.F.R. § 3550.211(d)(2) (2009); RD Handbook 2-3550, ¶ 6.4 (5/27/98). The RD handbook does, however, acknowledge that under some circumstances the agency will consider accepting a deed in lieu prior to acceleration. In those cases, the RD field offices are advised to contact CSC to secure direction on how to proceed. RD Handbook 2-3550, ¶ 6.4 (5/27/98).
[1224] *Id.* The RD/RHS debt settlement regulations are codified at 7 C.F.R. Part 3550 Subpart F (2009). A review of those regulations is beyond the scope of this manual.
[1225] 7 C.F.R. § 3550.211(a) (2009).
[1226] Handbook 2-3550, ¶ 6.4 (5/27/98).
[1227] *Id.*
[1228] *Id.*
[1229] *Id.*

to a foreclosure sale of the home following state foreclosure procedure. Depending on state laws and on the mortgage instrument used, a foreclosure sale may be conducted under a judicial decree or by private sale without judicial intervention.

RD/RHS prefers to use nonjudicial over judicial foreclosure because it is able to complete the process more rapidly and at a lesser cost. Since, however, not all states authorize the use of nonjudicial foreclosure, or "power of sale" as it is commonly known, and since several states that do authorize it have limited its use, RD/RHS uses nonjudicial foreclosure in fewer than half of the states.[1230]

Usually, the foreclosure method used is uniform throughout a state. RD/RHS may, however, use more than one method in a single state because of problems with a particular case or series of cases, the mortgage instrument used, or changes in the law.[1231] To determine which procedure RD/RHS generally uses in a particular state, contact the RD State Office or the USDA Office of General Counsel servicing the area. Whether RD/RHS will use judicial or nonjudicial foreclosure in any given case will depend on the mortgage instrument executed by the borrower, any special facts surrounding the case, and the current status of state law.

Judicial foreclosure. In most jurisdictions, foreclosure is an equitable proceeding. It begins with a complaint or petition to foreclose filed in court by RD/RHS against the borrower and any other persons who have a right, equitable or statutory, of redemption.

Prior to 1988, FmHA relied exclusively on United States Attorneys to prosecute all Section 502 judicial foreclosure proceedings, and as a consequence, brought all such proceedings in federal court. In 1988, Congress authorized FmHA to undertake foreclosures using USDA's Office of General Counsel or private attorneys. Technically, RD/RHS may use private attorneys only if they provide the agency with competent representation and their use is cost effective and will ensure that a new applicant eligible for Section 502 housing will be able to purchase and occupy foreclosed property sooner than if the agency were to rely on the U.S. Attorney, or that the quality of the property will be preserved through an expedited foreclosure.[1232] Using its authority, RD/RHS authorized State Directors to contract, under appropriate circumstances, with private attorneys to undertake foreclosures and related actions,[1233] with the understanding that such actions will be brought in the state courts.[1234]

Currently, RD/RHS relies on private attorneys to conduct foreclosures in most judicial foreclosure states and the number of foreclosures still handled by the U.S. Attorneys is negligible. As a consequence, foreclosures that used to be filed in the federal courts are now being filed in state courts.

Regardless of the court in which the action is filed, service of summons is either by personal service or by publication and mailing of notice when personal service is not possible. At the proceeding, RD/RHS must show that there was a default and that it has a right to foreclose. The borrower and any other defendant are given the opportunity to present any defenses. If the court determines that there has been a default, that RD/RHS has a right to foreclose, and that the borrower has no valid defenses, it will issue a decree or judgment setting out the amount due on the loan and specifying a period in which the borrower may redeem by paying off the whole obligation. The court will also specify a period within which notice must be given to the public that the property will be sold at a public auction. The notice, usually published in a local newspaper, includes a description of the property; the time, place, and terms of the sale; and the officer designated to conduct the sale, usually a master in chancery, a sheriff, or some other officer appointed or authorized by the court.

[1230] Defendant's Answer to Plaintiff's Interrogatory No. 11, *Rau v. Cavenaugh*, No. 78-5105 (D.S.D. 1980) (Clearinghouse No. 30,749) (Opinion reported at 500 F. Supp. 204 (D.S.D. 1980)).

[1231] For example, in the late 1970s, FmHA altered the mortgage instruments it uses in Idaho, Oregon, and Washington to allow it to foreclose nonjudicially. Thus, depending on when a borrower in one of these states obtained the FmHA loan, RD/RHS may now foreclose judicially or nonjudicially.

[1232] 42 U.S.C.A. § 1480(d)(1) (West 2003).

[1233] FmHA Instruction 2024-A, Ex. D (Rev. 2/27/91).

[1234] *Id.*, Ex. D, Attachment 1, ¶ A-1. *See* § 6.4.4, *infra*, regarding removal of actions from state to federal courts.

Unless it is precluded by law, RD/RHS will bid at the auction sale. In practice, it is often the only bidder. RD/RHS authorizes one of its employees to bid the present market value of the property or the value of its gross investment, whichever is less.[1235] If it bids less than the unpaid amount of the obligation secured by the mortgage, it need not pay anything since the bid price is applied to the mortgage debt. If the court approves the propriety of the sale, the officer who conducted the sale is ordered to execute a deed to the purchaser. If the law of the jurisdiction does not provide for a further period of redemption, the purchaser immediately becomes the sole and absolute owner of the land. If there is a statutory right of redemption, the purchaser's title may be defeasible until expiration of the prescribed period.[1236]

Nonjudicial foreclosure. Since nonjudicial foreclosure practices vary greatly from state to state, those procedures will not be reviewed here.[1237] Reduced to its basic elements, a nonjudicial foreclosure is a two-step process: (1) notice to the borrower that a public sale of the property will be conducted on a given date by an authorized person, and (2) the sale itself. There is no legal action at which the borrower may assert any defenses to foreclosure. Consequently, a borrower who has failed to prevail on an administrative appeal of the loan acceleration decision must act affirmatively and seek an injunction to stop the sale.

Notice. RD/RHS regulations and handbooks are silent as to the notice that is to be given to borrowers of an impending nonjudicial sale because RD/RHS state offices are required to have separate instructions that are intended to conform to the various state laws. At a minimum, those instructions should require RD/RHS to mail a notice of sale to each borrower at the borrower's last known address.[1238] In addition, the agency must also comply with state law,[1239] which commonly also requires notice by advertisement. The theory behind such notice is that the borrower's interest will be protected by public knowledge of the sale since bidders will be encouraged to attend, which will encourage a fair purchase price for the property.[1240] In fact, few bidders attend foreclosure sales, and in many instances, RD/RHS is the only bidder at the sale. It is also generally known that foreclosure sales do not command full market price.[1241]

The sale. Most nonjudicial foreclosure sales are conducted by, or at the direction of, a trustee who, depending on state law, may be a RD/RHS official, an independent third party designated in the mortgage instrument, or a public trustee. An RD/RHS official will make a bid at the foreclosure. The amount of the bid will be the lower of the agency's gross investment or the net recovery value of the security property.[1242] The highest bidder at the sale, most often RD/RHS, is issued a deed to the property by the trustee and thus becomes the new owner.

6.4 PREVENTING OR SETTING ASIDE A FORECLOSURE SALE: DEFENSES TO A FORECLOSURE

6.4.1 EXHAUSTION

Prior to 1994, exhaustion of administrative remedies was not a significant issue in RD/RHS foreclosure cases. That year, Congress enacted the legislation that established the National Appeals Division and formal appeals process and made exhaustion of administrative remedies a condition of judicial review prior to brining an action against the Department of Agriculture, its secretary, or any agency or employee of the department.[1243] Undoubtedly, this has reduced the number of cases that have been initiated in the courts and has made participation in the NAD appeals process a prerequisite to practically all cases where borrowers are seeking review of any RD/RHS decision, including foreclosure decisions. It has not necessarily limited the right to seek review of agency decisions in foreclosure cases initiated by the agency.

In affirmative cases brought by borrowers, four circuit courts that have split in their analyses

[1235] RD Handbook 1-3550, ¶ 13.20 E (3/19/08).
[1236] *See* § 6.8, *infra*.
[1237] *See* Madway, *supra* note 1159, at 170-72 (brief description of types of procedures generally authorized).
[1238] *See Mennonite Bd. of Missions v. Adams*, 462 U.S. 791, 798 (1983).
[1239] *See* § 6.1.1, *supra*.
[1240] Madway, *supra* note 1159, at 170.
[1241] *Id.*
[1242] RD Handbook 2-3550, ¶ 6.5 E 1 (11/26/01).
[1243] 7 U.S.C. § 6912(e) (West, WESTLAW, Current through P.L. 111-191 (excluding P.L. 111-148, 111-152, 111-159, and 111-173) approved 6-15-10).

and decisions on the RD/RHS exhaustion requirement. The Second Circuit has concluded that the USDA exhaustion requirement is jurisdictional and therefore denies access to the courts to the plaintiff who has failed to exhaust administrative remedies.[1244] The Fifth, Eighth, and Ninth Circuits have concluded that the NAD statute merely codifies the judicially established exhaustion requirement and does not limit a court's subject matter jurisdiction over a plaintiff's claims when administrative remedies were not exhausted.[1245] This latter view does not mean that the courts will not insist upon exhaustion of administrative remedies. It merely allows the plaintiff, who has not exhausted administrative remedies, to argue that the failure to exhaust remedies may be excused.

Traditional circumstances in which courts have excused a claimant's failure to exhaust administrative remedies include situations in which (1) the unexhausted administrative remedy would be plainly inadequate; (2) the claimant has made a constitutional challenge that would remain standing after exhaustion of the administrative remedy; (3) the adequacy of the administrative remedy is essentially coextensive with the merits of the claim (e.g., the claimant contends that the administrative process itself is unlawful); and (4) exhaustion of administrative remedies would be futile because the administrative agency will clearly reject the claim. In addition, exhaustion may be excused when (5) irreparable injury will result absent immediate judicial review.[1246]

In those instances that courts have concluded that the failure to exhaust administrative remedies is jurisdictional, a person may not even challenge an agency policy decision or regulation that is not appealable under the NAD appeals regulations until the person has sought and secured a decision from the NAD Director that the decision is indeed unappealable under the NAD regulations.[1247] This is a particularly harsh view of the exhaustion requirement, and advocates should be careful to exhaust this administrative remedy before challenging any agency decision in a court that follows this strict view.

One state court of appeals has held that the exhaustion requirement is not applicable in a foreclosure action brought by RD/RHS.[1248] Relying on an explicit reading of the statutory exhaustion requirement, it reasoned that it is simply not applicable when a borrower seeks review of an agency decision in a foreclosure case initiated by the government as opposed to a borrower bringing an action seeking review of a government decision.[1249] In so doing, the court distinguished an earlier case that held that in order to overcome the exhaustion requirement, the borrower had to raise and prevail on an equitable estoppel argument against RD/RHS.[1250]

6.4.2 VERIFYING DEFAULTS

Any defense to a foreclosure action should begin with a verification of the factual allegations of a default. In nonmonetary default cases, this may be accomplished with relative ease by talking with the client or visiting the property. In cases of monetary default, the process is more time consuming and complex. Begin by reviewing RD/RHS records of the client's account to determine accurately whether there is a default and its extent. This does not mean that you accept RD/RHS' figures for the past due balance on the loan. If possible, reconstruct the client's account from the beginning by reviewing the initial calculations for the monthly or annual payment schedule and by determining whether eligibility for an interest subsidy was made properly. If an interest subsidy was extended, calculate whether the amount was correct. If moratorium relief was granted, determine whether payments were properly deferred, interest canceled, or the loan accurately reamortized. If payments were missed or delayed, check whether RD/RHS

[1244] *Bastek v. Federal Crop Ins. Corp.*, 145 F.3d 90, 94-5 (2d Cir.1998). A Maine district court, has taken the same position. *Gleichman v. USDA*, 896 F.Supp. 42 (D.Me.1995).
[1245] *Dawson Farms v. Farm Service Agency*, 504 F.3d 592 (5th Cir. 2007**)** *Ace Prop. and Cas. Ins. Co. v. Fed. Crop Ins. Corp.*, 440 F.3d 992, 999-1000 (8th Cir. 2006); *McBride Cotton and Cattle Corp. v. Veneman*, 290 F.3d 973, 980 (9th Cir. 2002).
[1246] *Dawson Farms v. Farm Service Agency*, 504 F.3d 592, 606 (5th Cir. 2007) (citation omitted).
[1247] *Bastek v. Federal Crop Ins. Corp.*, 145 F3d 90, 95 (2nd Cir. 1998).
[1248] *United States v. Childers*, 152 Ohio App. 3d 622 (Ohio App. 4 Dist. 2003).
[1249] *Id.* at 694.
[1250] *In re Cottrell*, 213 B.R. 33 (M.D. Ala. 1997).

communicated with the client and check the content of that communication. In short, become thoroughly familiar with the client's account.

Although the process may require extensive calculations and time, it is important both because RD/RHS makes mistakes and because it may identify crucial time periods when RD/RHS did not properly service the loan. If you are able to draw a nexus between the improper servicing and your client's ultimate default, you are likely to be successful in defending against the foreclosure.

Most, if not all, of the client's records may be obtained from CSC. Any records that are not there may be available from the local RD field office.[1251]

6.4.3 REACHING AN AGREEMENT WITH RD/RHS

From the moment of an alleged default to the time of eviction after a foreclosure sale, borrowers and their representatives should actively explore ways to reach an agreement with RD/RHS that enables the borrower to bring his or her account current. This may be achieved by correcting any RD/RHS accounting errors, crediting the borrower's account with improperly withheld assistance, such as interest subsidy, extending moratorium and attendant relief, and refinancing the loan or executing a Delinquency Workout Agreement. The various tools available to RD/RHS for servicing the borrower's account are reviewed elsewhere in this manual.[1252]

Even if RD/RHS has accelerated the note or proceeded to a foreclosure sale, you should not be deterred from seeking a settlement reinstating that account. As noted earlier, CSC has authority to accept offers to pay to cure a default if it has not been cured within the last two years, and the CSC director even has authority to waive the two-year requirement.[1253]

In judicial foreclosure proceedings, reinstatement of the loan may be achieved by settlement or consent decree. In a nonjudicial foreclosure, RD/RHs may agree to reinstate the loan even after a foreclosure sale, provided a third party was not the successful bidder. Because the decision to accelerate and foreclose was made by the CSC, any efforts to reinstate the loan after acceleration should be directed to that office.

Generally, the larger the borrower's default and the further RD/RHS has proceeded toward the foreclosure sale, the more difficult it is to reinstate the loan. Therefore, you should attempt to work out the default as soon as possible. On the other hand, the more irregularities found in servicing the loan, the more likely it is that RD/RHS will reinstate the account. You should, therefore, thoroughly investigate the defenses that may be available to your client. RD/RHS is also more likely to agree to reinstate a loan if the client makes a substantial payment towards the past due amount than if the client is solely relying on various servicing techniques to bring the account current. Lastly, the agency is also more likely to reinstate the loan if your client is able to demonstrate that he or she has adequate repayment ability to continue making payments once the loan has been reinstated.

6.4.4 DEFENSES TO A FORECLOSURE: INTRODUCTION

Defenses to a foreclosure may be raised both in administrative appeals proceedings and in the courts. The appeals process is available to borrowers as a matter of right after RD/RHS' decision to accelerate the loan.[1254] The courts are available to them on one or more occasions depending on the type of foreclosure proceeding used by RD/RHS. In a judicial foreclosure, the borrower is the defendant in the proceeding and should appear to assert any available defenses to the foreclosure. If a default judgment is entered because the borrower failed to appear, the court may consider the borrower's defenses as part of the proceeding to set the judgment aside. In a nonjudicial foreclosure, the courts are available before the foreclosure sale only if the borrower seeks to enjoin the sale. After the sale, the borrower may commence a suit to set the foreclosure aside or to prevent an eviction. Borrowers in judicial foreclosure states may also initiate a suit to enjoin

[1251] CSC's address is 1520 Market Street, St. Louis, MO 63101.
[1252] *See* Chs. 3 and 5, *supra*.
[1253] Handbook 2-3550, ¶ 6.5 B 5 (11/26/01).
[1254] *See* 7 C.F.R. § 3550.4 (2009).

RD/RHS from initiating a foreclosure or to seek judicial review of agency action.

Advocates in judicial and nonjudicial foreclosure states should carefully review the exhaustion of administrative remedies issue. In non-judicial foreclosure states, they are not likely to be able to initiate a judicial review of agency action unless the client has exhausted administrative remedies. Similarly, in judicial foreclosure states, clients may not be able to preempt an RD/RHS action without first exhausting administrative remedies. However, they should be able to secure review of agency action in foreclosure cases initiated by RD/RHS.[1255]

Borrowers have several potential defenses to a foreclosure.[1256] First, they may have defenses based on RD/RHS' failure to abide by its regulations or to implement properly the Housing Act of 1949. In addition, they may have contract defenses arising out of their loan contract. Finally, in nonjudicial foreclosures, they may have defenses based on state nonjudicial foreclosure law or on due process deficiencies in the foreclosure process. The borrower's defenses will obviously vary depending on the step in the proceeding, the form of the foreclosure, and the forum of the proceeding.

Judicial forum selection. As noted earlier, RD/RHS will generally initiate a judicial foreclosure in state court using a private contract attorney. In some cases, it may still initiative the case in federal court if it is relying on the United States Attorney to prosecute the case. Cases initiated by RD/RHS in federal court must be litigated in those courts. However, cases initiated in state courts may be litigated in state court or may be removed by the defendant borrower to federal court.

Under 28 U.S.C.A. § 1441, a defendant may remove a civil action initiated in state court if the district courts of the United States have original jurisdiction over the matter.[1257] Among matters that are removable are diversity and federal question cases. In *United States v. Roberts*,[1258] the court held that an FmHA case commenced in state court was removable because under 28 U.S.C.A. § 1345, the federal courts have original jurisdiction over all civil actions commenced by the United States. Arguably, an RD/RHS foreclosure is also removable because original jurisdiction, conferred by 28 U.S.C.A. § 1331, is obtained by virtue of the fact that the mortgage was a federal mortgage and that RD/RHS' obligations under the mortgage -- which are conditions precedent to bringing the foreclosure action -- are all questions of federal law.[1259]

RD/RHS borrowers facing foreclosure in state court should seriously consider removing their cases to federal court because it may be disadvantageous for them to litigate in state courts. State court judges are often unfamiliar with RD/RHS programs and may give the agency undue deference, particularly when a borrower seeks to invalidate a RD/RHS regulation in defending a foreclosure.[1260]

Borrowers who seek to enjoin a nonjudicial foreclosure sale or who seek to set aside a completed sale may commence the action in either state or federal court. If the case is initiated in state court, RD/RHS is very likely to remove the case to federal court. Thus, borrowers may want to initiate the case in the federal court and avoid the delays brought on by RD/RHS' removal.

6.4.5 DEFENSES BASED ON RD/RHS REGULATIONS AND STATUTES

In the Housing Act of 1949, Congress recognized that the obligation to provide decent, safe, and sanitary housing to low- and moderate-income persons does not end after a loan is made. To respond effectively to inevitable temporary crises that face low-income borrowers, over the year, Congress has authorized the agency to:

[1255] *See* § 6.4.1, *supra.*

[1256] Where the borrower initiates judicial action, the borrower's defenses are characterized as affirmative claims.

[1257] To be timely, a petition for removal must be filed within 30 days after receipt by the petitioner of the complaint and summons. 28 U.S.C.A. § 1446(b) (West Supp. 1993).

[1258] No. 91-14196-CIV-Roettger (S.D. Fla. Mar. 30, 1992).

[1259] Likewise, it could be argued that borrowers whose loans have been sold to the Rural Housing Trust 1987-1 (RHT) may use this ground to remove an RHT-initiated foreclosure from state to federal court.

[1260] *See, e.g.*, *United States v. Shields*, 733 F. Supp. 776 (D. Vt. 1989) (FmHA denied the right to foreclose on a Section 502 loan because it had not properly serviced the loan, when consistent with its regulations that the court found to be contrary to statute, it denied borrower the right to seek a moratorium after loan acceleration).

subsidize loans through an interest subsidy; provide borrowers with temporary relief from principal and interest payments (moratorium relief); refinance loans; collect and escrow taxes and insurance; provide construction supervision and inspection; adjust and modify mortgage terms; and provide other technical and supervisory services that may be necessary to achieve the objectives of the housing act.

RD/RHS has taken the position that Congress has vested it with discretion over whether or not to implement the granted authorities. Therefore, it has chosen not to implement certain authorities, has put the burden of seeking particular forms of assistance on borrowers, and at the same time, has failed to adequately inform borrowers of the availability of certain assistance. Until 1974, some 25 years after several of the FmHA authorities were enacted, no one challenged FmHA's position. If a borrower defaulted, FmHA had a right to foreclose, regardless of whether it offered assistance to or considered assisting the defaulting borrower with one of the numerous loan servicing tools available. If the borrower was unfamiliar with a particular program and did not request a specific form of assistance, that was the borrower's misfortune. FmHA's right to foreclose was absolute.

A series of cases brought and decided between 1973 and 1984, combined with some statutory amendments, drastically altered this situation. The first of these was *Pealo v. FmHA*,[1261] in which the plaintiffs, on behalf of a national class of eligible borrowers, successfully challenged FmHA's suspension of the Interest Credit program. FmHA, which had terminated the program as part of the Nixon Administration's housing moratorium, argued that the statute's precatory language gave it discretion over whether or not to use its appropriated funds for Interest Credit.[1262] The court rejected the argument, noting that it made no difference if the provision in question contained the word "may" or "shall." Whether FmHA was required to operate the Interest Credit program could only be decided in light of its obligation to exercise all of its powers, functions, and duties consistently with the statutory goal of providing a decent, safe, and sanitary home for every American family.[1263] The court concluded that by ceasing operation of the Interest Credit program, FmHA acted in "contravention of statutory authority and [its] authority under the Constitution."[1264]

A second case that undermined FmHA's discretionary argument was *Yracheta v. Butz*.[1265] The plaintiff in that case sought, among other things, implementation of the Section 505 moratorium relief program, which FmHA had ignored for nearly 25 years.[1266] Approximately two weeks after the case was filed, FmHA published regulations in the *Federal Register*[1267] purportedly implementing the moratorium relief program. *Yracheta* was voluntarily withdrawn, even though the regulation placed the burden of applying for relief on the borrower.[1268]

Two similar cases, both resolved in 1977, further eroded FmHA's position. In *United States v. White*,[1269] the borrowers, whose Section 502 loan had been nonjudicially foreclosed, successfully challenged the foreclosure proceeding for FmHA's failure to notify them of the availability of moratorium relief and its failure to conduct a hearing at which they could have challenged FmHA's termination of their Interest Credit, the loan acceleration, and the foreclosure. The court held that:

> [T]he Whites had a right to put forth their claim for a moratorium on a loan and interest payments under 42 U.S.C. § 1475 in the meaningful evidentiary hearing mandated by *Goldberg v. Kelly*, 397 U.S. 254 (1970)] . . . Furthermore, FmHA has the responsibility to service the real estate [loan] in a manner which will accomplish both the loan objectives as well as protect the government's financial interest . . . Obviously, meaningful consideration of the Whites' moratorium request would be intricately related to proper resolution of their assertion that FmHA had failed to meet its duty . . . [1270]

[1261] 361 F. Supp. 1320 (D.D.C. 1973).
[1262] *Id.* at 1323.
[1263] *Id.* at 1324.
[1264] *Id.*
[1265] No. 574-255 (E.D. Cal. filed June 24, 1974).
[1266] *See* § 5.1, *supra*.
[1267] 39 Fed. Reg. 25,312-14 (July 10, 1974).
[1268] 7 C.F.R. § 1861.10(c) (1976).
[1269] 429 F. Supp. 1245 (N.D. Miss. 1977) (on remand).
[1270] *Id.* at 1252-53.

Williams v. Butz[1271] was the second major case to result in changes to FmHA's foreclosure practices. The plaintiffs, who had brought this class action on behalf of all Section 502 borrowers in Georgia, sought to enjoin all FmHA foreclosures until FmHA gave borrowers personal notice of the availability of moratorium relief and of an opportunity to apply for it before foreclosure. FmHA settled the case by consenting to inform all Georgia borrowers of the availability of relief at the time of the loan closing, at any time a collection letter is sent, and in the notice of the acceleration.[1272] Shortly thereafter, FmHA published regulations extending nationwide the moratorium notice requirement to all Section 502 borrowers.[1273] Subsequently, several courts have held that FmHA's failure to inform borrowers of the availability of moratorium relief prior to foreclosure is an affirmative defense which precludes the agency's proceeding with a foreclosure, thereby requiring it to abide by its regulations.[1274]

If anything was left of FmHA's position, it was laid to rest in *United States v. Trimble*,[1275] in which the court held that notice to the borrower of the availability of relief is a condition precedent to FmHA's bringing a foreclosure action and that in accordance with Rule 9(c) of the Federal Rules of Civil Procedure, FmHA must allege compliance with the regulation in its complaint seeking foreclosure.[1276] Since FmHA failed to so allege compliance, the case was dismissed, although without prejudice.[1277]

The *Trimble* case is of tremendous significance, placing the burden on RD/RHS to allege and in the case of a dispute, prove compliance with the notice provisions of the moratorium relief program. More importantly, the case completes the repudiation of RD/RHS' position that it has no affirmative obligation to help borrowers in order to achieve the objectives of the 1949 Housing Act.

Collectively, *Pealo*, *Yracheta*, *White*, *Williams*, and *Trimble* stand for the proposition that RD/RHS has an affirmative obligation to implement all the servicing provisions of the Housing Act of 1949. At the very least, this requires RD/RHS to notify borrowers of the availability of its various loan servicing options and to provide them with an opportunity to apply. In fact, the agency may also have to consider independently the eligibility of borrowers for various forms of assistance and to extend it to all eligible borrowers.

These cases also stand for the proposition that RD/RHS may not reject an application for assistance or otherwise terminate a service, including a loan, without providing notice of its action and a meaningful hearing at which the applicant or borrower may challenge the proposed decision.[1278] In 1978, Congress codified that proposition by requiring RD/RHS to adopt regulations that provide applicants and borrowers an opportunity to appeal adverse decisions to a neutral person who had no role in the decision-making process.[1279] In 1994, Congress amplified that requirement by enacting legislation that gives borrowers the right to appeal RD/RHS decisions before the National Appeals Division.

The following sections review RD/RHS' loan servicing responsibilities and how its failure to meet them may be asserted on behalf of a client seeking to prevent foreclosure. A description of

[1271] No. CV 176-153 (S.D. Ga. Oct. 7, 1977) (consent order and judgment), 12 CLEARINGHOUSE REV. 132 (June 1978) (No. 19,468). In 1990, FmHA obtained judicial approval to modify the consent decree in *Williams* and to resume nonjudicial foreclosures in Georgia. *Williams v. Lyng*, No. 176-153 (S.D. Ga. June 20, 1990) (*on remand from* 843 F.2d 1335, *reh'g denied*, 854 F.2d 1326 (11th Cir. 1988), *cert. denied*, 488 U.S. 956, 109 S.Ct. 392 (1989)).

[1272] *Id.*, consent order at 3-4.

[1273] 42 Fed. Reg. 55,091 (Oct. 13, 1977) (the regulations, since revised, were codified in 7 C.F.R. § 1951.313 (1994)).

[1274] *United States v. Roberts*, No. 79-78 (D.V.I., July 3, 1979) (stipulation); *United States v. Howard*, No. 78-8318-Civ.-CF (S.D. Fla. Aug. 7, 1979); *United States v. Noel*, No. 77-10148 (E.D. Mich. Nov. 28, 1979), 13 CLEARINGHOUSE REV. 797 (Feb. 1980) (No. 28,188); *United States v. Villanueva*, 453 F. Supp. 17 (E.D. Wash. 1978); *United States v. Rodriguez*, 453 F. Supp. 21 (E.D. Wash. 1978); *United States v. Matthews*, No. 77-8033 (S.D. Fla. Nov. 21, 1978). *See Johnson v. USDA*, 734 F.2d 774, 782 (11th Cir. 1984); *United States v. Gomiller*, 545 F. Supp. 17 (N.D. Miss. 1981). *Contra United States v. Rodriguez*, No. 76-883 (M.D. Fla. Apr. 19, 1979); *United States v. Terry*, No. 77-99 (E.D. Ky. Oct. 23, 1978).

[1275] 86 F.R.D. 435 (S.D. Fla. 1980).

[1276] *Id.* at 436-37.

[1277] *Id.*

[1278] *See Johnson v. USDA*, *supra* note 1274, at 782-83.

[1279] 42 U.S.C.A. § 1480(g) (West 2003).

how the various servicing tools may be used to avoid default and foreclosure is given elsewhere.[1280]

6.4.5.1 The Basic Argument: RD/RHS' Affirmative Obligation to Service Loans

Statutory argument. RD/RHS' obligation to help borrowers retain their homes emanates from several provisions in the Housing Act of 1949.[1281] The stated purpose of that legislation is the "realization as soon as feasible of the goal of a decent home and a suitable living environment for every American. . . ."[1282] To achieve that goal, Congress mandated that:

> [The] Department of Housing and Urban Development and any other departments or agencies of the Federal Government having powers, functions or duties with respect to housing, shall exercise their powers, functions and duties under this or any other law, consistently with the national housing policy declared by this Act and in such manner as will facilitate sustained progress in attaining the national housing objective hereby established. . . .[1283]

Numerous courts have clarified that these goals are not merely ideals, but rather place affirmative obligations on both RD/RHS and HUD.[1284] Therefore, when the agency is granted statutory authority, it does not have unfettered discretion to implement or not to implement that authority.[1285] Further, it may not implement the authority in a way that effectively withholds a program's benefits from its intended beneficiaries[1286] or contravenes the purposes of the program or the Housing Act.[1287] The rationale underlying these positions was best described in *Brown v. Lynn*,[1288] a case challenging HUD's failure to require insured mortgagees to service their loans affirmatively in order to prevent foreclosure:

> If the allegations of the complaint and the uncontroverted affidavits filed by plaintiffs are correct, HUD has tragically misled thousands of low-income Americans. Believing, as Congress apparently intended, that a policy and program had been adopted which would enable them to acquire a home notwithstanding their marginal financial circumstances, these low-income families entered in good faith into purchases and mortgages which they would otherwise not have been able to do. As reflected in the HUD guidelines, the program apparently contemplated the necessary flexibility to deal with the inevitable temporary crises such as illness, temporary unemployment, etc., which all involved in the program knew would occur. Extensions, recasting of the mortgages, purchase of the mortgages by the FHA prior to foreclosure and their subsequent recasting, all were obviously necessary to carry out the Congressional purpose as the guidelines recognize.[1289]

Due process argument. The Fifth Amendment's Due Process Clause is another source of RD/RHS' obligation to implement its various statutory authorities in a way that will enable borrowers to use the programs effectively. With rare exceptions, the Due Process Clause obligates the government to provide notice and a prior hearing satisfying minimum fairness standards when a proposed governmental action will deny, alter, or terminate a claimed privilege or right.[1290]

[1280] *See* Chs. 3 and 5, *supra*.

[1281] 63 Stat. 432, codified in scattered sections of 12 and 42 U.S.C.A.

[1282] 42 U.S.C.A. § 1441 (West 2003).

[1283] *Id.*

[1284] *E.g.*, *United States v. Garner*, 767 F.2d 104 (5th Cir. 1985); *United States v. Winthrop Towers*, 628 F.2d 1028 (7th Cir. 1980); *Pennsylvania v. Lynn*, 501 F.2d 848 (D.C. Cir. 1974); *Techer v. Roberts-Harris*, 83 F.R.D. 124, 129 (D. Conn. 1979); *Brown v. Lynn*, 385 F. Supp. 986 (N.D. Ill. 1974). *See United States v. Shields*, *supra* note 1260, at 785.

[1285] *United States v. Garner*, *supra* note 1284; *Pennsylvania v. Lynn*, 501 F.2d 848 (D.C. Cir. 1974); *United States v. Shields*, *supra* note 1260, at 783; *Rocky Ford Hous. Auth. v. USDA*, 427 F. Supp. 118 (D.D.C. 1977); *Pealo v. FmHA*, *supra* note 1261.

[1286] *United States v. White*, *supra* note 1269, at 1252-53; *Brown v. Lynn*, 385 F. Supp. 986 (N.D. Ill. 1974). *See United States v. Garner*, *supra* note 1284; *Williams v. Butz*, *supra* note 1271, *modified sub nom. Williams v. Lyng*, *supra* note 1271.

[1287] *United States v. Shields*, *supra* note 1260, at 785; *Pealo v. FmHA*, *supra* note 1261, at 1324.

[1288] 385 F. Supp. 986 (N.D. Ill. 1974).

[1289] *Id.* at 1000. *See Pealo v. FmHA*, *supra* note 1261, at 1323.

[1290] *See, e.g.*, *Goss v. Lopez*, 419 U.S. 565 (1975); *Goldberg v. Kelly*, 397 U.S. 254 (1970); *Sniadach v. Family Fin. Corp.*, 395 U.S. 337 (1969); *Slochower v. Board of Higher Educ.*,

Unquestionably, the benefits of homeownership as provided by the Section 502 and 504 loan programs are statutory entitlements for people qualified to receive them, just as welfare payments were held to be statutory entitlements in *Goldberg v. Kelly*.[1291] Moreover, eligible applicants are statutorily entitled to more than just the loan from the government. They are entitled to the full range of statutorily mandated services, such as interest subsidy and moratorium relief, that will assure the retention of their home. These benefits have more than a *de minimus* value,[1292] and because of the grave consequences of their loss, namely, foreclosure, they are protected by due process, just as the threatened loss of welfare benefits was protected in *Goldberg v. Kelly*. Therefore, before being deprived of any of these services, borrowers must receive notice of availability of the service and an opportunity to be heard. RD/RHS' failure to provide notice of the availability of loan servicing is a violation of due process.[1293]

The due process argument can be more easily grounded on RD/RHS' statutory obligation to provide borrowers whose assistance is being reduced, terminated, or not renewed with notice of the impending action and a right to appeal that decision.[1294] Since borrowers facing foreclosure are deprived not only of their loan, but also of all RD/RHS services, due process mandates that they be given notice of those services and of their right to appeal the adverse decision.

Finally, with respect to implemented authorities such as moratorium relief and interest subsidy, the same conclusion may be reached by relying upon RD/RHS authorizing statutes, regulations and handbooks. These authorities set forth policies and procedures intended to "help borrowers become current and succeed in repaying the loan."[1295] Thus, RD/RHS has an obligation to advise borrowers of and if they are eligible, to provide them with supervision and counseling,[1296] to extend an interest subsidy,[1297] moratorium relief,[1298] reamortization,[1299] refinancing,[1300] and other financial workout agreements, and where appropriate, to assist borrowers in meeting their property tax[1301] and insurance obligations.[1302]

In sum, the regulations obligate CSC to use all the loan servicing tools available through RD/RHS to help borrowers meet the objectives of the loan program and avoid foreclosure. This clearly includes giving borrowers notice of the services for which they are eligible and advice on how to obtain those services and avoid foreclosure.

The statutory authorities by which RD/RHS may service loans are numerous. They include, in the order in which they appear in the statute: the authority to make subsequent loans under either the Section 502[1303] or Section 504[1304] programs; to refinance loans;[1305] to escrow and make payments for taxes and insurance;[1306] to make grants under the Section 504 program;[1307] to grant moratorium relief;[1308] to set standards for the construction of RD/RHS-financed housing and to supervise and inspect the construction of that housing;[1309] to provide technical services in conjunction with RD/RHs financing;[1310] to pay for the repair of new

350 U.S. 551 (1956) (termination of employment by government contractor); *Joint Anti-Fascist Refugee Comm. v. McGrath*, 341 U.S. 123 (1951) (determination that organization was communist); *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306 (1950); *Goldsmith v. United States Bd. of Tax Appeals*, 270 U.S. 117 (1926) (admission to practice before Board of Tax Appeals); *Londoner v. City and Cnty. of Denver*, 210 U.S. 373 (1908); *Hornsby v. Allen*, 326 F.2d 605 (5th Cir. 1964) (revocation of liquor license); *Dixon v. Alabama State Bd. of Educ.*, 294 F.2d 150 (5th Cir. 1961), *cert. denied*, 368 U.S. 930 (1961) (expulsion from public school).

[1291] *Supra* note 1290. *Johnson v. USDA*, *supra* note 1274. *See Are FmHA Loan Entitlements Protected by the Due Process Clause?* 34 DRAKE L. REV. 389 (1984-85).

[1292] *Goss v. Lopez*, *supra* note 1290.

[1293] *See Baldwin v. Hale*, 68 U.S. 223, 338 (1863).

[1294] 42 U.S.C.A. §1480(g) (West 2003).

[1295] Handbook 2-3550, ¶ 5.1 (Rev. 7/13/05). *See* 7 C.F.R. § 3550.201 (2009). *See also* 42 U.S.C. § 1476(a) (West 2003).

[1296] See 42 U.S.C. § 1476(a) (West 2003).

[1297] 7 C.F.R. § 3550.68(d) (2009).

[1298] *Id.* § 3550.207.

[1299] *Id.* § 3550.208.

[1300] *Id.* § 3550.204.

[1301] *Id.* § 3550.206(a).

[1302] *Id.*

[1303] 42 U.S.C.A. § 1472 (West 2003).

[1304] *Id.* § 1474.

[1305] *Id.* § 1471.

[1306] *Id.*

[1307] *Id.* § 1474.

[1308] *Id.* § 1475.

[1309] *Id.* § 1476.

[1310] *Id.*

but defectively constructed housing;[1311] to adjust and modify the terms of mortgages;[1312] to enter into subordination or subrogation agreements and release borrowers from personal liability;[1313] and to make interest subsidy available to low- and moderate-income persons in conjunction with Section 502 loans.[1314] Finally, RD/RHS is given authority to make any rules and regulations deemed necessary to carry out the purposes of Title V of the Housing Act of 1949.[1315] The following sections discuss how RD/RHS' failure to exercise these authorities may be used to prevent a foreclosure.

6.4.5.2 Defenses Related to the Moratorium Relief Program

6.4.5.2.1 Procedural Issues

Failure to advise borrower of the availability of moratorium relief. Since the current moratorium relief regulations require that when servicing delinquent loans, RD/RHS, inform borrowers several times of the availability of moratorium relief, it is unlikely that many cases will arise in which the agency fails to comply with these regulations. Nonetheless, if such a case arises, you should be able to stop any subsequent foreclosure based on RD/RHS' failure to abide by its own regulations. The law on this matter is straightforward.[1316]

Failure to provide moratorium application form. As noted earlier,[1317] CSC is obligated to provide a moratorium application form to a borrower whenever it becomes aware of a circumstance that may make that borrower eligible for relief. CSC staff is more likely to violate this regulation than that obligating them to provide borrowers with a mere notice of the availability of moratorium relief. If a CSC fails to provide a moratorium application to a borrower to whom an application should have been given, you should be able to assert that violation as a defense to a foreclosure.[1318] To successfully assert the defense, you will need to show that CSC knew of circumstances that may have made your client eligible for a moratorium and that the CSC staff person did not provide your client with an application for relief.

Although you may be able to establish the necessary facts in support of the argument through your client's testimony or affidavit, the best available evidence is probably the problem case report that CSC creates when a borrower has defaulted on a loan. It may show that the CSC staff person had knowledge of circumstances that caused your client's default and may fail to show that a copy of a moratorium application was sent to your client. As discussed below, you should assert the defense even if the evidence discloses that a CSC staff person discussed the availability of a moratorium with your client and either dissuaded him or her from applying or concluded that your client was not eligible for relief.

RD/RHS does not respond to borrower's requests for moratorium assistance. In one case, RD/RHS' motion for summary judgment was denied because the borrower contended that she had called RD numerous times during a six months period requesting moratorium assistance due to a divorce and that RD had never responded to her calls.[1319]

Borrower discouraged from applying for a moratorium or advised that he or she is ineligible. It was not uncommon for FmHA County Supervisors to discourage borrowers from applying for moratorium relief. There was a variety of ways n which this was accomplished, including outright statements that it would be of little use to apply or that the borrower is not likely to qualify for relief.[1320] In some cases, the County Supervisor went so far as to calculate the borrower's eligibility and to make a notation in the running record that the borrower is ineligible for relief. It is not known

[1311] *Id.* § 1479(c).
[1312] *Id.* § 1480.
[1313] *Id.*
[1314] *Id.* § 1490a.
[1315] *Id.* § 1480(j).
[1316] *United States v. Howard*, *supra* note 1274; *United States v. Rodriguez*, 453 F. Supp. 21 (E.D. Wash. 1978); *United States v. Villanueva*, *supra* note 1274.
[1317] *See* § 5.5.1, *supra*.
[1318] NAS Appeal Decision (Okla. Aug. 1, 1989) (Webb); NAS Appeal Decision (Okla. Nov. 28, 1988) (Nelson).
[1319] *United States v. Childers*, 152 Ohio App. 3d 622 (Ohio App. 4 Dist. 2003).
[1320] *See United States v. Childers*, *supra* note 1319; *See In re Cottrell*, 213 B.R. 33 (M.D. Ala. 1997) (County Supervisor told borrower she was not eligible for moratorium relief because she has been assisted before).

whether similar practices are prevalent under the CSC servicing process,[1321] but if they are, an affected borrower should succeed in reversing the acceleration because the CSC staff person may have violated RD/RHS regulations and handbooks that require the CSC staff to: (1) provide the borrower with a moratorium application;[1322] (2) provide the borrower an opportunity to submit the application;[1323] (3) make a determination based on the borrower's application;[1324] and (4) advise the borrower of the eligibility decision in writing, together with a notice of the right to appeal the decision to the NAD.[1325]

Inadequacy of the moratorium relief notice. Some borrowers who do obtain notice of the availability of moratorium relief may not understand what RD/RHS is offering. This may be due to the complexity of the notice or the borrower's inability to read or comprehend it. For these borrowers, the notice is arguably not sufficient to meet due process.[1326] The courts have not, however, been favorably inclined toward this argument.[1327] This is because, as a practical matter, its successful assertion would ultimately cause RD/RHS to refuse to make loans to people who, while intended beneficiaries of the program, have not reached a certain level of education or lack certain reading skills. Nonetheless, the inadequacy of the notice may be asserted as a defense in cases where (1) the borrower has a limited capacity to read or comprehend the notice, and/or (2) RD/RHS, after advising the borrower of the availability of a moratorium -- and possibly even after providing the borrower with an application for relief -- discouraged the applicant from applying for assistance.[1328]

Improper consideration of eligibility for moratorium relief. If RD/RHS failed to follow any other of its regulations when considering a borrower's application for relief, the borrower should be able to assert RD/RHS' error as a basis for stopping the foreclosure and forcing agency reconsideration of the borrower's eligibility. Although there are no moratorium cases directly on point, the basis for this argument is no different than that in any other case in which the agency is obligated to follow its own regulations.[1329]

6.4.5.2.2 Substantive Issues

Arbitrary application of eligibility criteria. CSC and RD/RHS staff may comply with all its procedural regulatory requirements in processing a request for moratorium, yet deny the borrower's request on grounds that he or she did not, in the CSC staff person's opinion, meet certain eligibility criteria. While the decision may not be contrary to explicit RD/RHS regulations, it may nonetheless be arbitrary and capricious, an abuse of discretion or otherwise not in accordance with law. If you are unable to overturn the decision in the RD/RHS appeals process, you may seek judicial review of the decision under the Administrative Procedure Act.[1330] Numerous HUD Assignment program eligibility decisions have been overturned by the courts using these standards.[1331]

[1321] *But see United States v. Martinez*, 2004 WL 2827045 (E.D. Pa. 2004) (RD/RHS motion for summary judgment denied because plaintiff contended that she had sent three applications for moratorium relief to CSC while RD/RHS took contradictory positions in its briefs: first, that it never received her moratorium application; and second, that her request for relief was denied.); *United States v. Childers*, 152 Ohio App. 3d 622 (Ohio App. 4 Dist. 2003) (CSC never responded to borrower's request for moratorium).

[1322] *See* HB 2-3550, ¶ 5.5 B (Rev. 9/3/08). Some staff may discourage a borrower from applying for relief even after providing him or her with a moratorium application. Such action is nonetheless violative of RD/RHS policies. *See United States v. Gomiller*, *supra* note 1274.

[1323] *United States v. Childers*, *supra*, note 1320.

[1324] Handbook 2-3550, ¶ 5.5 C (Rev. 9/3/08).

[1325] 7 C.F.R. § 3550.4 (2009). *See United States v. Gomiller*, *supra* note 1274.

[1326] *See Mullane v. Central Hanover Bank & Trust Co.*, *supra* note 1290, at 314. This may be particularly true if the borrower does not speak English. RD/RHS has an obligation to provide notices to borrowers in languages other than English. Executive Order 13166, Improving Access to Services for Persons with Limited English Proficiency, August 11, 2000. It has, however, not drafted any notices in languages other than Spanish.

[1327] *See Johnson v. USDA*, *supra* note 1274, 784 n.8.

[1328] *See United States v. Martinez*, *supra* note 1321; *United States v. Gomiller*, *supra* note 1274. *But see United States v. Ford*, 551 F. Supp. 1101 (N.D. Miss. 1982).

[1329] *See United States v. Noel*, *supra* note 1274; *United States v. Rodriguez*, *supra* note 1316.

[1330] 5 U.S.C.A. § 702 (West 1977).

[1331] *See, e.g., Cronkhite v. Kemp*, 741 F. Supp. 822 (E.D. Wash. 1989). The HUD Assignment Program was terminated in 1995. Decisions with respect to program implementation remain precedential.

Failure to implement moratorium relief program properly. Chapter 5 of this manual discusses the various ways in which RD/RHS has improperly implemented the Moratorium Relief program, such as requiring that borrowers have a 20% reduction in income within one year of applying for relief.[1332] If your client was denied moratorium relief for any of these reasons, you can challenge the foreclosure on the ground that RD/RHS improperly implemented the program.[1333]

6.4.5.3 Defenses Based on RD/RHS Failure to Extend Interest Subsidy

6.4.5.3.1 Procedural Issues

Failure to inform borrowers of the availability of Interest Credit. RD/RHS handbooks require agency personnel to advise borrowers of the availability of interest subsidies whenever a borrower becomes delinquent on a loan.[1334] The use of standardized servicing letters makes it likely that borrowers are informed of the availability of these subsidies at one time or another. Nonetheless, if your client did not receive such a notice, you should challenge the acceleration or foreclosure on grounds that RD/RHS failed to properly service your client's loan.

Failure to extend or increase interest subsidy to borrowers experiencing a change in circumstances. CSC may sometimes, fail to provide or increase interest subsidy to borrowers who have experienced a change in circumstance and are otherwise eligible for the assistance. If you represent such a borrower, you should be able to prevent a foreclosure by arguing that RD/RHS has an affirmative obligation to extend or increase interest subsidy to borrowers and that its failure to do so is a defense to the foreclosure.[1335]

In response, RD/RHS is likely to argue that it has no affirmative obligation to monitor the client's circumstances or to inform him or her of the availability of interest subsidy and that the agency has made its position clear in its regulations and instructions.[1336] This argument can best be met by relying on the RD/RHS interest subsidy and servicing handbooks. The former obligates CSC to extend or increase interest subsidies to a borrower when it comes to the servicer's attention that the borrower's circumstances have changed.[1337] The latter obligates the CSC to attempt to contact the borrower whenever a payment is missed to discuss why it was not made and to develop specific plans for making it.[1338] In those instances where personal contact is actually made, it is difficult to imagine how an RD/RHS staff person can meet this obligation without learning of the borrower's circumstances and without extending interest subsidy to an eligible borrower. The argument can be further supported by the regulation requiring CSC to assist borrowers in becoming successful in repaying the loan.[1339]

Failure to extend interest subsidy based on calculation errors. Mistakes in interest subsidy calculations may be made by the CSC staff.[1340] They are most likely to be made when determining initial eligibility or at the time of renewal.[1341] Any borrower that can show deprivation of interest subsidy due to an error in calculations or due to improper application of the interest subsidy eligibility criteria should be able to prevent a foreclosure based on RD/RHS' failure to follows its regulations.[1342]

Borrower discouraged from applying for interest subsidy or advised that he or she is not eligible; inadequacy of the interest subsidy notice. The arguments for stopping a foreclosure because RD/RHS discouraged a borrower from applying for interest subsidy or advised the borrower orally that

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[1332] *See* § 5.2.1.2.1, *supra*.

[1333] *See United States v. Shields*, *supra* note 1260; *United States v. White*, *supra* note 1269.

[1334] *See* Handbook 2-3550, ¶ 5.1 B (Rev. 7/13/05).

[1335] *See* § 5.6.5, *supra*.

[1336] 7 C.F.R. 3550.68(e) (2009). *See United States v. Brown*, No. WPB-76-8347-Civ.-CF (S.D. Fla. July 8, 1977), slip op. at 2.

[1337] *See* 7 C.F.R. § 3550.204 (2009); Handbook 2-3550, ¶ 5.3 (Rev. 1/9/08). *See United States v. Brown*, *supra* note 1336.

[1338] Handbook 2-3550, ¶ 5.1 (Rev. 7/13/05).

[1339] *Id.*

[1340] A 1980 FmHA audit of Interest Credit Agreements disclosed that 52 percent of all agreements were incorrect at execution. FmHA AN No. 476 (444) (Dec. 5, 1980). There is little reason to believe that the number of errors has decreased since that time.

[1341] Review Ch. 3, *supra*, to determine how interest subsidies are determined. Particular attention should be paid to § 3.5, *supra* (renewal of subsidy agreements).

[1342] *See United States v. Rodriguez*, *supra* note 1316. *See also United States v. White*, *supra* note 1269, at 1252.

she or he is not eligible for assistance, as well the claim that the interest subsidy notice is inadequate, are the same as those for the moratorium program.[1343]

6.4.5.3.2 Substantive Issues

Failure to implement the interest subsidy programs properly. Chapter 3 discusses the various ways in which RD/RHS has placed barriers on certain borrowers receiving additional interest subsidies. If your client was denied additional interest subsidy for any of these reasons, you should challenge the foreclosure based on RD/RHS' improper implementation of the program.[1344]

6.4.5.4 Defenses Related to Delinquency Workout Agreements

At the urging of the CSC or an RD/RHS official, a borrower who misses one or more payments will often execute a Delinquency Workout Agreement (DWA)[1345] in an attempt to forestall foreclosure. Under the agreement, the borrower may be obligated to repay the arrearage due on the loan according to a schedule, often devised by CSC, that does not take into consideration the borrower's ability to repay.

If your client executed a DWA without also completing a Family Budget form, you should argue that the agreement violated RD/RHS handbook provisions and that any subsequent default was caused by the fact that the payment level required under the agreement was determined in an arbitrary manner and is therefore illegal.[1346]

In these cases, it may be helpful to show that, had RD/RHS entered into the DWA based on the client's ability to repay, the client could have met the loan obligations. It should not, however, be necessary to show this, since borrowers have a right to have their loans serviced in accordance with RD/RHS policies as enunciated in statutes, regulations and handbooks. They should not be denied their rights based on their ability to take advantage of them.[1347] Moreover, whether they could have taken advantage of a properly executed agreement is a factual determination that should first be made by the agency, not the courts.[1348]

Even if the DWA was accompanied by a Family Budget form that shows repayment ability, review the form carefully with your client to determine whether the expenses reported on the form were your client's actual expenses or whether they were simply figures inserted in the form at the insistence of the CSC staff person. If they are the latter, you should challenge the validity of the family budget and the DWA that was based on it. Borrowers who have not been given an opportunity to execute a DWA may prevent a foreclosure on the basis that RD/RHS has an obligation to inform them of the availability of such an agreement.[1349]

6.4.5.5 Failure to Offer Refinancing of Section 502 or Section 504 Loans

Chapter 5 discussed RD/RHS' authority to use refinancing as a loan servicing tool and its refusal to implement a refinancing program for all but a handful of RD/RHS borrowers.[1350] If you represent a borrower who is facing foreclosure and who could have benefitted from refinancing because his or her payments after refinancing would have been significantly lower than what they were after RD/RHS had used its other loan servicing alternatives, you should consider challenging the foreclosure on the ground that the agency failed to implement a refinancing program as mandated by Congress in the Housing and Community Development Amendments of 1974.[1351] The arguments in support of such a challenge are set forth in Chapter 5.

[1343] *See* § 6.4.5.2.1, *supra*.

[1344] *See United States v. Shields*, *supra* note 1260; *United States v. White*, *supra* note 1269.

[1345] Form FmHA 1951-37 (11/90).

[1346] Handbook 2-3550, ¶ 5.2 B (Rev. 7/13/05) (Note that the payment must be reasonable but that the agreement may not extend beyond two years). *See* § 5.6.1, *supra*.

[1347] *See Rau v. Cavenaugh*, *supra* note 1230, 500 F. Supp. at 209.

[1348] *See United States v. Villanueva*, *supra* note 1274; *Ricker v. United States*, 417 F. Supp. 133, 139 (D. Me. 1976).

[1349] Handbook 2-3550, ¶¶ 5.1 and 5.2 B (Rev. 7.13.05).

[1350] *See* § 5.6.4, *supra.*

[1351] 42 U.S.C.A. § 1471(a) (West 2003).

6.4.5.6 RD/RHS' Failure to Inspect and Adequately Supervise Housing Financed by Its Loans or to Provide Assistance Under Section 509(c)

Purchasers of RD/RHS-financed homes often discover defects that could or should have been discovered through proper construction inspection or inspection prior to purchase. When these borrowers seek the agency's assistance to repair the defects, the agency maintains that it has no authority to compel repairs or to make them itself. It further rejects all liability for improper construction and inspection.[1352] Consequently, borrowers often engage in prolonged disputes regarding RD/RHS' liability for correcting the defects, and when no assistance is forthcoming, either spend their own money or frequently borrow additional funds to make the repairs. RD/RHS' failure to resolve the defects has sometimes so frustrated borrowers that they have discontinued making loan payments. At other times, the repair costs increased borrowers' loan obligations to the point that they have been unable to meet their other obligations, resulting in a default on the loan.

Borrowers who have disputes with RD/RHS regarding construction defects, whether or not the defect is the cause of the default, have contended that RD/RHS' failure to properly inspect and supervise the construction is a defense to foreclosure. The basis for their argument has been identical to that concerning RD/RHS' liability for defective construction,[1353] except that instead of seeking damages for the repair, borrowers assert that the agency's failure to inspect and supervise the construction is a breach of the Loan Agreement that precludes foreclosure.

Because the courts have been reluctant to recognize RD/RHS' liability for defective construction,[1354] they have also not been eager to recognize the agency's liability as a defense to a foreclosure. In fact, three courts that appear to have considered the issue have rejected the argument.

In *United States v. Thurber*,[1355] the court denied defendant's claim for relief when he asserted FmHA's failure to supervise and inspect the construction as a counterclaim to the FmHA foreclosure. It held that the claim did not arise out of the same transaction or occurrence as the government's suit for foreclosure and that the claim could not be maintained unless the United States waived its sovereign immunity under either the Tucker Act or the Federal Tort Claims Act. The court found that the defendant was precluded from recovering under the Tucker Act because he had failed to act with dispatch on his claim and found that the statute of limitations barred his tort claim.[1356]

In *United States v. Cannon*,[1357] the court rejected both a tort and contract defense on the grounds that FmHA had no statutory duty to the borrower and had assumed no contractual duty that would give rise to the defense. Similarly, in *United States v. Rodriguez*,[1358] the court refused to recognize FmHA's liability for defective construction as a defense to a foreclosure, believing such a claim to be barred by the Supreme Court's holding in *United States v. Neustadt*.[1359]

Although the mechanical application of *Neustadt* to FmHA cases was rejected by the Supreme Court in *Block v. Neal*,[1360] thus distinguishing both *Cannon* and *Rodriguez*,[1361] most courts' continued rejection of RD/RHS' liability for defective construction[1362] makes it unlikely that the

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[1352] *See* § 4.7, *supra*.

[1353] *See* Ch. 4, *supra*, for discussion of RD/RHS' liability for defective construction.

[1354] *See* § 4.7, *supra*.

[1355] 376 F. Supp. 670 (D.Vt. 1974).

[1356] *Id.*

[1357] No. 76-1834 (D.S.C. Apr. 4, 1977).

[1358] *Supra* note 1316, at 22.

[1359] 366 U.S. 696 (1961). *See* § 4.8.3.2, *supra* (discussion of *Neustadt* and its applicability to RD/RHS).

[1360] 460 U.S. 289 (1983). *See also Kipf v. USDA*, 501 F. Supp. 110 (D. Mont. 1980); *Park v. United States*, 517 F. Supp. 970 (D. Or. 1981); *Parker v. Knebel*, No. EC 76-210K (N.D. Miss. Aug. 29, 1978).

[1361] *Thurber* is also distinguishable on several grounds. First, the loan in question was a HUD/FHA Section 235 loan administered by FmHA, not a Section 502 loan. Since FmHA's statutory authorities with respect to that program were totally different from its obligations under the Section 502 program, the case has no precedential value for Section 502 cases. Second, the claims in *Thurber* were not defenses to the foreclosure, but rather affirmative counterclaims for which a set-off or rescission was sought. Third, the tort and contract claims were decided on procedural rather than substantive grounds. 376 F. Supp. at 674.

[1362] *See, e.g., Moody v. United States*, 585 F. Supp. 286 (E.D. Tenn. 1984), *aff'd*, 774 F.2d 150 (6th Cir. 1985), *cert. denied*, 479 U.S. 14, 107 S.Ct. 65 (1986); *Manstream v. USDA*, 649 F. Supp. 874 (M.D. Ala. 1986).

theory will be recognized as a defense in the foreclosure context.[1363]

Only one court has held that when a borrower has a dispute with FmHA regarding its obligation to supervise and inspect construction, FmHA's failure to grant a meaningful hearing at which the borrower can present his or her claim for relief violates the borrower's statutory and due process rights. Foreclosure was therefore held constitutionally impermissible.[1364] Although that court did not reach the substantive issue of FmHA's liability for defective construction, it clearly suggested that FmHA may in fact be liable and that the agency's failure to correct the defects may be a defense to foreclosure.[1365]

Finally, when a borrower has a remedy for the repair of the defect under the Section 509(c) program, but RD/RHS fails either to administer that program properly or to provide the borrower with compensation for the construction defect, the borrower should assert that failure as a defense to the foreclosure. The argument in such a case is identical to that used when RD/RHS has not extended proper interest subsidy or moratorium relief.[1366]

6.4.5.7 Other Types of Improper Loan Servicing

Miscellaneous obligations. By now it should be obvious that RD/RHS' improper administration of its obligations to service a loan can and should be raised as an affirmative defense to foreclosure, particularly when proper servicing could have avoided the default. Therefore, the same arguments made with respect to the moratorium relief and interest subsidy programs[1367] can be made concerning RD/RHs' obligation to provide the borrower supervision and credit counseling[1368] and planning assistance.[1369]

Combining defenses. Sometimes RD/RHS, although conceding that its improper servicing of a loan at one time would have been a valid defense to a default occurring at that time, may argue that its failure does not excuse subsequent defaults. In these cases, carefully review the facts to determine whether, but for the agency's initial failure, the client would have been in default at a later time, and whether there are other defenses that may excuse the subsequent defaults. If the client would not have been in default, or if other defenses exist, you can defend the foreclosure on those bases.

For example, if, as a consequence of a previous default, a borrower entered into a Delinquency Workout Agreement obligating him or her to make payments beyond his or her ability, the borrower's efforts to meet the payments under the agreement may cause him or her to fall behind in other obligations and eventually, on the RD/RHS loan. In this case, RD/RHS' initial failure to service the loan properly should be a defense to the client's second default.

Even if there is no causal connection between the initial servicing error and the client's subsequent default, review whether the various defaults are independently excused by RD/RHS' failure to take proper actions in each case.

Lastly, it may not be immediately obvious that RD/RHS serviced a loan improperly because there may be no single identifiable action that violated a specific statutory or regulatory obligation. In such cases, you should check whether RD/RHS failed to consider adequately your client's particular circumstances and to adjust its servicing to meet the client's particular needs. If it can be shown that the agency failed to service the loan

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[1363] Even if the rationale of *Neustadt* were applicable to RD/RHS cases, RD/RHS' failure to inspect and supervise construction is arguably a valid defense to foreclosure, though it may not give rise to an action for damages. In *Neustadt*, the Supreme Court conceded that the FHA may have committed a tort by providing the purchaser with a misleading appraisal. 366 U.S. 696 at 702. The court held, however, that the plaintiff was precluded from recovering damages for the misrepresentation because the Federal Tort Claims Act specifically excludes the tort of misrepresentation from the waiver of sovereign immunity. *Id.* at 711. When a RD/RHS borrower asserts as a defense to a foreclosure that the agency did not properly supervise or inspect the construction, the borrower is seeking equitable relief and not damages. Therefore, *Neustadt* should not apply, even if one assumes that the sole RD/RHS tort was that of misrepresentation.

[1364] *United States v. White*, *supra* note 1269, at 1252-53.

[1365] *Id. See Parker v. Knebel*, *supra* note 1360, slip op. at 5-6, *dismissed on other grounds* (N.D. Miss. Jan. 22, 1979).

[1366] *See* §§ 6.4.4.2 and 6.4.4.3, *supra*.

[1367] *Id.*

[1368] *See* Handbook 2-3550, ¶ 5.1 B (Rev. 7/13/05).

[1369] *See 7 C.F.R.* § 1924.5(f)(2) (2009). Handbook 1-3550, Section 6 Managing Construction (Rev. 4/15/10).

adequately, you should be able to defend against the foreclosure.

6.4.6 DEFENSES BASED ON RD/RHS' FAILURE TO PROVIDE BORROWERS WITH DUE PROCESS

6.4.6.1 Statutory and Regulatory Arguments

While the adoption of new appeal regulations and the institution of the quasi-independent National Appeals Division (NAD) have substantially improved the RD/RHS appeals process, the agency staff may take actions that undermine the due process that should be provided to borrowers. Therefore, when representing clients who are facing foreclosure, you should review carefully whether they received the due process guaranteed them under 42 U.S.C.A. § 1480(g), the NAD appeals process, and RD/RHS regulations.

6.4.6.1.1 Oral Denials of Assistance

Whenever an RD/RHS official denies assistance to a borrower, RD/RHS regulations require that the denial be in writing, that it give specific reasons for the denial, and that it advise the borrower of the opportunity to appeal the decision.[1370] Moreover, the due process rights of borrowers are violated when they receive oral notices of ineligibility because the notification does not include the required notice of the right to appeal the decision. Thus, if you discover that your client was denied assistance or discouraged from applying for assistance, that if granted, could have averted or cured a default and ultimately the acceleration, you should assert the denial as a violation of your client's due process rights and raise it as a defense to the acceleration or foreclosure.

6.4.6.1.2 Nonappealable Decisions

RD/RHs staff may advise borrowers that certain decisions are nonappealable when by regulation, they are appealable. By and large, this is due to the fact that RD/RHS staff may not always understand which decisions are appealable and which are not. Consequently, check if in servicing your client's loan, RD/RHS had properly advised him or her with respect to the appealability of all decisions. Remember, even if a decision is not appealable, your client has a right to seek a review of that decision. If your client was erroneously informed that a decision was unappealable and that decision, had it been reversed, could have prevented your client's default or would have enabled the client to cure a default, you should assert the error as a defense to the acceleration and foreclosure.

6.4.6.1.3 Reversal of Appeal Decision by NAS Director

If in connection with your client's default or ability to cure a default, your client was successful on an initial appeal, but the NAS director reversed the decision in response to RD/RHS' request for a review, check whether RD/RHS followed the proper procedure when it requested the review and whether the review was completed and a decision rendered within the prescribed deadlines.[1371] If the appropriate procedure was not followed or the time lines prescribed in the RD/RHS regulations were violated, argue that the reversal was invalid and that the initial hearing decision should be reinstated.[1372]

6.4.6.1.4 The Notice May Not Be Adequate

If RD/RHS notifies the borrower of the right to appeal, the notice may not be adequate to apprise the particular borrower of his or her rights and thus, may violate due process requirements. In *Mullane v. Central Hanover Bank & Trust Co.*,[1373] the Supreme Court stated, "An elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is notice reasonably calculated, under all circumstances to apprise interested parties of the pendency of the action and afford them an opportunity to present objections."[1374] It follows that the notice must be tailored to the capacities of the individual receiving it, in that it must apprise that individual of the

[1370] 7 C.F.R. § 3550.4 (2009).

[1371] *See* § 9.3.5, *infra*.

[1372] *See Helms v. Madigan*, No. 91-0818-R (W.D. Va. July 2, 1992) (Stipulation of Dismissal).

[1373] *Supra* note 1290.

[1374] *Id.* at 314.

impending actions and the rights he or she may exercise.[1375]

Arguably, the RD/RHS notice of acceleration, which contains the borrower's appeal rights, is not even tailored to the RD/RHS borrower of average education, let alone to borrowers with limited education or reading ability. The notice is written in highly technical and legal terms, contains lengthy sentences composed of numerous clauses, and relies on multisyllabic words not generally used in everyday language. One expert has concluded that the acceleration notice used by FmHA in the 1970s and early 1980s required a comprehension level based on 16 years of education.[1376] At one time, it was determined that RD/RHS borrowers as a class have a median education level of about 11 years,[1377] or five years fewer than that required to comprehend the notice of acceleration. Individual borrowers may in fact have substantially lower reading levels.[1378] For these borrowers, the content of the notice of acceleration and of the right to a moratorium may be meaningless and therefore deprive them of due process.[1379]

However, at least two courts that have been presented with the issue of the adequacy of FmHA notices have indicated that they are disinclined to sustain an argument that the notices violated borrowers' due process rights because the FmHA program is directed at low- and very low-income persons and that a practical balance needs to be struck between a careful and reasoned notice and an absolute understanding of it.[1380] Thus, unless you can show that the RD/RHS notice is overly complex and that RD/RHs could have easily reworded it for persons with limited reading skills, a due process claim is unlikely to prevail.

6.4.6.2 The Constitutional Argument

Until 1978, when Congress first mandated that RD/RHS adopt an appeal procedure, borrowers facing foreclosure had to assert their Fifth Amendment due process rights to obtain notice of the impending action and an opportunity to appeal the decision to an impartial official. FmHA resisted borrowers' assertions by arguing that due process did not apply to FmHA foreclosure[1381] or in the alternative, that borrowers had waived their due process rights.[1382] The courts and Congress were not persuaded by either argument.[1383] Therefore, FmHA was forced to implement an appeals process in 1978.

In most instances, borrowers' procedural due process rights are adequately protected by the appeal statutes[1384] and USDA regulations[1385] currently in effect. On occasion, where the statute and regulations are silent, borrowers may need to assert their Fifth Amendment due process rights. When asserting these rights, borrowers will first need to establish that they have a protected property interest in the RD/RHS loan. Because it should not be difficult to establish that borrowers have constitutionally protected property interests, that issue is only briefly discussed here.

It is unquestionable that borrowers whose homes are financed with RD/RHS loans have one or more property interests that are protected by the Fifth Amendment and that cannot be abridged

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[1375] *See Matthews v. Eldridge*, 424 U.S. 319, 333 (1976); *Morrisey v. Brewer*, 408 U.S. 471, 481 (1972); *Goldberg v. Kelly*, *supra* note 1290, at 268-69; and *Covey v. Town of Somers*, 351 U.S. 141, 146-47 (1956).

[1376] Affidavit of Jane L. Davidson, Ph.D., at 2-3, filed in *United States v. Rice*, No. 79-2291-2 (D.S.C. filed Mar. 11, 1980).

[1377] Spurlock, MORTGAGED RURAL HOMES -- CHARACTERISTICS OF HOUSING UNITS AND OCCUPANTS, at 18 (Nov. 1979) (Economic Dev. Div., Economics, Statistics, and Co-op. Serv., USDA, Rural Dev. Res. Report No. 17).

[1378] The same study showed that 25.8% of all borrowers whose loans were made before 1974, and 17.2% of the borrowers whose loans were made between 1974 and 1976, had fewer than eight years of education.

[1379] *See Memphis Light, Gas & Water Div. v. Craft*, 436 U.S. 1 (1978) (Stevens, J., dissenting on other grounds); *North Alabama Exp., Inc. v. United States*, 585 F.2d 783, 789 (5th Cir. 1978); *In re Nissan Motor Corp. Antitrust Litigation*, 552 F.2d 1088, 1103 (5th Cir. 1977).

[1380] *See Johnson v. USDA*, *supra* note 1274, at 784 n.8; *United States v. Gomiller*, *supra* note 1274.

[1381] *See* Memorandum from James V. Loughran, Jr., Director, Community Development Division, Office of General Counsel, USDA, to James Michael Kelly, Assistant General Counsel, Office of General Counsel, USDA, regarding *United States v. White* (Apr. 21, 1977).

[1382] *Id.*

[1383] *See, e.g.*, *United States v. White*, *supra* note 1269. *See* 42 U.S.C.A. § 1480(g) (West 2003).

[1384] 42 U.S.C.A. § 1480(g) (West 2003) and 7 U.S.C.A. § 6901 (West, Current through P.L. 111-191 (excluding P.L. 111-148, 111-152, 111-159, and 111-173) approved 6-15-10).

[1385] 7 C.F.R. Part 3550 Subpart A (2009).

without due process of law.[1386] At a minimum, this means that borrowers must be provided timely and adequate notice of any impending action that would jeopardize those interests and be provided an opportunity to be heard or to defend.[1387] Although ordinarily the formality and procedural requisites of the hearing are determined by the severity of the loss and the nature of the governmental function involved,[1388] RD/RHS borrowers facing foreclosure should have no difficulty obtaining a *Goldberg*-type pretermination hearing.[1389] NAD already provides such a hearing as part of its appeal process,[1390] and it is independently justified by the severity of the borrower's potential loss.[1391]

Given RD/RHS' regulations governing notice and opportunity for a hearing, borrowers facing judicial foreclosure do not have any significant arguments based on the Constitution that could not also be based on the agency's regulations. RD/RHS provides borrowers notice of default and of acceleration and gives them an opportunity to appeal the acceleration decision. If these notices do not adequately inform borrowers of their rights, the borrowers' constitutional argument is no different from that based on the statute or regulations.[1392]

Borrowers facing judicial or nonjudicial foreclosure are not informed of the right to appeal the initial decision to foreclose, as distinguished from the decision to accelerate the loan. Although this may violate the borrowers' statutory rights, it is doubtful that it violates any constitutional rights. By providing the borrower an opportunity to appeal the acceleration decision, RD/RHS provides the borrower with a pre-termination hearing. The judicial foreclosure hearing, at which the borrower may assert any and all arguments or defenses, probably satisfies any post-termination hearing requirements imposed by due process.[1393]

Borrowers facing nonjudicial foreclosure may have a constitutional due process issue involving their notice of foreclosure under state nonjudicial foreclosure laws. To address that issue, it is first necessary to briefly review due process and state nonjudicial foreclosure laws.

Generally, state power of sale statutes have withstood due process attacks. Statutes have been upheld either under the theory that there is no Fourteenth Amendment state action in the nonjudicial proceeding or under the theory that the statutes are consumer protection statutes prescribing minimal procedures to be followed in cases in which the parties have contractually agreed that power of sale may be used to foreclose.[1394] This latter rationale does not apply when RD/RHS is the mortgagee having the power of sale. RD/RHS' involvement creates state action under the Fifth Amendment[1395] and as a result, RD/RHS is required to provide borrowers with adequate notice of the foreclosure and, arguably, an opportunity for a hearing.[1396] RD/RHS may avoid this requirement if

[1386] *Johnson v. USDA*, *supra* note 1274; *United States v. Henderson*, *supra* note 1203, at 857; *United States v. Rodriguez*, No. 76-883 Civ. T-K (M.D. Fla. Apr. 19, 1979); *United States v. White*, *supra* note 1269, at 1250. *See Ricker v. United States*, *supra* note 1348, at 138; *Law v. USDA*, 366 F. Supp. 1233, 1238 n.6 (N.D. Ga. 1973). *See also Fuentes v. Shevin*, 407 U.S. 67 (1972); *Goldberg v. Kelly*, *supra* note 1290; *Thorpe v. Housing Auth. of Durham*, 393 U.S. 268 (1969).

[1387] *Johnson v. USDA*, *supra* note 1274, at 772; *United States v. White*, *supra* note 1269, at 1250.

[1388] *Goldberg v. Kelly*, *supra* note 1290, at 262-65.

[1389] This includes timely and adequate notice detailing the reasons for the proposed foreclosure, an opportunity to confront and cross-examine adverse witnesses, the right to be represented by counsel provided by the borrower, a decision based on evidence adduced at the hearing in which the reasons are set forth, and an impartial decisionmaker. *Goldberg v. Kelly*, *supra* note 1290, at 267-71. *But see*, *Are FmHA Loan Entitlements Protected by the Due Process Clause?*, *supra* note 1291. In *Johnson v. USDA*, *supra* note 1274, the court found it unnecessary to decide the scope of the borrower's pretermination hearing rights because the FmHA regulations in effect at the time provided all the protections afforded by *Goldberg v. Kelly*. Generally, the same is true today.

[1390] *See* § 5.5.7, *supra*, and Chap. 9 *infra*.

[1391] *See United States v. White*, *supra* note 1269, at 1251.

[1392] *See* § 6.4.6, *supra*.

[1393] *See United States v. Rodriguez*, *supra* note 1386; *United States v. Terry*, *supra* note 1274; *United States v. Brown*, *supra* note 1336. It could be argued that in a nonjudicial foreclosure, borrowers are deprived of their right to a hearing after RD/RHS decides to foreclose the loan. However, since these borrowers have an opportunity to appeal the decision leading to the foreclosure (*i.e.*, the acceleration decision), it is doubtful, absent a constitutional deficiency in the hearing procedure, that any court would require RD/RHS to provide borrowers a second hearing.

[1394] Madway, *supra* note 1159, at 260.

[1395] *United States v. White*, *supra* note 1269; *Ricker v. United States*, *supra* note 1348; *Law v. USDA*, *supra* note 1386.

[1396] *Johnson v. USDA*, *supra* note 1274; *United States v. White*, *supra* note 1269; *Ricker v. United States*, *supra* note 1348; *Law v. USDA*, *supra* note 1386.

under state law, the borrower's rights may be waived; the borrower waives them; and the waiver is made knowingly, intelligently, and voluntarily.[1397]

In states that authorize power of sale, the notice to the mortgagor of the proposed auction sale may range from constructive notice by publication or posting on the courthouse door to notice by certified mail.[1398] Perhaps because notice by publication and posting at the courthouse door have been held constitutionally inadequate when the address of the mortgagor is known[1399] or reasonably ascertainable,[1400] RD/RHS generally requires that the notice of sale be mailed to each borrower at the address to which the notice of acceleration was sent or if RD/RHS is aware of a new address, to the new address.[1401]

Nevertheless, compliance with the notice regulation may not be sufficient. Due process requires that the notice be designed to inform the parties of the pendency of the action.[1402] In one case, FmHA sent the borrowers notices of acceleration and foreclosure in accordance with FmHA regulations then in effect, in addition to providing notice by publication. The notices were returned unclaimed because the borrowers were not home at the time ordinary mail deliveries took place. FmHA knew that the borrowers continued to reside at the address to which the letters were sent because its staff had previously hand-delivered a default notice that was returned unclaimed. The court held that because FmHA knew the location of the borrowers' residence and had previously hand-delivered returned letters, notice by publication alone does not satisfy due process.[1403]

Other circumstances may give rise to a similar argument. For example, if a person is known by RD/RHS to be mentally incompetent, notice by mail may not be sufficient.[1404] Notice may also be insufficient when RD/RHS knows that the borrower is temporarily disabled or unable to manage his or her own affairs.[1405]

The RD/RHS foreclosure notice may also be insufficient in content and therefore subject to attack either on grounds that it fails to inform the borrower adequately of the basis for RD/RHS' unilateral decision to declare a default and accelerate the loan or on the grounds that it fails to tell the borrower that the only way to prevent the nonjudicial sale and to adjudicate any claimed defense is to bring an action to enjoin the sale.[1406] Finally, the notice may be deficient in that it is too complex for the borrower to understand.[1407]

6.4.6.3 Waiver of the Borrower's Due Process Rights

Many FmHA mortgage instruments used before 1979 that authorized nonjudicial foreclosure also contained an express waiver of the borrower's right to notice and a hearing before the foreclosure sale.[1408] Not surprisingly, borrowers who have raised the due process issue in FmHA foreclosure cases have been and may continue to be met by an FmHA contention that they have expressly waived their due process rights. Although there are several ways to overcome that argument, borrowers have relied only on the argument that the waiver was not voluntarily, intelligently, and knowingly made. So far, the borrowers have been uniformly successful in using this argument.[1409] Because the burden of

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[1397] *United States v. White*, *supra* note 1269; *Ricker v. United States*, *supra* note 1348; *Law v. USDA*, *supra* note 1386.

[1398] Madway, *supra* note 1159, at 165. *See Mennonite Bd. of Missions v. Adams*, 462 U.S. 791 (1983).

[1399] *Schroeder v. City of New York*, 371 U.S. 208 (1962); *Walker v. City of Hutchinson*, 352 U.S. 112 (1956); *Mullane v. Central Hanover Bank & Trust Co.*, *supra* note 1290.

[1400] *Mennonite Bd. of Missions v. Adams*, *supra* note 1398; *Ricker v. United States*, *supra* note 1348.

[1401] Handbook 2-3550 ¶ 6.5 B (Rev. 11/26/01).

[1402] *Mullane v. Central Hanover Bank & Trust Co.*, *supra* note 1290, at 314, 70 S.Ct. 652, 657 (1950).

[1403] *Rau v. Cavenaugh*, *supra* note 1230.

[1404] *Covey v. Town of Somers*, *supra* note 1375.

[1405] *See Jones v. Monarch Realty Co.*, 108 Daily Wash. L. Rptr. 21 (D.C. Super. Ct. Nov. 16, 1979).

[1406] A court proceeding may be the only opportunity to raise certain defenses. For example, RD/RHS will probably refuse to recognize certain arguments in an administrative appeal as validly appealable (*e.g.*, the right to obtain refinancing of a Section 502 loan). *See* § 5.6.4, *supra*. In such a case, the borrower will only be able to have the issue adjudicated in court.

[1407] *See* § 6.4.6.1.4, *supra*.

[1408] *E.g.*, Form FmHA 427-1 CO (Rev. 9-26-79) (real estate deed of trust for Colorado).

[1409] *Rau v. Cavenaugh*, *supra* note 1230; *United States v. White*, *supra* note 1269, at 1253. *See Johnson v. USDA*, *supra* note 1274, at 784; *Ricker v. United States*, *supra* note 1348, at

establishing a contractual waiver falls on RD/RHS,[1410] there is a strong presumption against a waiver of a constitutional right.[1411] To be valid, the waiver must be voluntarily, knowingly, and intelligently made,[1412] and it must also be shown that the right to notice and an opportunity for a hearing may be contractually waived under the particular state's law.[1413]

In each case, borrowers have prevailed by showing that the waiver clause was hidden among other clauses in a lengthy mortgage instrument, that it was not brought to their attention or explained to them by either a RD/RHS employee or the closing attorney, that the borrowers had minimal educational background and real estate experience and therefore had limited ability to comprehend fully the acceleration and foreclosure language in the deed of trust, and that substantial inequality of bargaining power existed between them and the agency.[1414]

Although no court has done so, you could rely on other grounds to overcome the waiver argument. First, the waiver provision contained in RD/RHS mortgage instruments is not authorized by any RD/RHS regulation. It, therefore, may violate the APA's requirement that the agency publish in the *Federal Register* all substantive rules of general applicability adopted as authorized by law and all statements of general policy or interpretations of general applicability formulated and adopted by the agency,[1415] and that it do so only after providing the public with an opportunity for comment.[1416]

Second, the waiver may be invalid because it is obtained as a condition for the granting of a federal benefit, in this case, a loan. As early as 1926, the Supreme Court held that a waiver of due process rights may not be extracted as a quid pro quo for the granting of governmental benefit or privilege.[1417] The government as lender is still the government,[1418] and although private creditors may extract waivers,[1419] RD/RHS should not be permitted to strip borrowers of their due process rights as a condition of granting them a loan.

Third, since 1978, Congress has mandated that RD/RHS provide borrowers with notice and an opportunity to appeal decisions that deny, terminate, reduce, or fail to renew assistance[1420] RD/RHS cannot ignore that mandate and insulate its failure to provide borrowers with due process by relying on the waiver. Such action violates the Housing Act because it is inherently contrary to the Act's purposes.

A curious waiver clause has been inserted by FmHA in many mortgage instruments revised after 1977. It reads:

> Waiver: The borrower acknowledges and agrees that if borrower defaults a

139-40; *Law v. USDA*, *supra* note 1386. *But see McCachren v. USDA*, 599 F.2d 655 (5th Cir. 1979) (*per curiam*).

[1410] *United States v. Wynn*, 528 F.2d 1048, 1050 (5th Cir. 1976); *Rau v. Cavenaugh*, *supra* note 1230; *United States v. White*, *supra* note 1269, at 1251. *See Ricker v. United States*, *supra* note 1348, at 139. *See also Fuentes v. Shevin*, 407 U.S. 67 (1972); *Gonzalez v. County of Hidalgo*, 489 F.2d 1043, 1046 (5th Cir. 1973).

[1411] *United States v. White*, *supra* note 1269, at 1251. *See Johnson v. USDA*, *supra* note 1274, at 784; *Gonzalez v. County of Hidalgo*, *supra* note 1410.

[1412] *D.H. Overmeyer Co. v. Frick Co.*, 405 U.S. 174, 185-86 (1972); *Johnson v. USDA*, *supra* note 1274, at 784; *United States v. Wynn*, *supra* note 1410; *Hoffman v. United States*, 519 F.2d 1160 (5th Cir. 1975); *Gonzalez v. County of Hidalgo*, *supra* note 1410; *Rau v. Cavenaugh*, *supra* note 1230; *United States v. White*, *supra* note 1269.

[1413] *United States v. Wynn*, *supra* note 1410; *Rau v. Cavenaugh*, *supra* note 1230. *See United States v. Kimbell Foods, Inc.*, *supra* note 1101.

[1414] *Rau v. Cavenaugh*, *supra* note 1230; *United States v. White*, *supra* note 1269. *See Johnson v. USDA*, 734 F.2d 774, 784 (11th Cir. 1984); *Ricker v. United States*, *supra* note 1348; *Law v. USDA*, *supra* note 1386. *But see McCachren v. USDA*, *supra* note 1409.

[1415] 5 U.S.C.A. § 552(a)(1)(D) (West, WESTLAW, Current through P.L. 111-191 (excluding P.L. 111-148, 111-152, 111-159, and 111-173) approved 6-15-10).

[1416] *Id.* § 553. *See United States v. Marshall*, *supra* note 1112.

[1417] *Frost v. Railroad Comm'n*, *supra* note 1112. *See also Keyishian v. Board of Regents*, 385 U.S. 589 (1967); *Sherbert v. Verner*, 374 U.S. 398 (1963); *Slochower v. Board of Higher Educ.*, *supra* note 1290; *Wieman v. Updegraff*, 344 U.S. 183 (1952); *Dixon v. Alabama Bd. of Educ.*, *supra* note 1290, at 156-57, *cert. denied*, 368 U.S. 930 (1961); *Roberts v. Cameron Brown Co.*, 72 F.R.D. 483 (S.D. Ga. 1975), *rev'd on other grounds*, 556 F.2d 356 (1977). In HUD/FHA multifamily rental housing programs, courts have consistently refused to give effect to purported waivers in lease documents. *E.g.*, *Joy v. Daniels*, 479 F.2d 1236, 1243 (4th Cir. 1973); *Escalera v. New York City Hous. Auth.*, 425 F.2d 853, 864 (2d Cir. 1970), *cert. denied*, 400 U.S. 853 (1970); *Ruffin v. Housing Auth. of New Orleans*, 301 F. Supp. 251, 253 (E.D. La. 1969).

[1418] *See Thorpe v. Housing Auth. of Durham*, 386 U.S. 670, 678 (1967) (Douglas, J., concurring).

[1419] *Dixon v. Alabama State Bd. of Educ.*, *supra* note 1290, at 156-57, *cert. denied*, 368 U.S. 930 (1961).

[1420] 42 U.S.C.A. § 1480(g) (West 2003).

> nonjudicial foreclosure of the property may be conducted without a hearing of any kind. The borrower hereby waives any rights borrower may have to any such hearing. Nevertheless the regulations of the Farmers Home Administration in effect at the time such foreclosure is started may provide for a meeting and the government will follow these regulations.[1421]

If RD/RHS attempts to assert this waiver, you should challenge its validity. The statute in effect at the time FmHA drafted this waiver required FmHA to adopt an appeal procedure and FmHA did so.[1422] The agency has no authority to grant borrowers their appeal rights while reserving to itself the right to withdraw the regulations and the appeal rights at some future time, and at that time, insisting that the borrower waived his or her constitutional and statutory due process rights with respect to that future time.

Any other waivers inserted by FmHA, or now RD/RHS, in its mortgage or deed of trust documents after 1977 should be challenged on similar grounds.

6.4.7 OTHER SUBSTANTIVE DEFENSES

Ordinarily, non-RD/RHS borrowers may have various substantive defenses to foreclosure based on the mortgage contract or on state or federal law. RD/RHS borrowers are deprived of some of these defenses because of their unique relationship to the federal government and its preemption of certain state laws. This section briefly explores mortgagors' traditional substantive defenses and their availability to RD/RHS borrowers.

6.4.7.1 Contract Defenses

Usury. The defense of usury is not available to RD/RHS borrowers because the agency has statutory authority to set interest rates for its various programs.[1423] Under that authority, RD/RHS sets interest rates that are not subject to state laws under the Supremacy Clause. Moreover, the RD/RHS rates are not likely to ever be usurious.

Waiver of default and estoppel. If it appears that the client has defaulted on the loan, review the facts of the case to determine whether RD/RHS may have waived the default. A waiver may occur when RD/RHS does not accelerate the loan for a substantial period of time, usually a period of months, after a payment has been due.[1424]

RD/RHS does not usually declare a default and accelerate a loan when the borrower merely makes late payments. If RD/RHS does declare a default based on late payments, you may be able to show a waiver of prompt performance by RD/RHS' practice of accepting payments late. Courts have held that such a practice constitutes a waiver of prompt performance, precluding acceleration of the loan.[1425] Note, however, that courts have been loath to apply the doctrines of waiver and estoppel against the federal government.[1426]

Once RD/RHS has accelerated the loan, the borrower's payment and RD/RHS' acceptance after the acceleration may not constitute a waiver of RD/RHS' right to foreclose. RD accepts partial payments but does not credit them to the borrower's account unless they are equal to the full payment due.[1427] It is not clear whether this applies to payments received after acceleration and whether the mere acceptance of the payment without crediting it to the borrower's account operates as a waiver.

In states that require a mortgagor to accept payments after acceleration and to reinstate the loan, a payment after acceleration clearly has the effect of a waiver.

[1421] *E.g.*, USDA Form FmHA 427-1 CA (rev. 1/10/79).
[1422] *See* Ch. 9, *infra*.
[1423] 42 U.S.C.A. §§ 1472, 1484(a), 1487(a)(2), 1490(a) (West 2003).
[1424] *Koschorek v. Fisher*, 145 So.2d 755 (Fla. Dist. Ct. App. 1962); *Gus' Baths v. Lightbawn*, 101 Fla. 1205, 133 So. 85 (1931), *reh'g denied*, 101 Fla. 1211, 135 So. 300 (1931); *Crossmore v. Page*, 73 Cal. 213, 14 P. 787 (1887). Note, however, that a waiver of default as to one payment does not prevent RD/RHS from declaring a default as to subsequent delinquent payments.
[1425] *Ashbach v. Wengel*, 141 Colo. 35, 346 P.2d 295 (1959); *Edwards v. Smith*, 322 S.W.2d 770 (Mo. Super. Ct. 1959); *Musso v. Ludwig*, 217 S.W.2d 165 (Tex. Civ. App. 1949); *Scelza v. Ryba*, 169 N.Y.S.2d 462 (Sup. Ct., Nassau Cnty., 1957).
[1426] *See, e.g., Federal Crop Insurance Corp. v. Merrill*, 332 U.S. 380 (1947).
[1427] Handbook 2-3550, ¶ 2.9 A (Rev. 5/27/98).

You may also be able to argue that RD/RHS' acceptance of the payment operates as an estoppel against the agency. The agency should not be allowed to accept payments from the borrower and at the same time be able to deny that the acceptance has any legal effect.[1428]

Mistake, fraud, and duress. The defenses of mistake, fraud, and duress are not likely to be available to RD/RHS borrowers because of the nature of the RD/RHS loan. They are therefore not discussed here.

6.4.7.2 Federal Truth in Lending

In foreclosure cases, the remedies under the Federal Truth in Lending Act are not of any benefit to the RD/RHS borrower. The right of rescission, one of the act's two primary remedies, is of little value at the time of foreclosure since it effectively obligates the borrower to repay the loan. The right to damages, the act's second primary remedy, is not available against government agencies.[1429]

6.4.8 PROCEDURAL DEFENSES

6.4.8.1 Judicial Foreclosure

In *United States v. Trimble*,[1430] the United States District Court for the Southern District of Florida held that FmHA's compliance with the notice provision of the moratorium relief program is a condition precedent to foreclosure, and under Rule 9(c) of the Federal Rules of Civil Procedure, must be alleged specifically in the complaint.[1431] The court reasoned that compliance with the notice provision of the moratorium relief program is not merely procedural and therefore is a valid defense to foreclosure. Having failed to allege compliance with the regulations, RD/RHS' complaint was dismissed, although without prejudice.[1432]

Borrowers facing judicial foreclosure should seek dismissal of any RD/RHs foreclosure complaint that does not specifically allege in the compliance with these regulations, as well as with all other RD/RHS servicing requirements. This will shift the burden of proof of compliance with RD/RHS' servicing regulations from the borrower to the agency whenever there is a dispute concerning compliance.[1433]

6.4.8.2 Nonjudicial Foreclosure

Because the power of sale is exercised without judicial sanction, there are no procedural defenses that may be asserted in a judicial proceeding. Precisely for these reasons, however, courts tend to closely scrutinize sales conducted under a power of sale to ensure that they are conducted strictly according to statute or the mortgage instrument and that they are fair.[1434] Therefore, if you believe a RD/RHS foreclosure sale was not conducted properly, try to have it set aside.

6.4.9 REINSTATEMENT AFTER SUCCESSFUL APPEAL OR JUDICIAL ACTION

If a borrower prevails on an appeal or in a judicial action, there are a variety of ways in which RD/RHS must reinstate and service the loan.

Interest Subsidy. A borrower who received an interest subsidy prior to RD/RHS accelerating his or her loan and whose subsidy agreement was not renewed after the acceleration must have the subsidy agreement reinstated as of the expiration of the prior agreement. This provides the borrower retroactive assistance for the period that RD/RHS had wrongfully refused to renew the agreement because it had accelerated the loan. Obviously, the borrower must have continued to be eligible for assistance during the entire period, and the amount credited to the borrower's account will depend on the borrower's income during the term that an interest subsidy agreement was not in effect.

Borrowers who were not receiving interest subsidy, who were denied assistance, and who prevail on the issue of RD/RHS' denial are also entitled to retroactive assistance from the date of denial.

[1428] *See* Davis, ADMINISTRATIVE LAW OF THE EIGHTIES, § 6.13 (1989).
[1429] 15 U.S.C.A. § 1612(b) (West 1982).
[1430] 86 F.R.D. 435 (S.D. Fla. 1980).
[1431] *Id. at* 437.
[1432] *Id.*
[1433] *See* § 6.4.4, *supra*.
[1434] *See* Nelson and Whitman, REAL ESTATE FINANCE LAW, § 7.21 (2d ed. 1985).

Moratorium relief. RD/RHS no longer has instructions on how it handles the accounts of borrowers who succeed in arguing that they were improperly denied moratorium relief. Under its prior regulations, if the borrower continued to need a moratorium when he or she prevailed at the appeal, RD/RHS was obligated to extend the moratorium, provided the two-year term of the moratorium from the date the borrower was denied relief had not expired.[1435] If the two-year period had expired, RD/RHS should have serviced the loan as if the borrower had completed a two-year moratorium and provided the borrower with the options that are available to all borrowers at the end of the moratorium period. There is no reason that the same practice should not be followed currently. If it has been more than two years since the borrower had made a mortgage payment, the borrower effectively had a moratorium during the time that the appeal was resolved and should be treated like other borrowers at the end of the moratorium period. If the two years had not expired, the borrower should be entitled to a continuing moratorium.

If the borrower is no longer in need of a moratorium, RD/RHS should also service the loan as if the borrower had completed a two-year moratorium and should service the loan in the manner it services all loans at the expiration of a moratorium.[1436] Frequently in the past, RD/RHS did not follow this option. Instead, it reinstated the loan by folding the past due balance into principal and reamortizing the new balance. This approach has several disadvantages to the borrower. First, if denies the borrower the right to obtain more favorable treatment, such as cancellation of part or all of the interest that accrued during the moratorium period.[1437] Second, it fails to categorize the borrower as one who has received a moratorium, thereby protecting the borrower against a deficiency judgment.[1438] Consequently, borrowers who successfully argue that RD/RHS improperly denied their request for moratorium assistance should resist RD/RHS' offer to reinstate it by merely reamortizing the loan.

Other servicing errors. Borrowers who were not entitled to assistance, such as interest subsidy or moratorium relief, but who were nonetheless successful in arguing that RD/RHS did not service their loan properly prior to acceleration, should have their loans reinstated and reamortized. There is no authority in RD/RHS regulations or handbooks for the agency to insist that these borrowers bring their account current in any other way.

The impact of reamortization on any particular borrower will vary depending on the borrower's income and the amount of interest subsidy for which he or she is eligible. If the borrower received the maximum amount of interest subsidy for which she was eligible prior to the acceleration, reamortization will cause the borrower's monthly mortgage payment to increase. If, however, the borrower was not receiving the maximum amount of interest subsidy, her monthly payment may not increase after reamortization because increased interest subsidy will offset the increased loan size. On the other hand, increased interest subsidy as a result of reamortization may subject the borrower to increased recapture upon full payment of the loan.[1439] The impact of reamortization and increased interest subsidy on the recapture amount is not predictable because the amount recaptured will vary depending on the amount of interest subsidy received by the borrower during the entire term of the loan, as well as the number of years the borrower had the loan.

Because the overall impact of reamortization is not predictable, it is difficult to advise borrowers who are able to make a substantial payment on the RD/RHS loan in lieu of reamortization whether they should seriously consider making such a payment.

6.5 EVICTION SUBSEQUENT TO FORECLOSURE SALE

A purchaser at the foreclosure sale will seek to evict the borrower from the home if the latter does not vacate the home voluntarily. If RD/RHS was the successful bidder, it will usually file an action in federal or state court or if the sale was judicial, seek an eviction order. If a third party was the successful bidder, it will probably bring an

[1435] 7 C.F.R. § 1900.58(a) (1994).
[1436] *See* 7 C.F.R. § 3550.207 (c) (2009).
[1437] *Id.*
[1438] *See* 42 U.S.C.A. § 1475(a) (West 2003).
[1439] *See* § 21.2, *infra*.

action in state court. Borrowers who have failed to assert their substantive or procedural defenses to the foreclosure or who have been unsuccessful in establishing their rights in an administrative proceeding may use the eviction proceeding to assert their rights to continued occupancy of their home. Borrowers may raise in these proceedings all of the substantive and procedural defenses they could have raised had they filed an affirmative action to enjoin the sale[1440] or had they initially defended the foreclosure in court. Note, however, that borrowers who have failed to take advantage of the RD/RHS appeals process are now likely to face a claim that they have failed to exhaust their administrative remedies.[1441]

If you have an opportunity to seek affirmative relief from the courts before the foreclosure sale, do not wait for the eviction action to assert the client's rights. Judges are more reluctant to void completed sales than to enjoin or refuse to authorize pending ones. They are particularly reluctant when the purchasers are third parties. In addition, you will encounter substantial obstacles if you wait to defend an eviction rather than seek to defend against an attempted foreclosure, enjoin a sale, or even set aside a completed sale. For example, if the purchaser is a third party and the eviction action is brought in state court, you will have to implead RD/RHS, which may remove the case to federal court. Moreover, the client will probably have to respond to claims of estoppel, waiver, and laches, or in the case of third-party purchasers, bona fide purchaser.[1442]

6.6 DEFICIENCY JUDGMENT

Some states preclude deficiency judgments altogether; others have placed significant restrictions on the right to obtain one. You should become familiar with the laws of your state, especially when handling foreclosure cases in which a deficiency judgment may be sought as part of the foreclosure proceedings. In that case, the failure to restrict the mortgagor's right to obtain a deficiency judgment as part of the foreclosure action, raised by way of an affirmative defense, may result in RD/RHS seeking a deficiency judgment through a separate action.

In many of its mortgage instruments, RD/RHS has inserted an express waiver of the borrower's rights under any state statute restricting its right to obtain a deficiency judgment.[1443] Several states do not recognize such a waiver. If it is recognized, attack it on the grounds discussed previously in this chapter.[1444]

RD/RHS may not seek a deficiency against a borrower when the borrower was granted a moratorium and subsequently, the borrower faithfully tried to meet his or her loan obligations.[1445] In other words, RD/RHS may not seek a deficiency from a borrower who defaults after receiving a moratorium if the default was caused by any financial hardship.

RD/RHS will not seek a deficiency merely to collect an unpaid recapture amount that is due to the agency from interest subsidy that the borrower received during the term of the loan.[1446] It will also not pursue a deficiency judgment when the agency and the Office of General Counsel determine that it is not cost effective to seek a deficiency in a particular case or, in non-judicial foreclosure states, when the Unites States Attorney will not accept a referral for a deficiency.[1447]

In other cases, if it is likely that the foreclosure sale will not satisfy the RD/RHS debt, the state office will review the borrower's financial condition to determine whether the borrower has or will have assets from which a deficiency judgment may be recovered.[1448] If the borrower does not have assets from which recovery may be had, the agency will not pursue a deficiency judgment.[1449]

For the purpose of determining the amount of the deficiency, RD/RHS includes unpaid principal and interest balance, plus all penalties,

[1440] *See United States v. White*, *supra* note 1269.
[1441] *See* § 9.3.8.1 (discussion of exhaustion).
[1442] *See Ricker v. United States*, *supra* note 1348.

[1443] *E.g.*, Form FmHA 427-NM (Rev. 9/25/79).
[1444] *See* note 1112, *supra*.
[1445] 42 U.S.C.A. § 1475(a) (West 2003); 7 C.F.R. § 3550.211(a) (2009). Neither the statute nor the regulations prescribe a time limit on the agency's ability to seek a deficiency. Thus, all borrowers who at one time have had a moratorium are covered by the prohibition against RD/RHS seeking to collect a deficiency.
[1446] RD Handbook 1-3550 ¶ 13.20 D (3/19/08). See Chapter 7 for a discussion of interest subsidy recapture.
[1447] *Id.*
[1448] RD Handbook 1-3550 ¶ 13.20 D (3/19/08).
[1449] *Id.*

costs and attorneys' fees to the extent permitted.[1450] If the loan is subject to interest subsidy recapture, it will include the full amount of the interest subsidy granted and the principal reduction attributable to subsidy in the unpaid balance.[1451]

The fact that a borrower is considered judgment proof does not necessarily deter RD/RHS from seeking a deficiency or an offset. With the advent of administrative and Internal Revenue Service Offsets,[1452] it is possible, if not likely, that RD/RHS will seek to collect deficiencies in small increments using the offset mechanism.

6.7 RIGHT TO SURPLUS FROM FORECLOSURE SALE

If the RD/RHS foreclosure sale yields a surplus, the distribution of the surplus is governed by state law. Although state laws vary, a common order of distributing RD/RHS sale proceeds (not just surplus) is: (1) payment of the cost and expense of carrying out the sale; (2) satisfaction of liens senior to that of RD/RHS; (3) satisfaction of RD/RHS debt; and (4) satisfaction of any junior liens required by law or a competent court to be paid. In its mortgage instruments, RD/RHS has reserved the right to pay any other debt owed to or insured by the government.[1453] Only after all these are paid are any remaining proceeds distributed to the borrower.[1454]

Borrowers with loans that are made after October 1, 1979and, therefore, subject to subsidy recapture of[1455] are not likely to share in any foreclosure proceeds unless they have substantial equity or received only a small amount of subsidy. This is because RD/RHS includes the total amount of subsidy paid to the borrower as the amount to be recaptured.[1456]

[1450] *See id.* ¶ E.
[1451] *Id.*
[1452] *See* § 6.12, *infra*.
[1453] *E.g.*, Form FmHA 427-1 AR (Rev. 9/12/79) (real estate mortgage for Arkansas).
[1454] *Id.*
[1455] *See* § 7.2, *infra*.
[1456] *See* § 7.3, *infra*.

6.8 BORROWER'S RIGHT OF REDEMPTION

About half the states have statutes that enable borrowers to get their property back during a specified period of time, either after a foreclosure sale or after a foreclosure judgment but before a sale, if they pay the mortgagor or subsequent owner a sum computed according to the statute.[1457] These statutes vary greatly in many respects, including whether they apply in judicial or nonjudicial foreclosure proceedings, the period of time during which redemption is available (in some states up to two years), whether the right is available for a period prior to or after a foreclosure sale, and whether the mortgagor has a right of possession during the period of redemption. One requirement that all the statutes have in common is that to redeem the property, the borrower must pay at least the sales price or, if the redemption is before foreclosure sale, the sum of the lien sought to be foreclosed. Usually, various additional costs, such as interest and attorneys' fees must also be paid.

For the RD/RHS borrower who was unable to make the monthly payments, the statutory right of redemption offers little chance of retaining the home.[1458] Even refinancing, often a viable option for some mortgagors with conventional loans, is not a practical alternative for a RD/RHS borrower. Nonetheless, the statutory right of redemption is important to RD/RHS borrowers because it gives them additional time during which they may sell the home and recover whatever equity they possess. It also may provide them needed time in which to find other housing or to file for bankruptcy.[1459]

Contrary to early court decisions,[1460] the right of redemption is applicable to RD/RHS loans[1461] and RD/RHS appears to have accepted that

[1457] *See* Madway, *supra* note 1159, at 149 (listing of various redemption statutes in effect in 1974).
[1458] Some states, such a Pennsylvania, have a state foreclosure relief program which may be of assistance to a limited number of borrowers.
[1459] *See* § 6.9, *infra*.
[1460] *See United States v. Stadium Apts., Inc.*, 425 F.2d 358 (9th Cir. 1970), *cert. denied sub nom. Lynch v. United States*, 400 U.S. 926 (1970).
[1461] *United States v. Hargrove*, *supra* note 1107. *See United States v. Kimbell Foods, Inc.*, *supra* note 1101. *See* § 6.1.1, *supra* (discussion of the applicability of various state-created rights to RD/RHS mortgages).

fact.[1462] The dissenting opinion in *United States v. Stadium Apartments, Inc.*[1463] gives a good discussion of the history and purposes of the right of redemption and the lack of conflict between state statutes providing for the right and the national housing acts.

Many RD/RHS mortgage instruments contain an express waiver of the borrower's right of redemption[1464] and RD/RHS has in the past sought to enforce it.[1465] Depending on the laws of your state, you may be able to show that the waiver is inapplicable to your client's situation because the waiver is contrary to state law or that it waives the right of redemption after but not before a foreclosure sale.[1466] In addition, you should be able to argue that the right of redemption is part of the state foreclosure process and that the Secretary has an obligation to follow state law whenever it is more favorable to the borrower.[1467]

6.9 USING BANKRUPTCY TO CURE DEFAULTS

Borrowers who were unsuccessful in asserting their defenses to a foreclosure in either the administrative or judicial proceeding, who do not have defenses to a RD/RHS foreclosure, who failed to exhaust their administrative remedies, or who otherwise may benefit from filing for bankruptcy, should consider bankruptcy as a means for stopping a foreclosure and curing their RD/RHS default. While it is beyond the scope of this manual to review in detail the use of bankruptcy to cure defaults, some of the advantages of filing a bankruptcy to avoid foreclosure will be discussed here. You should consult *Consumer Bankruptcy Law and Practice*[1468] for more detailed information on the subject.[1469]

The filing of a bankruptcy proceeding triggers the automatic stay provisions of the bankruptcy code[1470] that immediately stops all actions against the consumer which are intended to reduce his or her assets, including the actions of secured creditors such as RD/RHS.[1471] The filing will stop any foreclosure that is in progress,[1472] will preclude a foreclosure sale, and, depending on state law, may even preserve the borrower's equity after a foreclosure sale if state law provides for the right of redemption after a sale.[1473]

The bankruptcy proceeding may allow a borrower to repay over a period of time the arrearage that has accumulated on the loan.[1474] Thus, a borrower who was unsuccessful in negotiating a delinquency workout agreement with RD/RHS and who faces foreclosure may use the bankruptcy proceeding to establish a plan for repaying the arrearage and to retain the RD/RHS-financed home.

For purposes of calculating the arrearage on a RD/RHS loan, the bankruptcy proceeding has the effect of reinstating a suspended interest subsidy agreement.[1475] Thus, under the bankruptcy plan, the borrower's delinquency is calculated at the interest subsidy payment level and not at market rate of the note.[1476]

The bankruptcy proceeding may also provide the borrower a forum in which to challenge the foreclosure on the grounds that the agency did

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[1462] *See* 7 C.F.R. § 1955.60 (1994) (no longer applicable to single family loans. It does, however, reflect agency policy).

[1463] *Supra* note 1460, at 367 (Ely, C.J., dissenting).

[1464] *E.g.*, Form FmHA 427-1 TN (Rev. 10/27/76) (real estate deed of trust for Tennessee).

[1465] *See United States v. Johansson*, *supra* note 1112; *United States v. Hargrove*, *supra* note 1107.

[1466] *United States v. Johansson*, *supra* note 1112. *See* § 6.1.1, *supra* (discussion of other ways to challenge the waiver).

[1467] 42 U.S.C.A. § 1475(b) (West 2003).

[1468] (8th ed. 2006), published by the National Consumer Law Center, 7 Winthrop Square, Boston, MA 02110. See, http://www.consumerlaw.org/publications/manuals/consumer_bankruptcy.shtml.

[1469] For a concise discussion of the relevant provisions of bankruptcy law on foreclosures, *see* National Consumer Law Center, *Foreclosures* (2d Ed. 2007) and *2009 Supplement*.

[1470] 11 U.S.C.A. § 362 (West, WESTLAW, Current through P.L. 111-191 (excluding P.L. 111-148, 111-152, 111-159, and 111-173) approved 6-15-10).

[1471] *See*, *e.g.*, *In re Gaskin*, 120 B.R. 13 (D.N.J. 1990).

[1472] Note that under the 2005 Bankruptcy Act, the stay may be limited if the borrower has filed for bankruptcy previously.

[1473] *See*, *e.g.*, *In re Ivory*, 32 B.R. 788 (Bankr. D.Or. 1983). *But see In re Glen*, 760 F.2d 1428 (6th Cir. 1985).

[1474] 11 U.S.C. § 1322 (b)(5) (West, WESTLAW, Current through P.L. 111-191 (excluding P.L. 111-148, 111-152, 111-159, and 111-173) approved 6-15-10).

[1475] *In re Gaskin*, *supra* note 1471.

[1476] *Id.* If, however, the borrower does not complete the payments under the bankruptcy plan and the bankruptcy is dismissed, RD/RHS may immediately foreclose and seek the full contract amount. *Id.* at 17.

not properly service the loan.[1477] Because bankruptcy courts are viewed as being very sympathetic to homeowners, it may indeed be preferable to litigate issues in this forum.[1478]

Borrowers who file a Chapter 7 bankruptcy are discharged of personal liability on their RD/RHS loan. While RD/RHS may request a borrower who has completed a Chapter 7 bankruptcy to reaffirm the debt, there is no apparent advantage to the borrower to do so. If the borrower does not sign a new promissory note, RD/RHS will acknowledge that the borrower is not personally liable on the debt; RD/RHS will look only to the property for a recovery; and that in the event of foreclosure, RD/RHS is precluded from seeking a deficiency judgment.[1479] Moreover, as long as the borrower makes payments as scheduled and does not otherwise breach the mortgage covenants, RD/RHS will service the loan in the same manner as other RD/RHS loans. In other words, the borrower continues to be eligible for interest subsidy, moratorium relief and other loan servicing benefits to which any other RD/RHS borrower is entitled.[1480] RD/RHS has taken the position that when a bankruptcy court lifts the automatic stay accorded a borrower who has filed a Chapter 13 bankruptcy, it may proceed immediately to foreclose on the loan, provided all the appropriate servicing letters were sent to the borrower prior to his or her filing for bankruptcy.[1481] If, however, the account was not properly serviced prior to the bankruptcy filing, the loan may not be accelerated until all the proper loan servicing actions have been taken. It is not known whether RD/RHS still takes this position.

[1477] *See, e.g.*, *In re Huderson*, 96 B.R. 541 (Bankr. E.D. Pa. 1989), *aff'd sub nom. Huderson v. HUD*, C.A. No. 89-2152 (E.D. Pa. Aug. 9, 1989) (Clearinghouse No. 45,100).

[1478] The sympathies of a bankruptcy court are not likely, however, to extend to such matters as exhaustion of administrative remedies.

[1479] *See* Handbook 2-3550, ¶ 5.1 D 3 (Rev. 9/3/08).

[1480] *Id.*

[1481] 6 NAS Notes 3 (Feb. 1989).

6.10 DEFENDING FORECLOSURE OF LOANS HELD BY THE RURAL HOUSING TRUST 1987-1

Because RD/RHS Section 502 loans still held by the Rural Housing Trust 1987-1 (RHT) are subject to all RD/RHS regulations, borrowers whose loans are held by the RHT have all the defenses that are available to other Section 502 borrowers.

When representing RHT borrowers, carefully review whether the RHT serviced the loan in accordance with RD/RHS regulations instructions and handbooks. Moreover, review whether borrowers have been adequately informed of and granted their appeal rights. It is doubtful that RHT offers borrowers a meaningful opportunity to review or inspect their files, that it enables borrowers to question and call as witnesses employees of the RHT subservicer, or that it even provides a meaningful opportunity for a hearing.

If your client was possibly eligible for moratorium relief, carefully review whether the RHT advised him or her of the right to receive a moratorium and whether it adequately considered your client's eligibility. Because it is contrary to the RHT's interest to provide borrowers with moratorium relief,[1482] there are indications that the RHT does not always advise borrowers of the right and does not extend moratorium relief even when the borrower is eligible for it.[1483]

6.11 DEFENDING FORECLOSURES OF RD/RHS-GUARANTEED LOANS

Congress has on several occasions authorized RD/RHS to guarantee loans made by private lenders to borrowers in rural areas. The most recent authority for such loans is contained in Section 502(h) of the Housing Act of 1949.[1484] At different times, authorizations and appropriations for the guaranteed program have been restricted to

[1482] When the RHT grants a borrower a moratorium, it reduces its cash flow and potentially its ability to pay its investors.

[1483] Through its subservicer, the RHT tends to prefer extending Interest Credit assistance over moratorium relief because RD/RHS reimburses the RHT for additional Interest Credit. Thus, the RHT's return to its investors is not affected.

[1484] 42 U.S.C.A. § 1472(h) (West 2003).

above moderate-income families, to moderate- and above moderate-income families, or, on one occasion, to low- and moderate-income families. When the program was directed at low- and moderate-income families, Congress also authorized an interest subsidy, called "Interest Assistance," to enable low-income households to participate in the program without their having to expend a disproportionate portion of their income for shelter.[1485] While Interest Assistance is still available to borrowers who originally qualified for it, it is no longer available to new borrowers.

When RD/RHS first published final regulations for the most recent guarantee program, it encouraged guaranteed lenders to service loans in a manner that provided borrowers with the maximum opportunity to become successful homeowners, but refused to extend to these borrowers any substantive or procedural rights, such as moratorium relief, reamortization, refinancing and the right to appeal adverse decisions, as are available to direct Section 502 borrowers.[1486]

At the time, RD/RHS' rationale for not providing guaranteed borrowers with substantive rights was that:

> [T]he loan is the Lender's loan, not FmHA's loan. FmHA encourages lenders to work with borrowers and to offer servicing relief. FmHA is willing to cooperate with the lender in working with the borrower. The Agency believes that the statutes do not mandate that these rights to certain types of servicing relief extend to guaranteed loans.[1487]

FmHA's rationale for not providing borrowers with any meaningful appeal rights was similar:

> FmHA does not agree . . . that a lender's decision not to make a loan or to accelerate the account should be appealable. These decisions are made by the lender, not FmHA, and are therefore outside the scope of FmHA's administrative appeal process.[1488]

RD/RHS' position is simply untenable. The guaranteed loan program is incorporated into Title V of the Housing Act of 1949 by the addition of a new subsection 502(h).[1489] Thus, all provisions of Title V that are applicable to Section 502 direct loans, such as the moratorium, refinancing and appeals provisions, respectively codified at 42 U.S.C. §§ 1471, 1475 and 1480(g), are equally applicable to the guaranteed loan program as they are to the insured loan program.

Indeed, any doubt about the applicability of these and other servicing provisions is resolved by the authorizing legislation. It requires RD/RHS to "provide guaranteed loans in accordance with Section 517(d) [of the Housing Act of 1949]."[1490] Subsection 517(d)(3) states:

> Each loan made by the Secretary or other lenders under [Title V of the Housing Act of 1949] that is insured or guaranteed in accordance with this subsection shall, when offered for sale to the public, be accompanied by agreements for the benefit of the borrower under the loan that provide that --
>
> (A) the purchaser or any assignee of the loan shall not diminish any substantive or

[1485] *See* 7 C.F.R. § 1980.390 (2009).
[1486] 56 Fed. Reg. 15,752 (Apr. 17, 1991).
[1487] *Id.* RD/RHS took a similar position when it revised the regulations in 1995. At that time it stated that it has discretionary authority to extend moratoriums and was not required to exercise that authority. 60 Fed. Reg. 26980, 26984 (May 22, 1995). It, nonetheless, encouraged lenders to work with borrowers who are making good faith efforts to meet their loan obligations by temporarily modifying their payment schedules. *Id.*
[1488] *Id.* The regulations do provide borrowers and lenders with an opportunity to appeal an RD/RHS decision that directly and adversely impacts them. However, the borrower and lender must jointly execute a written request for appeal of the decision, although the lender need not be an active participant in the appeals process. 7 C.F.R. § 1980.399 (2009). RD/RHS contention that the decision is that of the lender and not RHS is also irrelevant. RD/RHS has extended appeal rights to residents of RD/RHS rental housing under the Section 514, 515, and 516 programs. Although the grievance process under those programs is different from that provided under the USDA's NAD appeals process, it is nonetheless a right to appeal decisions made by landlords with respect to the benefits of residents. *See*, 7 C.F.R. § 3560.160 (2009).
[1489] 42 U.S.C.A. § 1472(h) (West 2003).
[1490] *Id.*

procedural right of the borrower arising under this subchapter;

(B) upon any substantial default of the borrower, but prior to foreclosure, the loan shall be assigned to the Secretary for the purpose of avoiding foreclosure; and

(C) following any assignment under subparagraph (B) and before commencement of any action to foreclose or otherwise dispossess the borrower, the Secretary shall afford the borrower all substantive and procedural rights arising under this subchapter, including consideration for interest subsidy, moratorium, reamortization, refinancing, and appeal of any adverse decision to an impartial officer.[1491]

While this section obviously does not apply to guaranteed loans unless they are offered for sale to the public,[1492] there can be no question that this subsection confirms that in enacting the guaranteed loan program, Congress intended to provide borrowers with similar, if not identical, protections provided borrowers under the insured loan program. Thus, RD/RHS' failure to extend relief may be raised as a defense to foreclosure of a guaranteed loan.[1493]

Undoubtedly, in formulating its position with respect to the rights of borrowers who have guaranteed loans, RD/RHS relied on *Parker v. USDA,*[1494] which held that farmers who had received economic emergency loans guaranteed by FmHA were not entitled to appeal FmHA's approval of a lender's decision to foreclose under FmHA regulations, the appeal statute applicable to farm loans, or as third-party beneficiaries under the guarantee agreement between FmHA and the lender. *Parker* is, however, inapposite and should be of no avail to the agency.[1495] The statutory framework for the RD/RHS Guaranteed Home loans is entirely different from that involved in the *Parker* loan.

6.11.1 DEFENSES RELATED TO THE INTEREST ASSISTANCE PROGRAM

During Fiscal Year 1991, FmHA made guaranteed loans to low-income households that were subsidized with an interest subsidy called Interest Assistance. Under the program, the level of subsidy provided to any individual varies inversely to household income, with higher income families receiving a shallower subsidy. FmHA has limited the subsidy available to any household under the Interest Assistance program such that the effective interest rate paid by any borrower is never less than three percent. The effective interest rate increases in one percent increments as household income increases until it reaches a maximum of seven percent. The reasons FmHA established a three percent floor on the effective interest rate (as compared to one percent for the insured Section 502 loan program), as well as the basis for selecting the steps for determining the various cut-off percentages, are unknown.[1496] FmHA implemented the Interest Assistance feature of the program without seeking public comment on the level of subsidies to be provided low-income borrowers. The proposed rule left blank the formula that established the interest subsidy borrowers were to receive, and FmHA did not solicit any comments on the issue.[1497] In response to commentators' criticism of its failure to publish the figures for comment, FmHA stated that it "has determined that the actual amount of interest assistance granted is an administrative determination. This figure could

[1491] *Id.* § 1487(d)(3).

[1492] Why Congress extended this provision to cover guaranteed loans is somewhat perplexing inasmuch as RD/RHS, as guarantor of the loans, hardly possesses a marketable asset. The provision makes eminent sense in the insured loan context where RD/RHS is the holder of the borrowers' promissory notes which are readily marketable. Indeed, in accordance with the Omnibus Budget Reconciliation Act of 1987, FmHA, in 1987, sold in excess of $2 billion worth of promissory notes of Section 502 insured borrowers to a private entity, the Rural Housing Trust 1987-1, in order to reduce the federal deficit during that fiscal year.

[1493] Note that RD/RHS would have to be made a party to the foreclosure action in order to challenge its failure to extend the provisions of Title V to guaranteed borrowers.

[1494] 879 F.2d 1362 (6th Cir. 1989).

[1495] *See* § 9.5, *infra*.

[1496] According to one FmHA staff person, FmHA established the limits and the various steps in an effort to achieve an average loan interest level of five percent. Phone conversation of Gideon Anders with Jim Craun, FmHA Single-Family Housing Loan Processing Division (May 17, 1991). Why any level was deemed necessary and why five percent was chosen are unknown.

[1497] *See* 56 Fed. Reg. 202, 232 (Jan. 3, 1991).

change from time to time due to changes in the cost of money."[1498]

The final regulations for the guaranteed program also omit the formula for the interest subsidy.[1499] The only place the interest subsidy level is set out is in the individual Master Interest Assistance and Recapture Agreement with the Promissory Note that is executed by the borrower at the time of loan closing.

FmHA's failure to publish for comment the structure of the Interest Assistance program and consequently, its limitation on the level of subsidy that is to be provided to eligible borrowers appear to violate Department of Agriculture regulations incorporating the Administrative Procedure Act's requirement that the agency publish for comment all regulations affecting the public,[1500] as well as subsequent statutory requirements that the agency publish regulations for comment.[1501]

Moreover, the setting of the interest subsidy floor at three percent may itself be a violation of the Housing Act, which authorizes the Secretary to "reduce the effective interest rate [on Section 502 loans] to a rate not less than 1 per centum per annum . . . if without such assistance . . . applicants could not afford the dwelling or make payments on the indebtedness."[1502] This regulatory limitation on Interest Assistance is not unlike a1973 attempt by FmHA to terminate altogether the Interest Credit subsidy for the Section 502 insured loan program. A district court enjoined that effort on the ground that it violated FmHA's statutory and constitutional authority.[1503]

Borrowers who have defaulted on guaranteed loans and whose default could have been lessened or avoided by an increased interest subsidy should consider defending a foreclosure on the ground that FmHA implemented the Interest Assistance without publishing the details of the program for comment and on the ground that the agency adopted a limitation on the available subsidy that is arbitrary and contrary to the purposes of the Housing Act of 1949.

6.11.2 DEFENSES AGAINST THE GUARANTEED LENDER

The RD/RHS guaranteed loan regulations state that lenders will negotiate in good faith when a borrower defaults on the loan and that the borrower will be given a reasonable opportunity to bring the loan current before any foreclosure proceeding is started.[1504] This includes the requirements that: (1) a reasonable attempt be made to contact the borrower if the payment is not received by the 20th day after it is due; (2) a reasonable attempt be made to hold an interview with the borrower that attempts to resolve the delinquency before the loan becomes 60 days past due; (3) if the borrower does not respond to the lender, the lender must determine whether the property has been abandoned; and (4) the lender report the delinquency to credit repositories when the account is 90 days delinquent.[1505]

Foreclosure must be commenced within 90 days of the lender's decision to liquidate or, effectively, 180 days after the default.[1506]

There are potentially two grounds upon which a borrower may assert that the lender's failure to follow the servicing requirements constitutes a defense to a foreclosure action or as a basis for enjoining the sale. First, argue that the servicing requirements are mandatory in that they are part of the RD/RHS regulations. Second, argue that since a foreclosure action or a proceeding to enjoin a foreclosure is an equitable proceeding, the lender's failure to comply with the servicing obligations is an equitable defense to a foreclosure.[1507] You

[1498] 56 Fed. Reg. 15,750 (Apr. 17, 1991).
[1499] *See id.* at 15,780.
[1500] *See Rodway v. USDA*, *supra* note 1112. *See also Montgomery v. HUD*, No. C-85-2104 (N.D. Iowa filed Dec. 10, 1985), 19 CLEARINGHOUSE REV. 1444 (Apr. 1986) (No. 40,154) (HUD's failure to publish a change in the interest subsidy provided in connection with the Section 235 program challenged as violating 5 U.S.C. § 553; the case was reportedly settled in a sealed settlement agreement).
[1501] 42 U.S.C.A. § 1490n (West 2003).
[1502] 42 U.S.C.A. § 1490(a)(1)(B) (West 2003).
[1503] *Pealo v. FmHA*, *supra* note 1261, at 1324.
[1504] 7 C.F.R. § 1980.371 (2009)
[1505] *Id.*
[1506] *Id.* § 1980.374.
[1507] *See Brown v. Lynn*, *supra* note 1288, *reconsideration denied*, 392 F. Supp. 559 (N.D. Ill. 1975); *FNMA v. Ricks*, 372 N.Y.S.2d 485 (1975); *Cross v. FNMA*, 359 So.2d 464 (Fla. Dist. Ct. App. 1978); *GNMA v. Screen*, 379 N.Y.S.2d 327 (1976); *Society for Savings v. Dudley*, Civ. No. H-75-179 (D. Conn. Dec. 20, 1976); *Farragher v. Dorchester Savings Bank*, No. 02597 (Mass. Hsng. Ct., Boston, Dec. 27, 1974) (Clearinghouse No. 14,260); *FNMA v. Huffman*, No. 73 CH 7453 (Ill. Cir. Ct., Cook Cnty., Mar. 17, 1976) (Clearinghouse No. 15,097); *Midwest Federal Savings and Loan Ass'n of*

should remember that the regulations impose on the lender a requirement that it make reasonable efforts to assist the borrower to resolve the default. In an equitable proceeding, you can argue that the lender must utilize all the authorities available to it and that the failure to do so is unreasonable.

6.11.2.1 Foreclosure Mitigation Guide

In December of 2007, RD/RHS published an Administrative Notice that encourages guaranteed loan borrowers to offer several loss mitigation options to borrowers who are in default on their guaranteed loans.[1508] Attached to the notice is a Loss Mitigation Guide that sets out the options that are available to lenders depending on whether the borrower default is deemed curable or not curable. Among the curable options are special forbearance and loan modification plan. Among the non-curable options are pre-foreclosure sale plan and deed in lieu of foreclosure plan.

Unfortunately, the Administrative Notice and the Loss Mitigation Guide clarify that loss mitigation is discretionary and not mandatory. Thus, there is no way of requiring the guaranteed lender to extend any loss mitigation options to defaulting borrowers. At the same time, however, the obligation to make reasonable efforts to assist the borrower in curing the default limits the lender's discretion to not offer any alternatives to the borrower.

Curiously, the Administrative Notice offers cash incentives to lenders who are able to facilitate the transfer of security property to the lender in lieu of foreclosure. If they are able to secure the transfer prior to the initiation of foreclosure, the incentive is $1,000. After foreclosure has been initiated, it is reduced to $250.00. Curiously, no incentives are offered to facilitate loan deferrals or modifications that would assist the borrower to retain his or her home.

Since the Administrative Notice has expired[1509] and the loss mitigation options are discretionary, the various options set out in the Loss Mitigation Guide will not be reviewed here. Advocates are urged to review the Guide when discussing foreclosure avoidance mechanisms with guaranteed lenders to see whether lenders will consider the options when a borrower has defaulted on a RD/RHS Guaranteed loan.

6.11.2.2 HAMP

In response to the foreclosure crisis facing this country, the Obama Administration initiated the Home Affordable Modification Program (HAMP), designed to assist eligible single-family home borrowers to avoid foreclosure by modifying loans to a payment level that is affordable and sustainable for the long-term.[1510] While the Federal Housing Administration (FHA) and the Veterans Administration have implemented HAMP programs that are applicable to FHA and VA loans, as of June 2010, RD/RHS had not taken any steps to implement a similar program for the RD/RHS guaranteed loan program. Advocates are urged to review the HAMP website[1511] to see whether RD/RHS has since modified its programs to incorporate HAMP.

6.12 USE OF OFFSETS TO COLLECT DELINQUENCIES AND DEFICIENCIES

RD/RHS routinely asks federal agencies and the Internal Revenue Service to offset salaries, retirement benefits, or tax refunds, against debts owed to the agency. The practice is authorized by the Federal Collection Act of 1982 as amended by

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Minot v. Petties, No. 51-170 (Okla. Ct. App. July 18, 1978) (Clearinghouse No. 45,102); *Lomas & Nettleton Co. v. Stefanowicz*, C.A. No. 76-383 (W.D. Pa. June 24, 1976) (Clearinghouse No. 45,101); *Commonwealth of Pennsylvania v. Freeman*, Civ. No. 75-1092 (W.D. Pa. Oct. 28, 1975); *Associated East Mortgage Co. v. Young*, 394 A.2d 899, 163 N.J. Super. 315 (1978). *But see Hernandez v. Prudential Mortgage Corp.*, 553 F.2d 241 (1st Cir. 1977); *Roberts v. Cameron Brown Co.*, *supra* note 1417, 556 F.2d 356; *Young v. FNMA*, No. 74-1756A (N.D. Ga. Mar. 20, 1975).

[1508] RD AN 4321 (1980-D) (December 18, 2007). The AN had an expiration date of December 31, 2008. Accordingly, it is not clear whether any of its provisions, including the incentives that are discussed below, are still being followed.

[1509] The Administrative Notice expired as of December 31, 2008. It has not been renewed and is no longer available on the RD website.

[1510] For information about the Home Affordable Modification Program, see https://www.hmpadmin.com/portal/about/overview.html (last visited on Feb. 16, 2010).

[1511] https://www.hmpadmin.com/portal/index.html (last visited on Feb. 16, 2010).

the Debt Collection Act of 1996.[1512] RD/RHS regulations on offsets are set out in the Code of Federal Regulations.[1513]

It is beyond the scope of this manual to discuss offsets in detail. You should review the applicable RD/RHS regulations to familiarize yourself with these processes. In addition, consider reviewing an older three-part article by the National Consumer Law Center on the use of Intercepts of Tax Refunds to Offset Debts Owed to Federal Agencies.[1514]

Administrative offset. An administrative offset is the collection of funds that are due to the borrower from any other federal agency. RD/RHS will use administrative offsets at any time that an account is delinquent by more than two monthly payments and the delinquent amount is at least $25.[1515] Before initiating an administrative offset, the borrower must be given 30 days' notice of the agency's intent to offset, provided an opportunity to inspect agency records related to the debt, and seek a review of the agency's determination of indebtedness.[1516] RD/RHS will not use an administrative offset in states where the acceptance of a payment after acceleration has the effect of reinstating the account, when the borrower's account is in bankruptcy, the borrower is in on active military duty, the account is under some form of delinquency workout, including a moratorium, or the statute of limitations for collecting the debt has expired.[1517]

Internal Revenue Service (IRS) offset. An IRS refund offset is the most common offset method used by RD/RHS to collect debts from current and past borrowers. IRS offsets must be conducted in accordance with IRS regulations,[1518] and the borrower must receive at least a 60-day notice of the agency's intent to use the offset.[1519] IRS offsets cannot be used in conjunction with an administrative or salary offset.[1520]

[1512] Codified at 31 U.S.C.A. §§ 3701, *et seq.* (West, WESTLAW, Current through P.L. 111-191 (excluding P.L. 111-148, 111-152, 111-159, and 111-173) approved 6-15-10).
[1513] 7 C.F.R. Part 3 (2009).
[1514] *Intercept of Tax Refunds to Offset Debts Owed Federal Agencies: Part I*, 20 CLEARINGHOUSE REV. 557 (Aug./Sept. 1986); *Part II*, 20 CLEARINGHOUSE REV. 702 (Oct. 1986); *Part III*, 20 CLEARINGHOUSE REV. 822 (Nov. 1986).
[1515] RD Handbook 2-3550, ¶ 7.8 (10/15/08).
[1516] 7 C.F.R. § 3.41 (a) (2009).
[1517] RD Handbook 2-3550, ¶ 7.8 (10/15/08).
[1518] See 31 C.F.R. § 285.2 (2009).
[1519] RD Handbook 2-3550, ¶ 7.10 (1/9/08).
[1520] *Id.* ¶ 7.7 (10/15/08).

CHAPTER 7
REFINANCING RD/RHS LOANS WITH PRIVATE FINANCING AND RECAPTURE OF INTEREST SUBSIDY

7.1 REFINANCING WITH PRIVATE CREDIT

Rural Development/Rural Housing Service (RD/RHS) is a government lender of last resort and is directed to avoid competition with private lending institutions.[1521] Therefore, persons seeking RD/RHS loans must not be able to obtain credit from other lending institutions.[1522] To ensure that the agency does not compete with private lenders, borrowers who have received RD/RHS loans must refinance those loans with private lenders once they are able to do so upon reasonable rates and terms.[1523] RD/RHS refers to the process as Refinancing with Private Credit."[1524]

The obligation to refinance with private funds is statutory,[1525] and RD/RHS has promulgated regulations governing the process.[1526] In addition, most RD/RHS mortgage instruments incorporate an express covenant in which the borrower agrees to refinance the RD/RHS loan whenever able to do so upon reasonable rates and terms.[1527] If necessary, RD/RHS may enforce this obligation through acceleration of the loan and initiation of foreclosure proceedings[1528] and has successfully sought enforcement in the past.[1529]

7.1.1 DETERMINING THE BORROWER'S ABILITY TO REFINANCE WITH PRIVATE CREDIT

RD/RHS' Centralized Servicing Center (CSC) reviews a housing borrower's ability to refinance with private credit every two years.[1530] If RD/RHS has information suggesting that a borrower may be able to obtain credit from a private source, the borrower's ability to refinance with private credit may be reviewed at any time.[1531] Typically, RD/RHS is likely to become aware of a borrower's changed circumstances at the time that the borrower recertifies for a subsidy and the borrower's income or assets have changed significantly.

An initial review of the borrower's capacity to refinance is conducted internally by CSC using its MortgageServ computer program. This review looks at 20 factors to determine whether the borrower should undergo a more thorough review. Critically, the review focuses on the borrower's credit score, whether the borrower's RD/RHS unsubsidized promissory note interest rate is at least 2% points above 30 year fixed conventional interest rates, and whether there is at least an 8% reduction in the borrower's loan balance from the original loan amount.[1532] RD/RHS excludes from review borrowers who are in foreclosure or bankruptcy or who are currently on a Moratorium, Delinquency Workout Agreement, more than one month delinquent or have been delinquent more than once in the last 12 months, and borrowers whose account has been reamortized within the last 12 months.[1533]

[1521] *See* §§ 1.2.5, 2.4.2.4, *supra*.
[1522] 42 U.S.C. § 1471(c) (West 2003).
[1523] *Id*. § 1472(b)(3).
[1524] 7 C.F.R. § 3550.160 (2009), HandbookHandbook 2-3550 ¶2.18 (Rev. 5/21/10). The Refinancing with Private Credit regulations were formerly codified at 7 C.F.R. § 1951 Subpart F (1994). References to those regulations are no longer applicable to the RD/RHS housing programs. 7 C.F.R. § 1951.251 (2009). The new regulations are codified at 7 C.F.R. § 3550.160 et. seq. (2009). In addition, RHS has published two handbooks that explain agency policies with respect to the direct Section 502 loan program. Provisions regarding refinancing with private credit are set out in Handbook 2-3550, Section 4 (Rev. 5/21/10). Available at: http://www.rurdev.usda.gov/regs/hblist.html #hb2).
[1525] 42 U.S.C. § 1472(b)(3) (2003).
[1526] 7 C.F.R. Part 3550, Subpart D (2009) (7 C.F.R. §§ 3550.160 -3550.162).
[1527] *E.g.*, Form RD 1940-16, Promissory Note (Rev. 7/05); Form RD 3550-12 Subsidy Repayment Agreement (Rev. 9/06).
[1528] 7 C.F.R. § 3550.160(d)(2)(2009); Handbook 2-3550 ¶¶ 2.18 (rev. 5/21/10) and 2.21 (rev 9/3/08).
[1529] *United States v. Anderson*, 542 F.2d 516 (9th Cir. 1976).
[1530] Handbook 2-3550 ¶2.19 A. (rev. 5/21/10) (The regulations say 'periodically.' 7 C.F.R. § 3550.160(c) (2009)).
[1531] 7 C.F.R. § 3550.160(c) (2009).
[1532] Handbook 2-3550 ¶ 2.19 (rev. 9-3-08).
[1533] *Id.*

RD/RHS also excludes from review borrowers whose payments are reduced or deferred in accordance with the Service Members Relief Act of 2003, whose loan balance is less than $20,000, and whose loan maturity is less than 8 years.

All borrowers not excluded from the refinancing review process must undergo a thorough review, which requires the borrowers to submit within 30 days sufficient financial information to enable RD/RHS to determine their ability to refinance with private credit,[1534] and RD/RHS to review the borrowers' financial condition to determine if the borrowers may be able to graduate to private financing.

The current regulations and the Handbook[1535] do not state what information RD/RHS may request the borrower to provide and do not describe the method by which the agency will evaluate the borrower's ability to refinance. Historically, the agency has looked at the borrower's ability to pay the debt, the equity in the borrower's home, and the borrower's liquid assets to determine whether the borrower can refinance the RD/RHS loan. It is, therefore, worthwhile to briefly look at those factors.

The borrower's present and future ability to repay the debt if privately refinanced. Borrowers should refinance with private credit when they are able to do so. In conformance with other RD/RHS practices, determination of the borrower's ability to refinance with private credit should be based on the borrower's family budget[1536] and on an evaluation of the amount of family income that would be devoted to shelter costs after refinancing. That is, Centralized Servicing Center (CSC) should determine from the family budget whether the borrower has sufficient income, after deducting all expenses, to meet the terms of the new loan.

Sufficient income should not, however, be the sole determinant. If the payments will constitute a substantial portion of the borrower's total income, the borrower should not be forced to refinance with private credit. By analogy to the former Interest Credit subsidy program, if the new payments, including taxes and insurance, are less than 20% of the borrower's adjusted income, refinancing is probably warranted.[1537] If, however, the new payments exceed 29% of the borrower's income or the borrower's total debt obligations exceed 41% of the borrower's income, refinancing should clearly not be required.[1538]

Finally, the borrower's future income should also be considered. If, for example, the borrower has sufficient present income to refinance the RD/RHS loan, but the level of that income is expected to decline because of retirement, the borrower's ability to refinance should be determined on the basis of expected future income.

Borrower's liquid and nonessential assets. The regulations do not state how a borrower's assets are to be evaluated in the refinancing context. Clearly, a borrower should not be required to use assets upon which he or she relies for a living or which are otherwise essential to refinance the RD/RHS loan. Moreover, borrowers should not be required to exhaust all of their liquid assets in order to refinance the loan.

Equity in the dwelling and in other property. Although the borrower's equity in property is an important factor in determining ability to refinance the loan, it cannot be evaluated independently. Obviously, the borrower's equity will determine the size of the loan needed to refinance the RD/RHS loan. The borrower's ability to repay that loan must, however, be determined based upon the borrower's repayment ability.

Borrower's repayment history. A borrower's RD/RHS payment history is likely to affect a lender's willingness to refinance the borrower's RD/RHS loan. If RD/RHS uses the same criteria for determining whom it will ask to graduate as it uses in determining initial loan eligibility, only persons with the most impeccable credit history are likely to qualify.[1539]

Note that in determining any borrower's ability to graduate to private financing, RD/RHS may consider only the financial condition of the person(s) indebted to RHS. In other words, in the case of an individual borrower, RD/RHS may con-

[1534] 7 C.F.R. § 3550.160 (c)(1) (2009).
[1535] *Id.* § 3550.160(b).
[1536] Form RD 1944-3 (Rev. 6/97).
[1537] Arguably, higher percentage may apply to borrowers who are under the payment assistance program and who have been accustomed to paying a higher proportion of income for mortgage payments.
[1538] *See* 7 C.F.R. § 1980.345(c)(3) (2009) (RD guaranteed loan eligibility requirements).
[1539] *See* § 2.4.2.8, *supra*.

sider only the financial condition of the person who executed the promissory note and may not review information about other household members, even the borrower's spouse, if he or she is not indebted to RHS.[1540]

7.1.2 REQUESTING BORROWERS TO REFINANCE

Borrowers who CSC determines are eligible for refinancing are formally requested to do so and by regulation, are given 30 days in which to contest the RD/RHS decision and provide additional financial information to document an inability to refinance with private credit.[1541] Unfortunately, borrowers are never directly informed of this right. The letter that is sent to borrowers simply states that RD/RHS has determined that they may be able to refinance their loans and requires them to do so within 90 days or to provide RD/RHS with evidence, in the form of a lender's rejection letter, that that they are unable to do so.[1542] It does not mention the right to contest the decision set out in the regulations.[1543]

Borrowers determined eligible are requested to refinance within 90 days.[1544] If the borrower does not respond within 45 days of the initial letter, he or she is to be sent a reminder, with a 15 day response notice.[1545] If the borrower still does not respond, CSC staff is supposed to contact the borrower by phone within the last 15 days of the 90 day period.

A borrower unable to refinance must provide RD/RHS with the name of the lenders that he or she contacted, the amount and purpose of the loan requested, and the amount, if any, offered by the lender, as well as the offered rates and terms or the specific reason(s) why credit was not available.[1546]

If a borrower is offered a private loan, it does not mean that the borrower must refinance. The refinancing offer must be evaluated with respect to its reasonableness and the borrower's capacity to meet the new mortgage terms.[1547]

RD/RHS may initiate foreclosure on the loans of borrowers who refuse to refinance, fail to cooperate in the refinancing process, or fail to respond to RHS' requests for information.[1548] Under limited circumstances, RD/RHS officials authorized to accelerate single-family loans must obtain the concurrence of the Regional Attorney from the USDA's Office of General Counsel in order to accelerate a loan for the borrower's failure to refinance.[1549]

7.1.3 APPEAL RIGHTS

Borrowers who do not cooperate with RHS or who fail or refuse to refinance are not advised of their right to appeal the RD/RHS decision until they are notified of RD/RHS' decision to accelerate the

[1540] The definition of a borrower is "[a] recipient who is indebted under the section 502 or 504 programs." 7 C.F.R. § 3550.10 (2009) and Handbook 2-3550, (rev. 5/28/98) (Glossary).

[1541] 7 C.F.R. § 3550.160(c)(3) (2009).

[1542] Handbook 2-3550 Appendix 3, Handbook Letter 111 (3550).

[1543] When borrowers do not respond to the initial refinancing letter, they are sent a reminder letter, Handbook Letter 112 (3550), which invites them to call CSC to discuss their capacity to refinance if they have not already done so. This is not the same as advising borrowers of their right to contest the decision.

[1544] The borrower receives Handbook Letter 111 (3550), Request for Borrower to Refinance with Private Credit which provides him or her with information and instructions. (Handbook 2-3550 ¶ 2.20 (Rev. 9/3/08)).

[1545] Handbook Letter 112 (3550). Handbook 2-3550 ¶ 2.21 (Rev. 9/3/08).

[1546] 7 C.F.R. § 3550.160(d) (2009).

[1547] Borrowers may be required to refinance with private credit only if the rates and terms of that refinancing are reasonable. In RHS regulations that are no longer applicable to the Section 502 loan program, but are nonetheless persuasive, RHS states that loans are reasonable if they are comparable to those commercial rates and terms offered other borrowers for loans for similar periods of time. 7 C.F.R. § 1951.252 (2009). Whether a rate is reasonable is therefore determined not by comparing it to a borrower's RHS loan rate, but by comparison to the rates and terms of conventional lenders. However, the regulations warn that differences in rates and terms between RHS and other lenders will not be an acceptable reason for a borrower's failure to refinance if the rates and terms are within the borrower's ability to pay. 7 C.F.R. § 3550.160 (b)) (2009).

[1548] 7 C.F.R. § 3550.160(d)(2) (2009). Handbook 2-3550 ¶ 6.1 B (Rev. 5/21/10).

[1549] Handbook 2-3550 ¶ 6.1 A. 1 (Rev. 4/20/05). Foreclosures are referred to the Office of General Counsel if the foreclosure is based on a nonmonetary default, involves a civilian borrower who has since entered military service, or the property also serves as security for another USDA loan.

loan.[1550] This is unfortunate and probably illegal as it does not grant the borrower a right to appeal when the initial adverse decision was made, but rather, delays the appeal to the time of acceleration, which gives the borrower fewer options in responding to the default. The fact that borrowers are not advised of their right to appeal earlier should not, however, preclude them from appealing the RD/RHS decision at an earlier date, such as when they receive the refinancing request.

7.2 RECAPTURE OF THE INTEREST SUBSIDY

Section 521(a)(1)(d) of the Housing Act of 1949 requires RD/RHS to recapture from Section 502 borrowers -- out of the appreciated value of the homes at the time of sale, disposition or non-occupancy[1551] -- all or a portion of the interest subsidy advanced during the life of the loan.[1552] The purpose of this provision is to reduce the cost of operating the RD/RHS interest subsidy programs. This section also requires RD/RHS to provide borrowers with an incentive to maintain the property by not recapturing its full appreciated value.[1553]

The FmHA, the RD/RHS predecessor agency, first adopted regulations to recapture interest subsidies applicable to borrowers who received Interest Credit in conjunction with initial and subsequent loans made after October 1, 1979, as well as to loans assumed after that date.[1554] Therefore, any borrower whose loan was approved or assumed prior to October 1, 1979 is not subject to recapture, even though the borrower may have received Interest Credit after that date.[1555] This is true even for those borrowers whose loans were approved after October 31, 1978,[1556] but before October 1, 1979, whose mortgage instruments have express provisions making them subject to recapture.[1557]

Few borrowers who enter into Subsidy Repayment Agreements at the time of loan closing focus on or fully understand the agreement when they sign it -- in part because the agreement is not written in plain English -- and are surprised by its existence and effect when they seek to pay off their loans. Regrettably, there is little to be done about the force and effect of the agreement since the borrowers signed it at the loan closing and acknowledged its existence in the mortgage or deed of trust that they executed.[1558]

Borrowers whose loans were approved after October 1, 1979 and before December 26, 1996 entered into recapture agreements that were subject to regulations then in effect. In 1996, RD/RHS revised the regulations,[1559] and it appears that the agency applies the new regulations to all borrowers regardless of when they entered into the subsidy repayment agreement.[1560] Generally, the new agreements are more favorable to borrowers than the old agreements.[1561] Thus, borrowers should benefit from the change. However, there may be instances where the old agreements are more favorable. Advocates are therefore urged to look over agreements that borrowers signed before 1996 to see whether they are more or less favorable than the regulations

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[1550] *Id.*¶ 6.5. B.

[1551] 42 U.S.C. § 1490a(a)(1)(D) (2003).

[1552] The savings derived from the recapture were expected to be used to offset the cost of the Home Ownership Assistance Program (HOAP), which was also passed as part of the Housing and Community Development Amendments of 1978. *See* 42 U.S.C. § 1490a(a)(1)(C) (West 2003). Unfortunately, the agricultural appropriations committee, which controls the RD/RHS budget, never appropriated funds for HOAP and the program is not operating.

[1553] H.R. REP. NO. 1792, 95th Cong., 2d Sess. 90, *reprinted in* 1978 U.S.C.C.A.N. 4872, 4910; 42 U.S.C. § 1490a(a)(1)(D) (2003).

[1554] 7 C.F.R. § 3550.162 (a) (2009), Handbook 2-3550 § 5 (Recapture), at 2-29 (Rev. 9/3/08).

[1555] Note that if a borrower receives Interest Credit on a subsequent loan made after October 1, 1979, recapture applies to that loan but not to the original Interest Credit agreement on the initial loan.

[1556] Pub. L. No. 557, 92 Stat. 2080 (1978), was signed into law on that date.

[1557] 7 C.F.R. § 3550.162(a) (2009); Handbook 2-3550 Section 5 Recapture, at 2-29 (Rev. 9/3/08).

[1558] *See e.g.* NAD Case No. 2008S000220 (8-14-2008) (available at: https://nadtrack.nad.usda.gov/pls/wpdad/public_api_usa.download?p_file=2008S000220R.htm&query_text=NO_QUERY_TEXT as of 6/29/09).

[1559] 61 Fed. Reg. 59761, 59774, (November 22, 1996) (As amended by the Final rule at 67 Fed. Reg. 78321 (December 24, 2002).

[1560] There is no mention in the current RHS regulations or handbooks of the existence of earlier subsidy repayment agreements and no statement that old agreements will be enforced.

[1561] For example, the amount of appreciation recaptured by the government under the old agreement for a borrower who owned her home less than 5 years was 78%. FmHA Instructions 1951-I, Ex. A (9-27-79) Under current regulations, the recapture amount is only 50%. Form RD 3550-12 (Rev. 8-00).

that RD/RHS is currently enforcing. If the old agreement is more favorable, the borrower may want to insist that RD/RHS follow the old agreement.

The amount to be recaptured is secured by a lien on the borrower's home. Such liens are authorized in the recapture legislation,[1562] and their existence is disclosed in the FmHA and RHS mortgage and subsidy instruments.[1563]

The borrower must repay the subsidy when the home is sold or transferred, including a sale or transfer because of foreclosure or voluntary reconveyance, when the borrower requests full release of the RD/RHS lien,[1564] or when the borrower, without RD/RHS consent, ceases to occupy the home.[1565] A borrower who repays his or her loan fully and remains in the home is not subject to recapture so long as the home is not transferred another person or the borrower fails to continue to occupy the dwelling.[1566] Similarly, a borrower who graduates from an RD/RHS loan need not pay the amount to be recaptured until the dwelling is transferred or the borrower ceases to occupy it.[1567]

Borrowers who pay off their loans are not subject to immediate recapture and do not pay interest on the deferred recapture amount.[1568] From RD/RHS' perspective, this interest-free deferral is costly because it is a nonproducing asset that decreases in value due to inflation. In order to encourage borrowers to repay the recapture amount early and thus convert the asset into cash income for the government, RD/RHS began to offer a 25 percent discount on the recapture amount due to borrowers who repaid the deferred recapture amount early in a lump sum. Starting on October 29, 1993, RD/RHS made the 25 percent discount offer permanent.[1569] The discount is only offered to borrowers who are retaining title, will continue to occupy the house and who make the recapture payment within 30 days of making the final loan payment.[1570] However, if RD/RHS learns that the borrower has paid off the loan without arranging for the recapture payment, it will allow the borrower to receive the discount if he or she pays the recapture within 120 days.[1571] Thus, if you represent a client who owns a home subject to RD/RHS recapture, you should advise the client of the discount offer and suggest that the client consider taking advantage of it. Assuming the client can make the payment, a client who does not intend to remain in the home for many more years gains a tremendous advantage by accepting the discount. On the other hand, if the client has no intention to move, it may be more advantageous to continue to defer the payment.

To accommodate private lending institutions, RD/RHS will subordinate its lien for the amount of recapture if the security value of the property is not less than the sum of the loan to which RD/RHS will be subordinate and the RD/RHS lien.[1572] However, RD/RHS will subordinate its right to recapture only to the extent necessary to repay the RD/RHS debt plus reasonable closing costs, up to 1% of the loan amount for loan servicing costs (if required by the lender), and the costs of any necessary repairs and improvements to the property.[1573]

[1562] 42 U.S.C. § 1490a(a)(1)(D) (2003).

[1563] *See e.g.*, Form FmHA 427-1 CA, Real Estate Deed of Trust for California, ¶ 14 (Rev. 4/94). For a more recent form *See* Form RD 1940-16 (Rev. 7-05), Promissory Note, p.2, (available at http://forms.sc.egov.usda.gov/efcommon /eFileServices/Forms/RD1940-0016_050 700V004.pdf and Form RD 1944-6 (6.22.09), Interest Credit Agreement RD Form 1944-06 ¶ XIII (Section 502 RH Loans) (Rev. 3/97). (available at https://formsadmin.sc.egov.usda.gov/efcommon /eFileServices/Forms/RD1944-0006.pdf).

[1564] In *Allen v. USDA*, 698 F. Supp. 669 (S.D. Miss. 1988) the borrower challenged FmHA's efforts to recapture Interest Credit upon the borrowers' request to release the FmHA lien in full. The borrower contended that FmHA did not provide sufficient notice of its right to recapture the interest subsidy under those circumstances. The court rejected the challenge.

[1565] 7 C.F.R. 3550.162(d) (2009). RHS may accelerate the loan if the borrower has moved from the home and has not responded to the agency's recapture notice within 60 days. Handbook 2-3550 ¶ 2.22 (rev. 9-3-08).

[1566] 7 C.F.R. § 3550.162 (a) and (c); Handbook 2-3550 ¶ 2.22 (Rev. 9/3/08).

[1567] 7 C.F.R. § 3550.160(e); Handbook 2-3550 ¶¶ 2.19 C (Rev. 5/21/10).,and 2.25 (Rev.11.7.07).

[1568] 7 C.F.R. § 3550.162(a) (2009), Handbook 2-3550 Section 5 Recapture, at 2-29 (Rev. 9/3/08).

[1569] FmHA AN 2904 (1951-I) (Oct. 29, 1993). 7 C.F.R. § 3550.162(c)(3) (2009),

[1570] 7 C.F.R. § 3550.162 (c)(3) (2009).

[1571] Handbook 2-3550 ¶ 2.24 B.2 (Rev. 11/7/07).

[1572] 7 C.F.R. § 3550.160 (e) (2009); Handbook 2-3550 ¶ 2.25 A (Rev. 11/7/07).

[1573] *Id.*

Loans that have been sold to the Rural Housing Trust 1987-1 (RHT) are subject to the same recapture rules as other RD/RHS Section 502 loans. However, once a loan is paid in full, RHT will reassign the loan to RD/RHS if the borrower does not also repay the recapture amount due. The recapture amount must then be repaid to RD/RHS when the home is sold or transferred. Similarly, if the borrower seeks to subordinate the recapture lien to a private lender, the borrower must contact RHS.[1574]

7.3 AMOUNT OF SUBSIDY TO BE RECAPTURED

The amount of subsidy RD/RHS currently recaptures on sale or transfer of a property is determined by formula. Generally, it is the lesser of the amount of subsidy received or 50% of the difference between the value appreciation in the property and the added value of capital improvements to the property.[1575] In fact, the percentage actually recovered by RD/RHS varies dramatically depending on the amount of subsidy that the borrower received and the time the borrower has lived in the property. Indeed, if the borrower received only a shallow subsidy and lived in the property for over 30 years, the applicable rate can be reduced to as low as 9%.[1576]

If the loan is satisfied through sale or assumption, the amount recaptured by RD/RHS is a percentage of the property's appreciated value. The percentage recaptured is based on the number of months the loan was outstanding and the interest rate paid by the borrower over the life of the loan. The longer the loan was in effect and the higher the borrower's interest rate, the smaller the percentage of the property's appreciated value that RD/RHS will recapture.

The formula used by RD/RHS to determine the amount of recapture agreements is complex and the figures vary with each borrower. The formula and an illustrative example of how it is calculated are set out in detail in the RD Handbook and its attachments.[1577] It will not be repeated here except to highlight certain details.

Value Appreciation. For the purpose of determining recapture, the appreciated value of a property is the current market value of the property less the original value of prior liens, balance due on the agency loans being paid off, closing costs, principal reduction at note rate, original equity and capital improvement credit.[1578]

The current market value is determined from a sales contract or an appraisal conducted by RD/RHS or another lender. A broker's opinion is not acceptable for determining the current market value. If RD/RHS conducts an appraisal, it is paid by the agency.[1579]

Capital improvements are additions made to the property during the borrower's ownership, above and beyond repairs, that add to the value of the property. Borrowers must supply information to RD/RHS to determine any capital improvements made to the property and the value of the improvement(s). The cost of an improvement is not necessarily the value of the improvement. This value must be determined by an appraiser or RD/RHS.[1580]

All the remaining figures used in determining the appreciated value of the property are provided by RD/RHS and are based on RD Form 3550-12, which the borrower signed at the original loan closing, or on loan principal and interest calculations made by the agency. Therefore, these figures will be supplied, or must be requested from, the RD/RHS Finance Office.

When CSC learns that a borrower has paid off his or her account without calculation of recapture, the regulations require it to advise the borrower that the agency will obtain an appraisal of their property.[1581] Unfortunately, the regulations do not require RD/RHS to advise such borrowers that they may appeal either the appraisal or RD/RHS' reliance on the appraisal if they believe that it is not justified.[1582] Obviously, both agency decisions are appealable under the USDA appeals procedure.[1583]

[1574] Handbook 2-3550 ¶ 2.26 (11/7/07).
[1575] 7 C.F.R. § 355.161 (b) (2009).
[1576] Form RD 3550-12 (Rev. 9-06).
[1577] Handbook 2-3550 Chapter 2 and Attachments 2 A and 2B (Rev. 10/5/05).
[1578] *Id.* ¶ 2.23.
[1579] *Id.* ¶ 2.23 B.1.
[1580] *Id.*
[1581] *Id.* ¶¶ 2.24 A. and B. 2.
[1582] For example, it may be possible that a borrower has been unable to sell a property at the appraised price and was required to reduce to the price in order to sell it within a reasonable time period. In such a case, RD/RHS should not be able to rely on the appraisal to calculate the recapture amount. Handbook 1-3550 ¶ 1.9 (Rev. 12/17/08).
[1583] *Id.*

Assumption of loans subject to recapture. RD/RHS will reamortize the amount of subsidy that is to be recaptured in cases where loans are being assumed in lieu of making a subsequent loan to repay the subsidy.[1584]

Deficiency judgments for recaptured amount. RD/RHS will not seek a deficiency judgment against a borrower to recover any part of its lien that arises from application of the recapture formula and is not recovered from a sale or transfer of the home.[1585]

7.3.1 RECAPTURE IN VOLUNTARY CONVEYANCE AND FORECLOSURE CASES

In recapture agreements entered into prior to 1990, RD/RHS took the position that there would be no sharing of the appreciated value of the property when a property is voluntarily conveyed to the agency or liquidated through foreclosure.[1586] This provision is no longer in the Subsidy Repayment Agreement form, and the matter is not addressed in RD/RHS regulations or its Handbook. In fact, it was never addressed in the RD/RHS regulations. Accordingly, any effort to deny borrowers the right to share in the appreciation value of the property based upon the fact that the property is being foreclosed upon or reconveyed to the agency should be challenged on the basis that RD/RHS or its predecessor agency, FmHA, never adopted the recapture agreement provision into its regulations and its existence violates the Administrative Procedures Act.

7.4 RECAPTURE OF PRAS FOR LOANS ENTERED INTO BETWEEN OCTOBER 1, 1979, AND DECEMBER 31, 1989.

Borrowers with loans entered into prior to 1990 that are subject to recapture and have been paid in full are often perplexed by RD/RHS' including an amount ascribed to Principle Reduction Attributable to Subsidy (PRAS) in the recapture calculations. The PRAS amount is recaptured from the borrower regardless of whether the value of the borrower's home appreciated during the time that it was owned by the borrower. As explained below, this is because PRAS was a principal subsidy received by borrowers as a result of the manner in which FmHA, the RD/RHS predecessor agency, amortized loans prior to December 31, 1989.

To understand PRAS, it is necessary first to understand the intent of the Interest Credit program and how FmHA operated it prior to 1990. As its name implies, the Interest Credit program was always intended to operate only as an interest subsidy program. In other words, borrowers receiving Interest Credit assistance were to have their payments reduced by FmHA's subsidizing the interest due on the loan from the promissory note's market rate to a rate, depending on the borrower's income, as low as 1%. However, for reasons that are not entirely clear, when FmHA first implemented the Interest Credit program, it did so in a rather unique manner that inadvertently resulted in borrowers receiving a subsidy on principal as well as on interest.

Prior to January 1, 1990, whenever FmHA entered into an Interest Credit agreement, it calculated the borrower's monthly mortgage payment according to the Interest Credit formula.[1587] Using mortgage amortization tables, FmHA then calculated the effective interest rate that that payment represented, given the borrower's loan size and term. For example, if a borrower was entitled to Interest Credit on a $50,000 loan amortized over 33 years that would reduce the mortgage payments to $167 dollars per month, FmHA determined that the borrower had an effective interest rate of 1.75 percent.[1588]

Having made that determination, FmHA would then amortize the borrower's loan at the reduced interest rate instead of the promissory note rate, which, as an example, may have been at ten percent. As a result of amortizing the loan at the lower interest rate, a greater proportion of the borrower's monthly payment was attributable to principal than would have been had the loan been amor-

[1584] 7 C.F.R. § 3550.162(e) (2009); Handbook 2-3550 ¶ 2.22 B (Rev. 9/30/08).
[1585] 7 C.F.R. § 1951.407(a) (2009).
[1586] FmHA Instruction 1951 I, Ex. A, ¶ 5 (9-27-79).

[1587] *See* § 3.2.1.5.3, *supra*.
[1588] The borrower's amortization factor was calculated by dividing $50,000 into $167, which equals $3.33 per $1,000 of loan per month. By looking at an amortization table for 33-year loans, a $3.33-per- thousand rate was equivalent to a 1.75% loan.

tized at the promissory note rate.[1589] Moreover, the benefit of this subsidy would accrue to the borrower throughout the term of the loan even if Interest Credit was terminated at some time. This is because the portion of each payment that is attributable to interest is dependent upon the principal balance outstanding at the time the payment is made. Thus, once the principal amount had been reduced by the Interest Credit subsidy, a smaller portion of all the subsequent payments was attributable to interest.

While FmHA recognized long ago that its method of applying the Interest Credit subsidy to borrowers' accounts subsidized principal, it did not attempt to do anything about that until it implemented the recapture program. When it did, it made the full amount of PRAS subject to recapture.[1590]

PRAS is not a factor or an issue for loans entered into on or after January 1, 1990, because starting that year, FmHA amortized all loans receiving Interest Credit at the market interest rate and simply credited borrowers' accounts with a non-cash credit to account for the Interest Credit subsidy.[1591]

7.5 SPECIAL CONSIDERATION FOR SERVICEMEMBERS SUBJECT TO THE SERVICEMEMBERS RELIEF ACT OF 2003 (SCRA)

The SCRA reduces eligible members' interest rates on the promissory note to 6% whenever the loan interest rate is over 6%. This reduction is not subject to recapture under the RD/RHS formula.[1592]

7.6 ARGUMENTS FOR CHALLENGING RECAPTURED AMOUNT

Two arguments may be made to challenge the amount of recaptured subsidy. The first applies to all loans and is based upon the arbitrary way in which RD/RHS may have determined the amount to be recaptured. The second applies only to borrowers who are foreclosed upon and is based upon RHS' recovery of the total subsidy extended to these borrowers.

7.6.1 THE RECAPTURED AMOUNT WAS ESTABLISHED ARBITRARILY

The legislation providing for recapture requires RD/RHS to provide borrowers with an incentive to maintain their homes in a marketable condition.[1593] As stated by the Conference Committee Report accompanying the legislation that enacted the recapture provisions: "The Secretary is directed to permit the borrower to keep at least an amount determined to be an adequate incentive for maintaining the property in those instances where it has been demonstrated that the borrower has adequately maintained the property."[1594] It is clear from this language that RD/RHS should determine the incentives necessary for borrowers to maintain the property in marketable condition and should base the amount of recapture on those determinations and on whether the borrower has maintained the property. RD/RHS, however, does not follow this interpretation.

The Draft Impact Analysis Statement prepared in support of the recapture regulations in 1978

[1589] For example, the monthly payment on a $50,000 loan amortized over 33 years at 10% interest is $433. In the first month of the loan, $416.67 would be attributable to interest, while only $16.23 would be attributable to principal. The same loan amortized at 1.75% would produce a monthly payment of $167, of which, during the first month, $72.92 would be attributable to interest and $94.08 to principal. In this example, FmHA's method of calculating Interest Credit effectively subsidized the borrower's principal payment by $77.85 (*i.e.*, the difference between $16.23 principal paid under the conventional loan and $94.08 principal paid with the subsidy) in the first month of the loan.

[1590] *See* 7 C.F.R. § 1951, Subpart I, Ex. A, ¶ 6(e) (1994). (removed from C.F.R. pursuant to 61 Fed. Reg. 59761, 59764 (November 22, 1996).

[1591] Under the new procedure, RD/RHS may still be subsidizing the borrower's principal payments in effect since January of 1990, and certain borrowers may still gain advantage from Interest Credit by having their loans paid prematurely. However, the new procedure categorizes all the RD/RHS assistance as a subsidy and thus eliminates the need to separately recapture PRAS. Moreover, it seems that the new procedure does not fully recapture what was formerly categorized as PRAS. This appears to operate to the benefit of borrowers. *See* Handbook 2-3550 ¶ 2.23 B (Rev. 9/3/08).

[1592] Handbook 2-3550, Page 2-29 (Rev. 9-03-08).

[1593] 7 U.S.C. § 1490a(a)(1)(D) (2003).

[1594] H.R. REP. NO. 1792, 95th Cong., 2d Sess. 90, *reprinted in* 1978 U.S.C.C.A.N. 4872, 4910.

does not mention how FmHA arrived at the recapture amount or what it considered to be an adequate incentive for borrowers to maintain their homes.[1595] When asked to specify what data had been collected on the issue, FmHA's responded that, "[W]e have no data concerning the level of return to the borrower that would provide an incentive for maintenance."[1596] It appears that FmHA's decision was made arbitrarily and was therefore illegal under Section 553 of the Administrative Procedure Act.[1597]

Even if the formula adopted was arrived at after due consideration of what constitutes an appropriate incentive, the amount to be recaptured from each borrower does not take into account whether the borrower has maintained the property. Instead, the recapture amount is heavily dependent on the property's increased value and ignores the maintenance provided. Indeed, the only mention of maintenance in the recapture section of the Handbook is for the purpose of distinguishing 'maintenance' from 'capital improvements' and confirming that activities such as "yard maintenance, painting, wallpapering, floor coverings, water heaters" are not to be credited to the borrower as part of the "value appreciation" component of the recapture calculation.[1598] Therefore, a borrower who has maintained his or her home, but lives in a neighborhood with little or no appreciation in value, is likely to have a greater amount recaptured than another borrower who has not maintained the dwelling, but lives in a neighborhood where there is a substantial increase in property values.

[1595] FmHA, Draft Impact Analysis Statement (Dec. 13, 1978) (Decision Calendar No. FM 10,812).
[1596] Letter from Jennings Orr, Assistant Administrator, Single Family Housing, to Gideon Anders, National Housing Law Project (Apr. 2, 1979).
[1597] 5 U.S.C. § 553 (West 1977).
[1598] Handbook 2-3550 ¶ 2.22 B (Rev. 9/3/08). Applicable regulations, confirms that value appreciation may be a factor in calculating recapture but makes no mention of adjusting the recapture amount to provide an incentive for borrower maintenance. 7 C.F.R. § 3550.162(b) (2009).

CHAPTER 8
DISPOSITION OF RD/RHS-OWNED SINGLE FAMILY PROPERTIES

8.1 INTRODUCTION

Through foreclosure and voluntary conveyances, thousands of subsidized housing units across the nation come into RD/RHS' possession every year.[1599] A significant portion of these units are disposed of by RD/RHS without an adequate effort to ensure that the units remain part of this nation's low-income housing stock or that they remain decent, safe and sanitary. Because the supply of federally subsidized low-income housing falls far short of demand, RD/RHS' failure to maintain formerly subsidized housing as part of the low-income housing stock is another way in which the agency is failing to meet the objectives of the Housing Act of 1949. This chapter reviews the process of RD/RHS acquisition and disposition of inventory property and explores ways to force RD/RHS to make inventory property available to low-income persons in a decent, safe and sanitary condition.

8.2 ACQUISITION OF HOUSING BY RD/RHS

Foreclosure and reconveyancing are the primary ways RD/RHS gains possession of formerly subsidized housing. After a voluntary reconveyance, RD/RHS usually gains clear title to the property. It will also obtain clear title to property after a foreclosure sale, at least in those states without statutory rights of redemption. Even in states with statutory rights of redemption, RD/RHS will have a fee interest in the property once the statutory period of redemption has expired. Once it has title, RD/RHS can dispose of properties by direct sale, sealed bid, auction, or by other methods.[1600] In states where RD/RHS uses judicial foreclosure, it often will gain possession of abandoned property long before it obtains title. In those states, pending foreclosure, it may maintain, repair and rent the property, pay real estate taxes and assessments, and secure personal property left on the premises as necessary to protect the government's interest.[1601] Expenses will be charged to, and rents credited to, the borrower's account.

In most states, the judicial foreclosure process is slower than the nonjudicial foreclosure process. Historically, when undertaken by RD/RHS, the judicial foreclosure process has been extremely slow because foreclosures were carried out by the Assistant United States Attorneys, who frequently gave RD/RHS foreclosures a very low priority. Indeed, it was not uncommon to find a two-to-three-year delay in the processing of judicial foreclosures by United States Attorneys.[1602] To overcome this problem, Congress has authorized RD/RHS to use the Department of Agriculture's Office of General Counsel or private attorneys to undertake, among other matters, judicial foreclosures of Section 502 loans.[1603] In recent years, RD/RHS has contracted out the foreclosure process to local private attorneys or title companies. As a result, the foreclosure pro-

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[1599] *Agriculture, Rural Development and Related Agencies Appropriations for 1981: Hearings Before a Subcomm. of the House Comm. on Appropriations*, 96th Cong., 2d Sess. 59 (1980).

[1600] 42 U.S.C.A. § 1480(e) (2003). *See* § 8.3, *infra*. 7 C.F.R. § 3550.251(a) (2009).

[1601] 42 U.S.C.A. § 1472(b)(4) (2003); 7 C.F.R. § 3550.251(b) (2009). *See, e.g.,* RD Form 3550-14 (Mortgages/Deeds of Trust). *See* § 8.3, *infra* (discussion of how eligible persons may rent property). *See generally* RHS Handbook 1-3550-DLOS (Dedicated Loan Origination and Servicing System) Field Office (2008), available at http://www.rurdev.usda.gov/regs/hblist.html, Chap. 15, Managing Custodial and REO Property. The Handbook is a 'how-to' guide for RD/RHS staff. It is not a regulation and does not have the force and effect of law. However, it may be enforceable against RD/RHS.

[1602] Indeed, in one case, FmHA (the RHA predecessor agency) was barred from collecting on a promissory note, but not from foreclosure, for failure to commence a judicial foreclosure action until eight years after the promissory note was accelerated. *United States v. Alvarado*, 5 F.3d 1425 (11th Cir. 1993), *aff'g in part, rev'g in part,* No. 89-143-CIV-FTM-21A (M.D. Fla. Sept. 6, 1991), 25 CLEARINGHOUSE REV. 1236 (Feb. 1994) (No. 47,083).

[1603] 42 U.S.C.A. § 1480(d)(1) (2003). Starting in late 1989, FmHA began to contract with private attorneys for foreclosures in various states and has authorized them to undertake judicial foreclosures in state courts. *See, e.g.,* Memorandum of Neal Sox Johnson, FmHA Acting Administrator, to Michael P. Kelsey, Acting State Director, RHS New Jersey (Oct. 3, 1989).

cess, even in judicial foreclosure states, has been accelerated substantially.

The condition of the housing coming into RD/RHS' possession varies greatly. Some units are in very good condition; others are dilapidated or vandalized. There are many reasons for the disparate condition of repossessed housing. Some units, particularly those in the Section 504 program, may have never been decent, safe and sanitary. Others were not constructed to specifications. Still others were not maintained by the borrower or were vandalized after the borrower vacated the unit. When RD/RHS takes possession of a vacant unit and does not have a tenant to whom it may be rented, the agency has authority to secure the building in an attempt to avoid vandalism.[1604]

8.3 RD/RHS PROPERTY DISPOSITION PRACTICES

Historically, RD/RHS' decisions with respect to repossessed and acquired property were geared to the single goal of protecting the government's financial interest.[1605] Little or no consideration was given to using the property to meet the 1949 Housing Act's goal of providing decent, safe and sanitary housing to low-income persons.[1606] Since 1988, RD/RHS has placed greater emphasis on selling decent single-family inventory property to persons eligible for RD/RHS assistance and to nonprofit organizations that will use it for rental housing and on leasing it to organizations for use as shelters for homeless persons.[1607] Notwithstanding these efforts, vestiges of RD/RHS' attitude of protecting its financial interests continue to permeate its property disposition practices.

8.3.1 PROPERTY SUBJECT TO FORECLOSURE

For most of the history of the program, RD field staff was not given specific direction on handling vacated property subject to foreclosure. The regulations authorized them to take possession of the property, to make necessary repairs, and to enter into a lease, management, or caretaker's agreement with third parties. This led the field staff to take various approaches to repossessed property. Some boarded up units until foreclosure had taken place. Others rented or leased the property either on the open market or to potential low-income purchasers. Some RD/RHS staff entered into agreements with local entities, most often realtors, to manage and rent the property.

In recent years RD/RHS has included a chapter in its single family field office handbook that provides guidelines to its field staff regarding taking possession of both custodial[1608] and Real Estate Owned (REO)[1609] properties.[1610] The handbook gives substantial discretion to RD field staff in handling the property, depending on whether it is simply abandoned or subject to foreclosure.

8.3.2 INVENTORY PROPERTY[1611]

RD/RHS Staff must classify all property that secured RD/RHS housing loans as "program" or "nonprogram" (NP) property when RD/RHS acquires title to it.[1612] "Program" property is property that "is eligible for financing under the section 502 program, or which could reasonably be repaired to be eligible," regardless of whether it is located in a rural area.[1613] Property that "cannot reasonably be repaired to be eligible as section 502 property and property that has been improved to a point that it will no longer qualify as modest under section 502, is classified as "NP [nonprogram] property."[1614] Unfortunately, because RD/RHS regulations lack clarity on distinguishing between program and nonprogram property, some properties that should be classified as program property are not.

[1604] Handbook 1-3550 § 15.4, B 1 (Rev. 5/16/07).
[1605] *See* 7 C.F.R. § 3550.251(a) (2009).
[1606] 42 U.S.C.A. § 1441 (West 2003).
[1607] Handbook 1-3550, § 16.1 (9/27/06).
[1608] Custodial property is abandoned or other property in which RHS has a security interest and to which it has taken possession, but not title, in order to protect the Government's security. 7 C.F.R. § 3550.251(b) (2009).
[1609] REO property is property to which RHS has taken title, through foreclosure or deed in lieu of foreclosure. 7 C.F.R. § 3550.251(a), (c) (2009); Handbook 1-3550, ¶ 15.1 (Rev. 1/23/03).
[1610] Handbook 1-3550, Chap. 15 (2003).
[1611] Any property for which RHS has acquired title is inventory property.
[1612] 7 C.F.R. § 3550.251(c)(1) (2009).
[1613] *Id.* § 3550.251(c)(1).
[1614] *Id.*

RD/RHS regulations advise agency staff that when classifying property, they must carefully consider factors such as dwelling size, design, possible health or safety hazards and obsolescence due to functional, economic or locational conditions.[1615]

> Property that has been enlarged or improved, so that its value is clearly above program standards, or a property that would require major redesign or renovation to be brought to program standards, should be classified as NP property. REO property in an area no longer designated rural is treated as if it were still in a rural area.[1616]

Improper suitability determinations may be made due to the statement in the regulations that nonprogram property is property that "cannot reasonably be repaired to be eligible as section 502 property."[1617]

Relying on the term "reasonably," RD/RHS staff is likely to conclude that -- contrary to RD/RHS intent -- a dwelling should not be repaired whenever the cost of repair exceeds the value that would be added to the property or whenever the RD/RHS investment in the property exceeds the property's market value. The RD/RHS Handbook has addressed this issue by providing that: "repairs, if required, are typically a condition of sale and, repair lists should be incorporated with the sale listing for all REO" but that only "property that would require major redesign or renovation to be brought to program standards, should be classified as NP property."[1618] This is because RD/RHS has concluded that it generally makes the best recovery on its investment in inventory property by resale of program property to program-eligible buyers.[1619] Only when the cost of repairs becomes excessive should economic considerations enter the suitability determination.[1620]

When representing clients who seek to purchase RD/RHS inventory property, review the entire inventory of RD/RHS properties in the client's locality, and if it appears that properties have been improperly classified as nonprogram, review the RD/RHS determinations to ensure that they were properly made. If they were not properly made, consider challenging the decision either through the RD/RHS appeals process[1621] or in the courts under the Administrative Procedure Act.[1622]

8.3.2.1 Sale of Program Property to Individuals

"Most REO properties are sold through real estate brokers. However, the Agency may sell properties through sealed bid, auction, negotiation, or agreements with other Federal agencies, such as the Department of Housing and Urban Development (HUD)."[1623] The preferred method is through an exclusive contract with a single broker, which if used, is awarded on a competitive basis.[1624] The method used often depends on RD/RHS staffing and workload levels.[1625]

Price. Single-family inventory property is initially listed for sale for its present market value based upon a current appraisal.[1626] Required improvement costs must be disclosed with the sale offer and flood, mudslide and wetlands conditions and restrictions, as well as due diligence regarding hazardous materials, must be contained in the appraisal.[1627] If, after 90 days of active marketing, the

[1615] Handbook 1-3550, ¶ 15.4 A (Rev. 5/16/07). Note the reference in 15.4. A. to Chapter 5 of the Handbook which addresses requirements for program property in much greater detail.
[1616] *Id.*
[1617] 7 C.F.R. § 3550.251(c)(1) (2009).
[1618] Handbook 1-3550, ¶ 15.4. A. (Rev/ 5/16/07).
[1619] *See* FmHA AN 1763 (1955) (June 21, 1988).
[1620] *Id. But see* FmHA AN 2103 (1955) (June 18, 1990) (an inventory property that otherwise would be classified as program may be classified nonprogram if the highest and best use value markedly exceeds the residential value).
[1621] *But see* § 9.2.2, *infra* (discussion of nonappealable decisions).
[1622] 5 U.S.C.A. § 551, *et seq.* (West, WESTLAW Current through P.L. 111-174 (excluding P.L. 111-148, 111-152, 111-159, and 111-173) approved 5-27-10).
[1623] Handbook 3550-1, ¶ 16.1. A (Rev. 9/27/06).
[1624] *Id.* at ¶ 16.2.
[1625] *Id.*
[1626] *Id.* at ¶ 16.3. *See*, 7 C.F.R. § 3550.62 (2009), Handbook 1-3550 ¶ 5.13 (Rev. 9/27/06) and RD AN 4350 (1980-D) (April 11, 2008).
[1627] 7 C.F.R. § 3550.251(c)(2) (2009). Handbook 1-3550, ¶ 16.3.A (1/23/03).

property has not been sold, RD/RHS may reduce the price of the property by 10 percent of the appraised value.[1628] A further reduction of 10 percent of the appraised value is authorized if the property has been actively marketed for 150 days after initial offering.[1629] After 210 days from initial offer, the local office is to submit documentation of its marketing efforts to the RD State Office for advice or for authorization to market by sealed bid /auction.[1630]

Earnest money deposits. When a property is marketed by RD/RHS directly, RD/RHS may not collect an earnest money deposit. However, a broker marketing a property may collect an earnest money deposit in an amount customary for the market. The deposit is applied toward the purchaser's closing costs.[1631] An earnest money deposit of a person whose offer is not accepted or whose request for RD/RHS financing is rejected must be returned to the applicant.[1632] However, if the applicant fails to comply with the terms of an accepted offer, the broker, as an agent of RD, may retain the deposit.[1633]

Priorities. During the initial 60 days that a property is marketed and for 30 days after each price reduction or other change in sale terms, an offer to purchase a property may only be accepted from an eligible direct or guaranteed single family loan purchaser or a nonprofit organization or public body providing transitional housing [1634] Offers may be received from persons not eligible for RD/RHS financing at any time, but they may not be accepted during periods that persons eligible for RD/RHS financing have priority to purchase the property.[1635]

Any offer submitted within the first three days after a dwelling is listed is not considered received until the fourth day, at which time it is considered with all other offers actually received on the fourth day.[1636] Offers from persons eligible for RD/RHS financing that are received during periods when such persons do not have an exclusive right to purchase the property receive priority over offers from other persons received the same day.[1637] Equally acceptable offers[1638] are considered by the date submitted, and in the event more than one offer is submitted on the same day, are given priority by lottery.[1639]

Financing. Persons eligible for RD/RHS financing may obtain a Section 502 direct or guaranteed loan to finance purchase of the dwelling provided they meet all the loan eligibility requirements. Persons ineligible for Section 502 financing must pay cash, obtain private financing or qualify for financing on RD/RHS' Nonprogram terms.[1640]

Denial of credit request. A person whose offers to purchase a program property with Section 502 direct loan financing is accepted, but whose eligibility for the financing is denied, has the right to appeal the eligibility decision in accordance with USDA's Appeal Procedure.[1641] RD/RHS will not, however, keep the property off the market pending resolution of the appeal.[1642] Indeed, the RD/RHS Handbook instructs RD/RHS to consider the next offer, if any, or to advertise or relist the property.[1643] The RD/RHS regulations may be vulnerable to a challenge on the grounds that they deprive applicants of meaningful appeal rights and therefore, violate the borrower's statutory and constitutional due process rights.

In *Ungersma v. FmHA*,[1644] applicants found ineligible for an FmHA loan to purchase a program property forced FmHA to honor its sales contract

[1628] Handbook 1-3550. ¶ 16.3 B (1/23/03).
[1629] Handbook 1-3550 ¶ 16.3 B (1/23/03). *See* Handbook 1-3550 Exs. 16-1 and 16-2 (1/23/03).
[1630] 7 C.F.R. § 3550.251 (2009).
[1631] Handbook 1-3550, ¶ 16.7. D (1/23/03).
[1632] *Id*. ¶ 16.7. E.
[1633] *Id*.
[1634] 7 C.F.R. § 3550.251(c)(4) (2009), Handbook 1-3550 ¶16.3. B (1/23/03). *See also id*. Exs. 16-1 and 16-2.
[1635] 7 C.F.R. § 3550.251(c) (4)(ii) (2009).
[1636] *Id.* § 3550.251(c)(4)(iii).
[1637] *Id.* § 3550.251(c)(5)(i).
[1638] All offers from program eligible persons are considered equally acceptable regardless of the price offered since RHS will only sell the property to eligible borrowers using RHS financing for the listed sales price. 7 C.F.R. § 3550.251(c)(5)(i) (2009)
[1639] *Id.* § 3550.251(5)(ii) (2002), For details of the marketing practice *see* Handbook 1-3550 ¶ 16.7 (1./23/03).
[1640] Handbook 1-3550 ¶ 16.1. B (1/23/03).
[1641] 7 C.F.R. § 3550.4 (2009). Note that the definition of a "participant" under § 3550.10 includes "any individual . . . who has applied for, or whose right to participate in or receive a payment, loan, or other benefit is affected by an RHS decision."
[1642] *Id.* § 3550.251(c) (5)(iii).
[1643] Handbook 1-3550 ¶ 16.7. E (1/23/03).
[1644] Civ. No. 91-1303 LKK-JFM (E.D. Cal. Oct. 11, 1991) (stipulated order).

notwithstanding the fact that it had entered into a sales contract with another party. The applicants in *Ungersma* appealed the FmHA eligibility decision and the National Appeals Staff hearing officer reversed the decision prior to FmHA having entered into a sales contract with another applicant. When the Ungersmas sought to proceed with the purchase, FmHA advised them that it had entered into a sales contract with another party and that the inventory property was therefore no longer available.

Because the Ungersmas family was large and the inventory property was a four-bedroom house, they filed a lawsuit to enjoin FmHA from selling the inventory property to any other party and to require specific performance of their original purchase contract. They also sought declaratory relief that the FmHA regulations which authorized FmHA to contract to sell an inventory property to another party without regard for the applicants' appeal rights, were arbitrary and capricious and violated applicants' statutory and constitutional due process rights by depriving them of the right to a meaningful appeal. The Ungersmas argued that they were entitled to enforce their original purchase contract because FmHA had entered the new contract with knowledge that they had prevailed on the appeal. FmHA settled *Ungersmas* by rescinding its purchase contract with the third party and agreeing to sell the inventory home to the Ungersmas.

Persons who are denied a Section 502 guaranteed loan do not have a right to appeal the decision under RD/RHS regulations because the decision was not made by RD/RHS staff.[1645] The regulations are, however, inconsistent with the statute, which gives any person denied assistance under Title V of the Housing Act of 1949 the right to appeal the decision.[1646] For more discussion of this issue, *see* Chapter 2, *supra*.

8.3.2.2 Sale of Single-Family Program Property to Public or Nonprofit Organizations for Use as Rental Housing

RD/RHS may accept offers from nonprofit or public agencies to purchase single-family inventory homes for the purpose of providing affordable housing to very low- and low-income families.[1647] Property may also be sold to nonprofit or public agencies providing transitional housing.[1648] RD/RHS may make an additional loan to the organization in connection with the credit sale and to provide subsidies available under the Section 515 Rural Rental Housing program.[1649]

8.3.2.3 Sale of Nonprogram Property

Decent, safe and sanitary housing. RD/RHS sells non-program property that is decent, safe and sanitary in the same manner as it does program property, except that it will not offer the property to program-eligible applicants using Section 502 financing.[1650] RD/RHS will, however, finance the sale of such property on what it calls "nonprogram terms."[1651]

Property that is not decent, safe and sanitary. RD/RHS is precluded by statute from selling property that is not decent, safe and sanitary unless the purchaser, as a condition of sale, agrees to bring the property up to decent, safe and sanitary standards or to refrain from use of the property for habitation.[1652]

Regulations require RD/RHS staff to advise prospective buyers of the condition of inventory property that RD/RHS does not consider decent, safe and sanitary.[1653] RD/RHS will place a restriction in the deed of conveyance that precludes the purchaser from using the property for purposes of habitation until it is brought up to decent, safe and sanitary standards or any structures have been razed.[1654] In addition, the Handbook requires

[1645] 7 C.F.R. § 3550.4 (2009).
[1646] 42 U.S.C.A. § 1480(g) (West 2003).
[1647] 7 C.F.R. § 3550.251(d)(4) (2009).
[1648] *Id.* at 3550.251(c)(4). If an offer is made to purchase for transitional housing for the homeless, RHS may withdraw the property from the market for 30 days to allow the entity to enter into an agreement of sale, and under certain conditions, may discount the price. *Id.* 3550.251 (d)(2).
[1649] *Id.*
[1650] 7 C.F.R. § 3550.251(c)(1) (2009). Because there is no priority for program-eligible applicants, price reductions for nonprogram properties take place after 60 days instead of 90 days.
[1651] Handbook 1-3550 ¶ 16.1(B) (Rev. 9/27/06).
[1652] 42 U.S.C.A. § 1480(e) (2003).
[1653] 7 C.F.R. § 3550.251(c)(2) (2009).
[1654] *Id.*

RD/RHS to complete an environmental review[1655] and to follow strict guidelines with respect to lead contamination.[1656]

Unfortunately, RD/RHS' method of implementing the statutory restrictions is not very effective. RD/RHS employees seldom, if ever, enforce deed restrictions. Once the property is transferred to the purchaser, there is little incentive for RD/RHS to enforce the restrictions or for the purchaser to comply. A better approach would be for RD/RHS to agree to a sale, but to retain title to the property until the repairs have been made or the dwelling demolished.

8.3.2.4 Lease or Sale of Single-Family Properties as Transitional Housing for the Homeless

RD/RHS will sell both program and nonprogram properties to nonprofit and public entities for use as transitional housing for the homeless.[1657] Organizations interested in such properties may request a list of all single-family housing inventory properties held by RD/RHS, regardless of whether the properties are listed for sale with a broker.[1658] If the organization is interested in purchasing a specific property that is not under a sales contract, RD/RHS will withdraw the property from the market for a period of 30 days to enable the organization to execute a purchase contract.[1659] Organizations are entitled to a discount from the purchase price at any time for nonprogram properties and after the 60 day reservation period for program properties.[1660]

RD/RHS may also lease non-program inventory housing to public bodies and nonprofit organizations to provide transitional housing for the homeless.[1661] The housing may be leased for $1.00 per year. RD/RHS will make all repairs necessary to make the property decent, safe and sanitary and the lessee is thereafter responsible to repair and maintain the property.[1662] In 1991, FmHA set a policy goal of using 5 percent of its inventory housing as transitional housing and urged its staff to publicize the availability of its inventory property for these purposes.[1663] It is not known whether RD/RHS has met or even retained this objective.

RD/RHS inventory property may also be made available to shelter victims of a major disaster in an area designated by the President as a major disaster area.[1664]

8.3.3 CHALLENGING RD/RHS' PROPERTY DISPOSITION PRACTICES

Given the chronic shortage of low-income housing, you will occasionally have to find ways to persuade RD/RHS to rehabilitate its housing units and sell them to low-income persons. RD/RHS' policy and practices governing rehabilitation and disposition of property also must be consistent with the agency's statutes and the national housing goals. Those goals require RD/RHS to exercise its powers, functions, and duties consistently with the national housing policy and in such a manner as will facilitate sustained progress in attaining the national housing objective.[1665] Congress has also mandated that in administering the low-income housing programs, the highest priority and emphasis be given to meeting the housing needs of those families for which the national housing goal has not become a reality.[1666] Congress has declared that the preserva-

[1655] Under the National Environmental Policy Act, 42 U.S.C. § 4321 (West, WESTLAW, Current through P.L. 111-174 (excluding P.L. 111-148, 111-152, 111-159, and 111-173) approved 5-27-10) such a review is required whenever RHS believes that the transaction would result in a change in use of the property, the transaction is controversial for environmental reasons, the property is in a special flood or mudslide area, contains wetlands, is within a Coastal Barrier Resources System, is eligible for National Register of Historic Places listing, contains underground storage tanks or is contaminated with hazardous substances or petroleum products. *See* Handbook §§16.12 through 16.18 (1/23/03).

[1656] According to Handbook 1-3550 ¶ 16.19 (1/23/03), the RHS' Lead-Based Compliance Key must be used for all properties, and 24 C.F.R. part 35, (Lead-based paint poisoning prevention in certain residential structures) Subparts A, B., C., D., J. and R. are applicable to all housing constructed prior to 1978. *See also*, FmHA AN 1950 (1955) (July 14, 1989) and RD AN 4384(1924-A) (July 24, 2008).

[1657] 7 C.F.R. § 3550.251(d)(2) (2009).

[1658] Handbook 1-3550 ¶ 16.10(B) (1/23/03).

[1659] 7 C.F.R. § 3550.251(d)(2) (2009).

[1660] *Id.*

[1661] *Id.* § 3550.251 (d)(3).

[1662] *Id.*

[1663] FmHA AN No. 2380 (1955) (Oct. 9, 1991).

[1664] Handbook 1-3550 ¶ 15.11.B (Rev. 12/19/07), and Attachment 15-E.

[1665] 42 U.S.C.A. § 1441 (West 2003).

[1666] 12 U.S.C.A. § 1701t (West 2003).

tion of existing housing for low-income people is an important means of attaining the national goal of a decent, safe and sanitary home for every American.[1667] These goals place a continuing obligation on RD/RHS to ensure that the housing it finances, at each stage of that housing's existence, serves low- and moderate-income people. RD/RHS is therefore obligated to ensure that housing that comes into its possession remain available to low- and moderate-income people.[1668]

In *Cole v. Lynn*,[1669] the court, enjoining HUD from demolishing a foreclosed Section 236 project, stated: "The Secretary's statutory mandate to seek to better housing conditions for low-income groups does not evaporate when a Section 236 project comes into his hands through foreclosure. . . [The Secretary] must. . . act in an appropriate manner and for a rational reason related to the achievement of the statutory objectives."[1670]

More recently, in *Lee v. Kemp*,[1671] the court enjoined HUD from disposing of single-family inventory property pursuant to disposition regulations that were intended to provide HUD the maximum financial return and failed to consider HUD's obligations under the Housing Act. It is by now hornbook law that HUD cannot base its decisions solely on what will create the most revenue for the government.[1672] RD/RHS' obligation is no different from HUD's.

If you represent a person who wants to purchase RD/RHS inventory property but has been unable to do so, you will have to rely on these arguments to enjoin the sale of any property until RD/RHS amends its property disposition rules to assure that low- and moderate-income persons are granted priority in obtaining the housing.

[1667] *See* 42 U.S.C.A. § 1441a(c) (West 2003).

[1668] *See Lee v. Kemp*, 731 F. Supp. 1101, 1110-12 (D.D.C. 1989). *Cf. Cole v. Lynn*, 389 F. Supp. 99 (D.D.C. 1975), *aff'd on other grounds*, 571 F.2d 590 (D.C. Cir. 1977), *rev'd on other grounds*, 441 U.S. 39 (1979) (HUD must follow national housing goals in deciding to demolish foreclosed project); *United States v. White*, 429 F. Supp. 1245 (N.D. Miss. 1977) (FmHA must administer housing programs consistently with housing acts); *Brown v. Lynn*, 385 F. Supp. 986 (N.D. Ill. 1974) (HUD must adopt foreclosure policies consistent with purposes of housing acts); *Pealo v. FmHA*, 361 F. Supp. 1320 (D.D.C. 1973) (national housing goals are not precatory).

[1669] *Supra* note 1668.

[1670] *Cole v. Lynn, supra* note 1668, 389 F. Supp. at 102. *See Russell v. Landrieu*, 621 F.2d 1037 (9th Cir. 1980) (Kennedy, J.) (HUD must consider interests of low-income people before selling foreclosed project); *Walker v. Pierce*, 665 F. Supp. 831 (N.D. Cal. 1987) (sale of multifamily mortgages enjoined because of HUD's failure to consider obligations under the National Housing Act); *Sadler v. 218 Housing Corp.*, 417 F. Supp. 348, 358 (N.D. Ga. 1976) (HUD's decision to demolish project, reached after consideration of alternatives, was not based solely on economic factors and was held consistent with national housing goals). *Cf. Pennsylvania v. Lynn*, 501 F.2d 848, 855 (D.C. Cir. 1974) (national housing goals held to be applicable to decision by HUD to terminate entire Section 236 program). *But cf. Federal Property Management Corp. v. Harris*, 448 F. Supp. 560, 562-63 (S.D. Ohio 1978), *rev'd*, 603 F.2d 1226 (6th Cir. 1979) (HUD practice of using Rent Supplements as set-offs in troubled projects held to be in compliance with long-range goals of national housing program).

[1671] *Supra* note 1668.

[1672] *Walker v. Pierce*, *supra* note 1670, at 838: "[T]he Secretary's actions must be invalidated if he acts only to obtain maximum financial return for HUD and he fails to consider and implement alternatives that would have enabled him to effect the objectives of the [National Housing] Act."

CHAPTER 9
APPEALS

9.1 INTRODUCTION

For 24 years after the inception of the Section 502 direct home loan program, the Farmers Home Administration (FmHA), the predecessor agency to RHS, did not have a process by which applicants or borrowers could administratively appeal adverse decisions of local agency officials. In fact, FmHA's mortgage instruments included provisions by which borrowers waived their right to a due process hearing. In *United States v. White*,[1673] a Mississippi District Court held that FmHA's failure to provide borrowers a due process right to appeal adverse administrative decisions violated borrower's constitutional due process rights and that the waiver of the right in the deed of trust was ineffective.

In response to *White*, FmHA adopted a minimal administrative hearing process whereby decisions, then made by local county supervisors, could be appealed to another county supervisor who was not involved in the original decision. While the process was better than no administrative appeal process, it was not an effective process. In 1978, Congress enacted legislation that required FmHA to formally adopt an administrative appeals process that gave all FmHA program applicants and borrowers adequate written notice of the adverse decision and an opportunity to appeal the decision and to present additional information to a person, other than the original decisionmaker, who has the authority to reverse the decision.[1674] While the statute extended the FmHA appeals process to applicants and provided borrowers with a firmer basis for administratively appealing a greater number of FmHA decisions, it did not substantially change the FmHA process by which appeal hearings were conducted, and it often left applicants and borrowers without a truly independent review process.

Complaints about the FmHA appeals process grew substantially in the 1980s and early 1990s, particularly from farmers who had FmHA farm purchase or operating loans and who had a substantial interest in holding onto their farms and livelihoods, which were frequently put at stake when FmHA sought to foreclose their loans without adequate administrative due process. In response, in 1994, Congress enacted legislation that authorized the reorganization of the Department of Agriculture and required the department to form a new National Appeals Division (NAD) that would assume the hearing processes of several of the department's agencies and by reporting directly and only to the Secretary of Agriculture, would operate independent of those agencies.[1675] The legislation made a number of very significant improvements to the administrative appeals process, such as precluding any of the NAD hearing officers from conducting any other agency activities, allowing hearing officers to review the appealability of certain limited decisions that had been considered non-appealable, and authorizing them to review equitable requests for relief. The legislation also made hearings evidentiary, giving hearing officers access to the entire agency record and allowing hearing officers to subpoena witnesses, force the production of evidence and administer oaths and affirmations. It required that hearings be held in person in the state in which the applicant or borrower resides, unless the participant waives these rights, and severely limited ex-parte communications between hearing officers and agency staff. It also required that the hearing decision be based on the evidence and record before the hearing officer. Lastly, it allowed for a review of hearing officers' decisions by the NAD Director or a designee.

Unfortunately, the NAD hearings continue to be informal and allow hearsay evidence. They place the burden of persuasion on the applicant or borrower and restrict hearing officers from reviewing the legality or consistency of agency regulations with the authorizing statutes. Moreover, hearing de-

[1673] 429 F. Supp. 1245 (N.D. Miss. 1977), *aff'd*, 536 F.2d 1386 (5th Cir. 1977), *vacated and remanded on other grounds*, 542 F.2d 1139 (5th Cir. 1977).
[1674] 42 U.S.C. § 1480(g) (West 2003).

[1675] Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994, 7 U.S.C. 6901 (West, WESTLAW, Current through P.L. 111-35 (excluding P.L. 111-31) approved 6-30-09).

cisions are not precedential. Significantly, the legislation also makes exhaustion of the administrative process mandatory before allowing judicial review in a proceeding against the agency.

Since the adoption of the legislation, the Department of Agriculture has been diligent in staffing the National Appeal Division and implementing the statutory requirements. NAD is headed by a director who is appointed for a term of six years and cannot be removed except for cause. It has a deputy director, regional assistant directors for each of three regions, and hearing officers.[1676] It has published an NAD Hearing Guide which is available on the Internet[1677] and since 2002, has made all hearing decisions publicly available and searchable on the Internet.[1678] Notwithstanding the fact that appeal decisions are not precedential, they may be persuasive, and advocates are urged to research prior decisions to assist their clients.

While the legislation authorizing the NAD includes all the substantive protections that are included in the 1978 FmHA legislation, the NAD legislation does not repeal the administrative appeals process codified in Title V of the Housing Act of 1949 governing the RD/RHS housing programs. This is very significant in two respects. First, the NAD legislation only gives appeal rights to persons who are denied assistance or whose assistance is reduced or terminated by USDA staff. The FmHA legislation, on the other hand, gives all persons who are denied assistance or whose assistance is reduced or terminated under Title V of the Housing Act of 1949 the right to appeal the decision denying, reducing or terminating the assistance. This is particularly significant for persons whose loans are made or managed by private entities, such as the Section 502 guaranteed loans or the loans sold by FmHA to the Rural Housing Trust in 1987. The significance of this distinction is discussed more fully in Section 9.4 below.

The second distinction between the two statutory provisions is that only the 1994 legislation mandates exhaustion of administrative remedies. The significance of this distinction is not as clear, particularly since many courts require administrative exhaustion whenever an administrative appeals or review process is available to an individual seeking judicial review of agency decisions. This distinction is discussed in greater detail in Section 9.5 below.

Regulations governing the operations of NAD appeals are codified at 7 C.F.R. §§ 11.1 – 11.33 (2009). RD/RHS has some additional regulations regarding appeals that are codified at 7 C.F.R. §§ 1900.51 – 1900.57 (2009). Generally, these regulations defer to the NAD regulations, although they also provide some guidance on what are adverse decisions, appealable, and non-appealable decisions and include guide letters that RD/RHS staff must send to borrowers who are affected by adverse decisions.[1679]

The balance of this chapter reviews the National Appeals Division appeal procedure and discusses potential problems associated with certain types of appeals. This chapter also briefly reviews appeals of decisions made by the Rural Housing Trust 1987-1 and appeals of decisions made with respect to single-family guaranteed housing loans. With few exceptions, it does not discuss substantive issues that may be appealed. In addition to reading this chapter, you should review the chapter(s) dealing with the particular substantive issue(s) being appealed.

9.2 SCOPE OF REGULATIONS

9.2.1 APPEALABLE DECISIONS

The NAD appeal procedure is available for "participants" in a USDA agency program who have received an "adverse decision" from the administering "agency," including the Rural Housing Service

[1676] A complete NAD organizational chart is available at http://www.nad.usda.gov/about_organization.html (available as of July 7, 2009). The geographic coverage of each of the divisions can be viewed at http://www.nad.usda.gov/contact_us.html (available as of July 7, 2009).

[1677] The NAD Hearing Guide is available at http://www.nad.usda.gov/hearing_guide.html (available as of July 7, 2009). Advocates should be aware that the hearing guide is not published for notice and comment and can be changed by the NAD at any time without prior notice.

[1678] NAD appeal decisions are available at: http://www.nad.usda.gov/public_search.html (available as of July 7, 2009).

[1679] Advocates should not rely on the RD/RHS instructions that are posted on the RD/RHS website, http://www.rurdev.usda.gov/regs/regs_toc.html#1900 (available as of 7/7/09). These regulations are outdated and are no longer applicable to RD/RHS or NAD appeals.

and Rural Development. Agencies may issue a determination that the decision is one of general applicability and therefore, not appealable. In those instances, the participant may seek a review of the agency determination on appealability. Nonappealable decisions will be discussed in more detail in Section 9.2.2, below.

Participant: "Participant" is broadly defined as any individual or entity who has applied for or whose right to participate in or receive a payment, loan, loan guarantee, or other benefit is affected by a decision of the administering agency.[1680] However, the term "participant" does not apply to individuals whose underlying claims are not covered under the NAD appeals process.

For instance, individuals with claims arising under the Freedom of Information Act, who have suspension and debarment disputes, or whose claims arise under programs governed by federal contracting laws and regulations are not considered "participants."[1681] Similarly the NAD appeal procedure is also not available to tenant grievances or appeals for tenants in RD/RHS multi-family housing.[1682]

Additional persons not considered "participants" are those individuals with disputes that arise from the employment relationship, including equal employment opportunity disputes or complaints of discrimination that are prosecutable under other procedures,[1683] and claims arising under the Federal Tort Claims Act[1684] or the Military Personnel and Civilian Employees Claims Act.[1685]

Adverse Decision: An "adverse decision" is defined as an administrative decision that is adverse to a participant. It includes a denial of equitable relief by an agency or the failure or an agency to issue a decision or act on the request of a participant within specified timeframes, or within a reasonable time, if no timeframe was specified.[1686]

Examples of adverse decisions over which the NAD has jurisdiction include the denial of participation in an agency program or the denial of receipt of benefits under an agency program; the making or amount of payments or other benefits due to a participant in an agency program; and a determination that a parcel of land is a wetland or is highly erodible.[1687] The appeal process also applies to disputes about compliance with program requirements.[1688]

Agency: "Agency" refers to specific agencies within the USDA, including Rural Development (RD) and the Rural Housing Service (RHS), as well as any successor or predecessor to the above-named agencies, and any other agency or office of the USDA that the Secretary of Agriculture may designate.[1689]

9.2.2 NONAPPEALABLE DECSIONS

When RD/RHS issues an adverse decision notice, it must also advise the participant whether the decision is appealable. Frequently, RD/RHS may determine that a decision is outside of the scope of the appeal process and therefore, is not appealable. NAD does not have the authority to review statutes or regulations issued under federal law[1690] or to adjudicate challenges to agency decisions that are considered to be "matters of general applicability."[1691] Decisions that are "matters of general applicability" are not appealable, even if the agency erroneously granted appeal rights. For example, an agency decision to adopt a policy or procedure that applies to all program participants is not appealable simply because the policy may adversely affect one or more participants. However, adverse decisions that result from the interpretation of generally applicable policies are appealable.

If RD/RHS determines that its decision is not appealable, the participant must be given the opportunity to seek a review of that determination by the NAD Director. The director's review of the

[1680] 7 C.F.R. § 11.1 (2009)
[1681] *Id.*
[1682] *Id.*
[1683] *Id.*
[1684] *See* 28 U.S.C. § 2671 (West, WESTLAW (Current through P.L. 111-35 (excluding P.L. 111-31) approved 6-30-09).
[1685] *See* 31 U.S.C. § 3721 (West, WESTLAW (Current through P.L. 111-35 (excluding P.L. 111-31) approved 6-30-09).
[1686] 7 C.F.R. § 11.1 (2009).
[1687] *Id.* §11.3(a).
[1688] *Id.*
[1689] *Id.* §11.1. *See also* 7 U.S.C. §6991 (West, WESTLAW (Current through P.L. 111-35 (excluding P.L. 111-31) approved 6-30-09).
[1690] 7 C.F.R. §11.3(b) (2009).
[1691] *Id.* §11.6(a)(2).

appealability issue is considered final and is not appealable further.[1692] The participant has 30 days from the date of receipt of the agency determination to file a request for an appealability determination by the director. The request must be in writing and must be signed by the participant.[1693]

A request for review is considered filed when it is delivered in writing, when it is postmarked, or when a complete facsimile copy is received by the NAD.[1694] If the final date for submission of the review request falls on a Saturday, Sunday, or federal holiday, the time for filing is extended to the close of business on the next working day.[1695]

RD/RHS must provide a participant written notice of any adverse decision, which includes a notice that the agency has determined that the decision is one of general applicability and therefore, not appealable. Additionally, any determination notice that a decision is not appealable must adequately inform the participant of the right to request a review, including the filing deadline and signature requirements.[1696] The notice should also advise the participant where to submit the request. The NAD director may delegate his or her authority to conduct an appealability review to any subordinate official other than a hearing officer.[1697] Therefore, the notice should adequately inform the participant whether to submit the request to the director or to a local or regional office and should contain the appropriate address. The subordinate's determination is considered the determination of the director, and like a direct determination from the director, is not appealable.[1698]

As a practice note, the review of the appealability determination is not concerned with why the participant disputes the adverse decision. The review is to determine whether the decision falls into one of the regulatory exemptions from the appeals process or whether it is determination of general applicability. Therefore, in addition to a copy of the appealability determination, the participant's review request should contain a brief explanation as to why the participant believes the adverse decision is appealable. The review request does not need to address why the participant disputes the adverse decision.[1699] If the director determines that the issue is appealable, the participant will be notified of the right to appeal.

9.3 PROCEDURAL ISSUES

The appeals process has several stages. First, the participant receives notice of an adverse decision, which may include the opportunity for an informal hearing with the administering agency.[1700] The participant has 30 days to request an in-person evidentiary hearing before a hearing officer. In the alternative, the participant may seek mediation or alternative dispute resolution before filing an appeal request. Requests for mediation or alternative dispute resolution will toll the 30-day filing deadline, but do not waive the right to continue with the appeal process. The participant may also request an informal meeting prior to the appeal. Either the participant or the agency may request that the NAD director review the hearing officer's decision. If the participant is not satisfied with the final director's decision, he or she may seek review in federal district court.[1701]

9.3.1 NOTICE OF THE DECISION, RIGHT TO INFORMAL REVIEW AND NOTICE OF RIGHT TO APPEAL

9.3.1.1 Adequacy of the Notice of Decision

The statute provides that no later than ten working days after an adverse decision is made that affects the participant, a written notice of the adverse decision must be provided to the partici-

[1692] *Id.*
[1693] *Id.*
[1694] *Id.* §11.14.
[1695] *Id.*
[1696] *See* 7 U.S.C. § 6994 (West, WESTLAW, (Current through P.L. 111-35 (excluding P.L. 111-31) approved 6-30-09). *See also* United States Department of Agriculture, NAD Hearing Guide 10 (2008) available at: http://www.nad.usda.gov /hearing_guide.html.
[1697] 7 C.F.R. § 11.6 (a)(3) (2009).
[1698] *Id.*
[1699] *See* NAD Hearing Guide, *supra* note 1696, at 10.
[1700] Prior to appealing to NAD, participants may request an agency informal review of adverse decisions issued by RD/RHS. 7 C.F.R. § 11.5(a)(b) (2009).
[1701] *Id.* § 11.13.

pant.[1702] The notice shall include the rights available to the participant under the NAD appeal process or other law applicable to the review of the adverse decision.[1703]

The NAD appeals hearing guide provides a suggested example of the information that should be included in the decision in order to comply with statutory requirements. The decision notice should advise the participant that the appeal must be filed with NAD within 30 days of receipt of the adverse decision; that the appeal must be signed personally; that the appeal should also include a copy of the adverse decision; and that the appeal should explain why the participant disputes the decision.[1704] The decision notice should also include the appropriate address to file the appeal.[1705] The notice should advise the participant of the right to have an informal review of the adverse decision and whether mediation or other alternative dispute resolution is available.[1706]

The adverse decision should inform the participant of the specific reasons for the adverse decision. Advocates and participants should watch for notices that fail to enumerate all the reasons for the decision or that generalize the reasons for the action instead of providing detailed and specific information. Both of these practices frustrate the resolution of disputes and substantially delay both the appeal process and the granting of assistance. Obviously, this works to the participant's disadvantage, particularly in view of the statutory requirement that the appeal must include an explanation of why the participant believes the agency decision is incorrect.

For applicants, as distinct from borrowers, there are few remedies for these practices. For example, an applicant for assistance may seek declaratory or injunctive relief that requires the agency to state with specificity all the reasons for the denial of assistance. An applicant is unlikely, however, to obtain any relief that will declare him or her eligible for assistance.

Unlike applicants, some borrowers whose assistance is threatened with termination or reduction may delay the termination or reduction until the agency gives them full and proper notice of the action and an opportunity to appeal the decision.[1707] They cannot, however, prevent the agency from finally terminating or reducing the assistance when the borrower is not eligible for the assistance or in appropriate circumstances, preclude the agency from recouping assistance improperly advanced during an appeal period.

If local RD/RHS officials persist in failing to provide participants with all the specific reasons for their action, advocates should seek declaratory and injunctive relief against the agency officials and if the practice persists, should begin contempt proceedings for the violation of a court's order, as the adverse decision notice must include a statement of all the specific facts underlying the decision.[1708]

Informal Denials. Advocates should be aware that adverse decisions can include the failure of an agency to issue a decision or act on the request or rights of a participant. Therefore, there will be instances where the participant does not receive any agency notice, which in turn may raise questions concerning when the 30-day filing deadline begins to run. Unfortunately, in such cases, the regulations look to the knowledge of the participant in order to determine the start of the 30-day time limit. According to regulations, if RD/RHS has failed to act on the request or rights of a participant, the participant must appeal to NAD not later than 30 days after the participant knew, or reasonably should have known, that RD/RHS failed to act within the timeframe specified by the program regulations.[1709] Where no timeframe is specified, the participant must appeal to NAD no later than 30 days after the participant reasonably should have known of

[1702] 7 U.S.C. § 6994 (West, WESTLAW, Current through P.L. 111-35 (excluding P.L. 111-31) approved 6-30-09).
[1703] *Id.*
[1704] *See* NAD Hearing Guide, *supra* note 1696, at 17.
[1705] *Id. See also* 7 C.F.R. §11.6(b) (2009). In 2009, RD/RHS inadvertently sent the wrong NAD Eastern Division address to 1325 borrowers whose Section 502 loans were accelerated. As a result, the borrowers were effectively precluded from filing an administrative appeal of the foreclosure decision. Advocates were successful in persuading RD/RHS that the foreclosure notices be rescinded and that the borrowers be given a new acceleration notice with the correct address for filing the appeal.
[1706] *See* 7 C.F.R. §11.5; *Id.* §1900.55(b)(2009). *See also id.* Part 1900, Subpart B, Ex. B-1(2009).
[1707] *See* 7 C.F.R. §1900.54 (2009). Note, however, that while the appeals procedure is applicable to government offsets, the offset will not be delayed or discontinued pending the appeal. *Id*. § 1900.54 (b).
[1708] *See Id.* Part 1900, Subpart B, Ex. B-1.
[1709] *Id.* §11.6(b).

RD/RHS' failure to act.[1710] The regulations do not place any penalties on RD/RHS for failing to issue an adverse notice.

This is a critical exception to the statutory and regulatory requirement that RD/RHS must issue a written adverse decision to the participant. By looking to the knowledge of the participant or what the participant reasonably should have known, the regulations effectively shift the burden to the participant to "know" that an agency is not going to act on the request and also to know how to perfect an appeal to NAD, in order to preserve any appeal rights. The burden also shifts to the participant to determine why the agency failed to act on the participant's request or rights.

Because the basis for a RD/RHS decision can be critical to any subsequent appeal, participants should insist on a written decision that conforms to statute, regulations, and the NAD hearing guide. For example, if a RD/RHS official informs a borrower verbally that he or she is not eligible for the particular assistance sought or discourages him or her from applying for assistance, the borrower should contact a superior RD/RHS official and insist on compliance with the regulation requiring a written decision.

Similarly, an agency official may review a participant's eligibility for a particular form of assistance, such as additional interest subsidy or moratorium relief, and not inform the individual that he or she was considered for the assistance and found ineligible. The decisionmaking official in these cases may make a notation regarding eligibility in the participant's case file and rely upon the notation at a later time to show that the participant has been granted all the applicable statutory rights. Such a practice violates the regulations. The affected persons are not informed of the decision and have no means of reviewing or appealing it at that time. If they later discover that they had been considered for a particular form of assistance and had not been informed of the adverse decision or of their right to appeal, they should argue that this practice violates their statutory due process rights.

[1710] *Id.*

9.3.1.2 Notice of Right to an Informal Meeting with the Decision-maker, and of the Right to Appeal

The written notice of decision must advise the participant of the right to an informal review of the adverse decision and whether the adverse decision is appealable. The right to an informal review exists whether or not the decision is appealable.[1711] The request must be made within 15 days of the date of the decision letter.[1712]

The purpose of the informal meeting is to give the decisionmaker an opportunity to explain the reasons for the decision, to respond to questions that the participant may have, or to review any additional information that the applicant believes may constitute a basis for changing the decision.[1713]

Although it is usually beneficial to have a meeting with the decisionmaker, the participant is not required to request or attend the meeting in order to preserve the right of appeal.[1714] Individuals who do not request an informal review with the decisionmaker must request an appeal hearing within 30 days of the date of the notice.[1715]

If the informal meeting with the decisionmaker does not result in a resolution of the matter, the applicant or borrower must again be advised of all the reasons for the adverse decision and of the right to appeal the decision to the NAD.[1716] The individual has 30 days from the date of the notice to request the appeal.[1717] However, current regulations do not provide a time frame for the decisionmaker to issue a notice to the participant of the results of the informal meeting.

An applicant or borrower who fails to meet with the decisionmaker -- either because the parties could not agree to a time or place for the meeting or the borrower/applicant misses the meeting -- is not deprived of the right to an appeal hearing. However, it is not clear from the regulations when the borrower/applicant's right to request an appeal expires. Arguably, when the parties fail to agree to a time

[1711] *See id.* Part 1900, Subpart B, Ex. C.
[1712] *Id.*
[1713] *See id.* Part 1900, Subpart B, Ex. B-1.
[1714] *Id.* § 11.5.
[1715] *Id.*
[1716] *Id.* Part 1900, Subpart B, Ex. B-2.
[1717] *Id.*

and place for a meeting or if the applicant or borrower misses the meeting, RD/RHS has an obligation to advise the participant of the time within which an appeal must be made. Otherwise, the remainder of the original 30-day appeal deadline may apply.

Nonappealable decisions. If a decision is deemed nonappealable, the applicant or borrower should be informed that there is generally a right to appeal, but that the particular decision is nonappealable under RD/RHS regulations. The individual must also be informed, however, that RD/RHS' decision on the nonappealability of the issue is itself reviewable by the NAD Director.[1718] Requests for such reviews must be filed within 30 days of the date of the decision letter advising the individual that the decision is not appealable.[1719]

The letter informing the applicant or borrower that a decision is not appealable also invites the individual to set up an appointment with the decisionmaker to discuss the reasons for the denial, reduction, or termination of assistance.[1720]

Decisions based on appealable and nonappealable issues. When an adverse decision is based on a nonappealable issue as well as an appealable issue, the regulations are unclear as to whether the decision is appealable.[1721] Prior regulations provided that the decision was not appealable, presumably because even if the appellant prevailed on the appealable issue, he or she would still not qualify for assistance because there remained other bases for the decision. Because current regulations are not clear on this issue, it may be possible to segregate that portion of the decision that is appealable. For those parts of the decision deemed nonappealable, the applicant or borrower must be advised that the determination of the decision's nonappealability is reviewable and that he or she may request a meeting with the decisionmaker to discuss the basis for the decision and to present additional information.[1722]

[1718] *Id.* § 1900.55(a); *id.* Part 1900, Subpart B, Ex. C.
[1719] *Id.* § 11.6(a); *id.* Part 1900, Subpart B, Ex. C.
[1720] *Id.* Part 1900, Subpart B, Ex. C.
[1721] *Id.*
[1722] *Id.*

9.3.2 RIGHT TO CONTINUED ASSISTANCE

Except for borrowers facing a governmental offset, borrowers whose RD/RHS assistance is threatened by an adverse decision may not have that assistance terminated pending the outcome of an appeal.[1723] Obviously, applicants for assistance do not have a right to it unless the adverse decision is overturned. Unfortunately, no effort is made to ensure that assistance will be available to an applicant should he or she prevail in the appeal.

For example, if an individual who has entered into a contract to purchase a home from the agency's inventory is found ineligible for a Section 502 loan to finance the purchase, RD/RHS will not refrain from contracting to sell the property to another applicant pending completion of the first borrower's appeal.[1724] Thus, an applicant who prevails on the appeal may not be able to acquire the home he or she had hoped to purchase.[1725]

The failure to preserve assistance for an applicant who is found initially ineligible for the assistance pending the conclusion of an appeal could be challenged on the grounds that it violates the applicant's due process rights, is discriminatory and otherwise arbitrary and capricious.

9.3.3 THE INFORMAL REVIEW AND MEDIATION

All participants have a right to an informal review or meeting with the decisionmaker whenever assistance is denied, reduced, or terminated, or they have otherwise received an adverse decision by an agency.[1726] The right exists whether or not the decision is appealable.[1727] Participants must request the

[1723] *Id.* § 1900.54.
[1724] *Id.* § 1955.114(a)(v).
[1725] In one case, FmHA, the predecessor agency to the RD/RHS, was forced to sell an inventory property to an applicant who successfully appealed the FmHA eligibility decision. In that case, the hearing decision, concluding that the applicant was eligible for FmHA financing, had been communicated to the FmHA county office before the county office had entered into a contract for the sale of the property to another individual. *Ungersma v. FmHA*, No. 91-1303 LKK-JFM (E.D. Cal. Oct. 11, 1991) (stipulation and order).
[1726] 7 C.F.R. §11.5 (2009).
[1727] *See id.* Part 1900, Subpart B, Ex. C.

informal meeting within 15 days of the date of the decision letter.[1728] Participants have the right to have a third person attend the meeting to represent them.[1729] The representative may be an attorney.[1730]

Taking advantage of the informal meeting. As noted earlier, it is usually to the applicant's or borrower's advantage to meet with the decisionmaker before proceeding to a hearing. Even those borrowers who do not have a right to appeal should meet with the decisionmaker. The meeting affords them an opportunity to review the decisionmaker's reasoning, to learn of particular regulations that may apply to their case, to present additional information that may persuade the decisionmaker to reverse or alter the decision, and to become familiar with the person who will be the adversary witness if there is a hearing. Moreover, if a dispute can be resolved through the informal meeting process, it will save applicants, borrowers, and advocates time that otherwise would be spent preparing for and conducting the hearing.

Preparation for the informal meeting. Applicants, borrowers, or advocates should take time to prepare for the informal meeting by reviewing RD/RHS regulations that may be applicable to their case. A review of the appropriate sections or chapters of this manual may also help applicants, borrowers, or advocates learn how RD/RHNS, Congress, and the courts interpret the RD/RHS regulations and statutes.

When the decision is based on outside information, such as credit reports or verified income, the applicant or borrower should try to obtain the adverse information from either RD/RHS or the outside source before the meeting in order to have a better understanding of the basis for the decision and to be able to provide the decisionmaker with rebuttal evidence or additional information. If the applicant or borrower has additional information that may persuade the decisionmaker to alter the decision, the information should be gathered and organized in a presentable format. If the basis of the decision is not clear from the decision letter, contact the decisionmaker before the meeting and request that he or she clarify the decision and provide more information so that you may be better prepared for the meeting.

For several reasons, it is advisable that a representative of the borrower or applicant attend the meeting with the decisionmaker. First, a representative familiar with the programs or agency procedure may be a more effective advocate for the client. Even if the representative is unfamiliar with the programs, he or she may be a more effective advocate than the borrower or applicant, particularly if the client is not fluent in English and the RD/RHS representative is not fluent in the client's language or if the client is not adept at mathematical calculations. Second, a representative at the meeting may be useful for taking notes, asking questions, or later, confirming what was said. Third, the representative's presence may simply provide the borrower or applicant with more confidence in facing a federal official.

Conduct of the meeting. The meeting with the decisionmaker is informal, without any set format or burdens of proof. Since in most cases it is preliminary to an appeal hearing, borrowers and applicants should use it to learn as much as possible about the basis for the particular decision and RD/RHS' procedure. There are several ways in which this can be done. First, have the decisionmaker explain the decision and its basis. Second, ask the decisionmaker to provide specific citations to the regulations that govern the case. If he or she is unable to cite specific regulations, probe the criteria used to arrive at the decision. You may discover that the decisionmaker used arbitrary rules of thumb or that he or she possesses certain biases. Third, if mathematical calculations are involved in the decision, have the decisionmaker go through the calculations carefully and request a copy. Fourth, if the decision is based on information obtained from outside sources, such as creditors or credit bureaus, ask for copies of the documents.

If you have additional information that the decisionmaker should consider, present it when discussing the decision or after the decisionmaker has provided all the requested information. Since the informal meeting is intended to resolve disputes, insist that the decisionmaker give you a preliminary response about whether the additional information changes the decision. Even if the information needs to be verified, the decisionmaker should give you an

[1728] *Id.* Part 1900, Subpart B, Ex. B-1, B-3, C.
[1729] *Id.*
[1730] *Id.*

answer based on the assumption that the information is verified as presented.

Finally, when it does not appear that the meeting will result in a resolution of the problem, ask the decisionmaker to explain carefully the conditions that your client must meet to qualify for assistance. This is particularly important when an applicant is deemed not creditworthy, does not qualify for a loan because of an inability to repay, or does not qualify for loan refinancing. In these instances, you may also wish to take the opportunity to review your client's file. You or your client have a right to examine and have a copy of the agency record, unless otherwise prohibited or exempt by law or regulation.[1731]

Decision from the informal meeting. After the informal meeting, the decisionmaker must send a letter confirming the decision.[1732] The regulations do not specify a deadline for issuing the letter, although RD/RHS regulations provide that if the assistance sought is not granted, the letter must state the reasons for the decision, inform the participant of the right to an appeal hearing, and inform him or her that an appeal request must be made within 30 days.[1733]

Mediation. In addition to an informal hearing, participants in certain instances now have the option of requesting mediation. The NAD regulations provide that participants shall have the right to utilize any available alternative dispute resolution or mediation in order to resolve an adverse decision prior to an NAD hearing.[1734] On the other hand, the RD/RHS Service regulations permit mediation only if the mediation program of the state in which the participant's farming operation is located has been certified by the Secretary to perform mediation.[1735] It is not apparent from the authorizing statute that mediation is limited to farmer borrowers, and the RD/RHS regulations may be inconsistent with the statute in states that allow or provide mediation services in other cases. Regardless, any adverse decision notice should also advise the participant whether mediation is available. In the event the notice is silent on this issue, advocates who are interested in mediation should contact the local agency office about the availability of alternative dispute resolution in their jurisdiction.

A request for mediation made prior to filing an appeal stops the running of the 30-day period during which the participant must file the appeal request[1736]. At the conclusion of the mediation, the participant has the balance of the 30-days remaining to file an appeal with NAD.[1737] If the participant has filed an appeal with NAD and then requests mediation before the appeal hearing has been held, the participant waives the right to have the appeal hearing within the normal 45-day time period. However, the participant will have the right to the hearing within 45 days of the conclusion of the mediation.[1738]

9.3.4 THE HEARING

Participants whose assistance request has not been resolved through the informal meeting process have a right to an appeal hearing if the decision is appealable.[1739] If the agency determines that the decision is not appealable, the applicant or borrower should consider filing a request with the NAD Director to review that determination.[1740] If a review is not appropriate or if the director confirms that the decision is not appealable, the participant has exhausted all administrative remedies and may now seek judicial review to challenge the decision on substantive grounds[1741] or a judicial review of the determination that the decision is unappealable.[1742]

9.3.4.1 Timeliness of Appeal Request

Persons seeking a hearing must send a written request for a hearing to the appropriate NAD regional office within 30 days of receiving the last notice of the right to a hearing.[1743] The hearing re-

[1731] *See* § 9.3.4.2, *infra* (discussion of client's right to inspect and copy documents from the file).
[1732] 7 C.F.R. Part 1900, Subpart B, Ex. B-2 (2009).
[1733] *Id.*
[1734] *Id.* §11.5(c).
[1735] *Id.* § 1900.55(c).
[1736] *Id.* §11.6(c)(1).
[1737] *Id.*
[1738] *Id.*
[1739] *See id.* Part 1900, Subpart B, Ex. B-2.
[1740] *Id.* § 1900.55(a).
[1741] *See* § 9.3.8.1, *infra* (discussion on exhaustion).
[1742] *See* 7 C.F.R. § 11.13(a) (2009).
[1743] *Id.* § 11.6 (b)(1). If the appellant sought an informal meeting with the decisionmaker, the request must be made within

quest must be signed by the participant.[1744] If available, a copy of the adverse decision must be included with the request. The request should also include a brief statement of why the participant believes the adverse decision or agency failure to act was wrong. A copy of the request for hearing should also be sent to the agency, although failure to do so is not fatal to perfecting an appeal. Requests are deemed filed when postmarked or delivered to NAD.[1745] Unless the informal review of the adverse decision is required, participants may directly initiate the appeal process.

If the participant has an authorized representative, the authorized representative must file a declaration with NAD. The declaration must state that participant has authorized the declarant, in writing, to represent the participant for purposes of a specific adverse decision or decisions. The declaration must be executed in compliance with 28 U.S.C. § 1746,[1746] and must include the written authorization of representation, signed by the participant.[1747] If an appeal request is signed by a representative without the appropriate declaration, NAD will notify the sender of the original signature requirement and the documentation that must be filed in order to represent the participant.[1748] Although it is not clear from the regulations whether the failure to correct these errors within the 30-day time period is fatal, the NAD hearing guide states that a Regional Assistant Director may specify a time frame by which the participant must correct any administrative errors.[1749]

Both the regulations and the hearing guide make clear, however, that failure to timely file the appeal request is fatal. The regulations do not provide for any good cause exception to filing after the deadline, while the hearing guide provides that NAD has no jurisdiction over late-filed appeals.[1750] If the appeal request was in fact timely filed, but is not perfected due to administrative errors, the Regional Assistant Director may deem it timely filed once the appellant makes the appropriate corrections. As noted above, an example of an administrative error may be the failure to include an authorized representative designation with the appeal request. Because the regulations only provide an opportunity to make administrative corrections after the appeal deadline, it is critical that appellants submit a completed appeal request prior to the 30-day deadline. The timeliness of the appeal request is determined from the postmark on the letter requesting the hearing.[1751]

9.3.4.2 Right to Examine Records Prior to the Hearing

Once the participant has perfected the appeal by timely filing with the NAD, the agency must promptly provide NAD with a copy of the agency record. If the participant requests a copy of the record, the agency must provide a copy within 10 days of receipt of the participant's request. The regulations are silent as to whether there is any cost to the participant.

9.3.4.3 The Hearing Officer

Once the appeal is perfected, the Director will assign a hearing officer who is an employee of NAD to conduct the hearing and issue a determination on the appeal of the adverse decision.[1752] The NAD director or designee has the sole discretion to determine which hearing office will hear the appeal.[1753] However, the assignment of an appeal to a particular hearing officer is normally based on the location of the appellant and the agency office, available hearing sites, the hearing officer's case load, conflict of interest concerns, and similar factors.[1754] Although the assignment is discretionary, a

30 days of the date of the letter advising the appellant of the results of the informal meeting. If the appellant did not request an informal meeting with the decisionmaker, the request must be made within 30 days of the date of the letter advising the appellant of the adverse decision. 7 C.F.R. Part 1900 Subpart B, Ex. B-2 (2009).

[1744] *Id.* § 11.6(b)(2).

[1745] *Id.* §11.6(b).

[1746] (West, WESTLAW (Current through P.L. 111-35 (excluding P.L. 111-31) approved 6-30-09).

[1747] *Id.* § 11.6(c).

[1748] NAD Hearing Guide, *supra* note 1696, at 18.

[1749] *Id.*

[1750] *Id.* at 14.

[1751] 7 C.F.R. § 11.14 (2009); *See id.* Part 1900, Subpart B, Ex. B-1.

[1752] *Id.* §11.1.

[1753] NAD Hearing Guide, *supra* note 1696 at 21.

[1754] *Id.*

party may object if there are appropriate grounds, such as evidence of a conflict of interest.

The Director or designee will notify the parties of the hearing officer assigned to the appeal. This notice will also advise the parties of the right to a telephone hearing in lieu of an in-person hearing and of the documents they will be required to submit.[1755] The participant will be required to submit a short statement of why the decision is wrong, copies of any documents not already in the agency record that the participant intends to introduce at the hearing, and a list of anticipated witnesses and brief descriptions of the evidence they will offer.[1756] The agency will be required to submit a copy of the adverse decision that is at issue, a written explanation of the agency's position, including regulatory or statutory reasons for the decision, copies of any documents not in the agency record that the agency anticipates introducing at the hearing, and a list of anticipated witnesses for the agency, including brief descriptions of the evidence they will offer.[1757]

9.3.4.4 *Ex Parte* Communications

Once the appeal has been filed and before a final determination has been issued, NAD employees are prohibited from engaging in any *ex-parte* communications with the participant, the agency, or any person that may have an interest in the pending appeal. However, the prohibition does not apply to discussions relating only to procedural matters or discussions regarding the merits of the appeal when all parties to the appeal have been given prior notice of and an opportunity to participate in the discussion.[1758]

If there is a discussion about the merits of the case after all parties have been provided notice and an opportunity to participate, a memorandum of the discussion must be included in the hearing record. Additionally, any hearing officer or NAD employee who receives any written *ex-parte* communication concerning the substance of the appeal must place the communication, along with any written responses, in the record . If the *ex-parte* communication was oral, the employee must prepare a memorandum stating the substance of the communication and place it in the hearing record.[1759]

The hearing officer or director may require any party to the appeal who has knowingly made an *ex-parte* communication concerning the hearing to show cause why the party's claim in the appeal should not be dismissed, disregarded, or adversely affected because of the violation.[1760]

9.3.4.5 Dismissal of Appeals

In some instances, appeals may be dismissed without a decision being issued. For example, if the appellant files for bankruptcy during the appeal, the appeal will be dismissed without prejudice by the hearing officer or the regional assistant director unless the bankruptcy court has lifted the automatic stay or otherwise permits the appeal to proceed. This applies to all bankruptcy filings, even if the appellant is operating under a confirmed chapter 11, 12, or 13 bankruptcy plan.[1761]

NAD will also dismiss an appeal with no review right if it is unable to determine that NAD has jurisdiction.[1762] As noted, the appeal request must identify either an adverse agency decision or the failure of an agency to act on the request or rights of the participant in order for NAD to have jurisdiction over the appeal request. An appeal request that fails to identify an adverse decision will be dismissed for lack of jurisdiction. NAD also lacks jurisdiction if the agency withdraws its adverse decision. In such cases, the appellant may withdraw the appeal request, or NAD may elect to dismiss the appeal.[1763]

Unfortunately, the dismissal for lack of jurisdiction in these cases does not resolve the underlying dispute with the agency. A pro se participant's inability to clearly articulate an adverse decision does not necessarily mean that the agency has not acted adversely with respect to the participant's rights. Similarly, when the appeal is dismissed because the agency rescinds the adverse decision, this does not necessarily guarantee that the appellant will obtain the relief sought or that the agency has not acted contrary to the appellant's rights. Clearly,

[1755] 7 C.F.R.§ 11.8(c) (2009).
[1756] *Id.*
[1757] *Id.*
[1758] *Id.* §11.7(a).
[1759] *Id.* §11.7(c).
[1760] *Id.* §11.7(d).
[1761] NAD Hearing Guide, *supra* note 1696, at 13-14.
[1762] *Id.*
[1763] *Id.*

the agency should not be able to act contrary to the appellant's rights and simultaneously preclude the appellant from utilizing the appeal process.

When an appeal has been dismissed for failure to identify an adverse decision or because the agency has rescinded the adverse action, the appellant should not be left without any remedy to challenge either the agency action or the NAD dismissal. As NAD considers these dismissals non-reviewable, they are arguably final NAD determinations. Alternatively, because the participant can go no further in the appeal process, he or she has exhausted all administrative appeal procedures. Under either theory, the participant should be able to seek judicial relief in order to challenge either the agency action or NAD's decision to dismiss the appeal for lack of jurisdiction.[1764]

Appeals may also be dismissed if one of the parties fails to appear for the hearing.[1765] When a party fails to appear, the hearing officer may cancel the hearing and notify the absent party that he or she has a specific period of time, usually 10 days, to explain the non-appearance.[1766] If the party shows good cause, the appeal will be rescheduled. Forgetting the date of the hearing may not constitute good cause in the absence of extenuating circumstances, such as a medical condition or disability.[1767] If the party is unable to show good cause for missing the hearing, the hearing officer may dismiss the entire appeal.[1768] Unlike appeals that are dismissed for lack of jurisdiction, a decision to dismiss an appeal for nonappearance is considered appealable to the NAD Director.[1769]

The hearing officer is not required to dismiss the appeal for nonappearance, however, and may elect to treat the case as a record review and issue a determination based on the hearing record already developed.[1770] Finally, the hearing officer may cancel the hearing, accept the evidence submitted by any party present, provide a copy to the absent party, and allow the absent party ten days to submit a response to the new evidence.[1771]

As noted above, late-filed requests will be dismissed unless the late-filing is the result of "administrative oversights," that are corrected by the participant within a reasonable time as determined by the Regional Assistant Director.[1772] Whenever there is a decision to dismiss the appeal, the parties should be notified and the exact reasons provided in the notice and in the agency file. Advocates should insist on adequate notice, as the basis for dismissing the appeal will determine whether the appellant may seek a NAD Director's review or must proceed with judicial action.

9.3.4.6 Suspension of the Appeal

If the hearing officer becomes aware of any change in circumstances or other occurrences material to the decision after a request for an appeal has been filed, he or she must notify the Regional Assistant Director.[1773] Such circumstances can include the appellant's request for mediation or alternative dispute resolution; the appellant's filing of a discrimination complaint with the USDA Office of Civil Rights that concerns matters at issue in the appeal; the illness or an unexpected availability of one of the parties or witnesses; or the discovery that one of the issues on appeal is subject to litigation in a court.[1774] In cases where the appellant has requested mediation or alternative dispute resolution subsequent to filing the appeal request, the appeal must be suspended until the conclusion of the mediation process.[1775] In other cases, the Regional Assistant Director has the discretion to suspend the case temporarily on his or her own initiative or at the request of the hearing officer.[1776]

The Regional Assistant Director may suspend an appeal even if NAD otherwise would not. For example, if an appellant has also filed a discrimination complaint with the USDA Office of Civil Rights concerning issues in the appeal, the Regional Director may suspend the appeal although NAD normally would not suspend the case.[1777] If the issue on appeal is within the jurisdiction of a

[1764] 7 C.F.R. §11.13 (2009).
[1765] *Id.* §11.8(c)(6).
[1766] *Id.*
[1767] NAD Hearing Guide, *supra* note 1696, at 42-43.
[1768] 7 C.F.R. §11.8(c)(6) (2009).
[1769] NAD Hearing Guide, *supra* note 1696, at 43.
[1770] 7 C.F.R. §11.8(c)(6) (2009).
[1771] *Id.*
[1772] NAD Appeal Guide, *supra* note 1696, at 14.
[1773] *Id.* at 15.
[1774] *Id.*
[1775] *See* 7 C.F.R. §11.5(c) (2009).
[1776] NAD Hearing Guide, *supra* note 1696, at 15.
[1777] *Id.*

court, the Regional Director must contact the appropriate government attorney's office and then determine whether to suspend the appeal.[1778]

Nevertheless, discretionary suspensions may only be issued upon a showing of good cause, and the basis for the suspension must be documented in the case record.[1779] Additionally, the suspension is temporary, and the hearing officer must review the suspension at least every 60 days.[1780] Unfortunately, these requirements may be of little benefit to an appellant who needs a prompt resolution of an adverse decision. If the question of suspension arises in your client's case, you should make certain that good cause is indeed present to justify the suspension and that the suspension is limited to the amount of time necessary to resolve the circumstances giving rise to the suspension. Further, you should insist that NAD follow the same time limits mandated for suspensions while alternative dispute resolution is proceeding, which provide the appellant with the right to a hearing within 45 days of the conclusion of the mediation.[1781]

9.3.4.7 Appellant's Waiver of Hearing

Appellants may waive the right to a hearing at any time prior to the hearing and instead submit the matter to the hearing officer for a record review.[1782] In a record review, the hearing officer issues a decision based on the record, any written statement or evidence that the appellant submits, and other information the hearing officer deems necessary.[1783] If the appellant requests a record review, the hearing officer will set a date by which parties may submit additional information, such as affidavits, not already in the record. The additional information must also be provided to the other party, and each party may comment on the other party's submission.[1784] The hearing officer must issue a decision on the record review within 45 days from the receipt of the appellant's request. Generally, it is advisable to waive the hearing only in cases where there are no factual issues in dispute and the matter involves only an application of the facts to regulations or interpretation of regulations.

9.3.4.8 Pre-Hearing Conference

Whenever appropriate, the hearing officer is required to hold a pre-hearing conference.[1785] The purpose of the conference is to narrow the issues involved or possibly, to resolve the dispute. The conferences are held by telephone unless all parties agree to hold the conference in person. The hearing officer should schedule the conference early enough to allow the hearing to be held within 45 days of receipt of the appeals request with the required minimum 14 day notice of the appeal hearing date, time and location.[1786]

The hearing officer should make a tape recording of the pre-hearing conference that will become part of the case record.[1787] Parties can request a copy of the recording free-of-charge. Parties may also request that a verbatim transcript be made.[1788] However, the requesting party must pay for the transcription service and provide a certified copy free of charge to the hearing officer. If a transcript is made of the pre-hearing conference, it also becomes part of the case record.

At the pre-hearing conference, the parties will have an opportunity to clarify the issues and to define the actual basis of the dispute. They can also stipulate to facts not in dispute or set out expected testimony or evidence that will be offered. The conference is also an opportunity to determine any scheduling conflicts for parties and witnesses and the need for any accommodations for person with disabilities.[1789]

During the conference, the hearing officer should advise the parties that the proceedings are being recorded, identify the case, and have the parties introduce themselves and identify their role in the appeal. The hearing officer should also review the hearing procedures with parties, verify that a copy of the agency record has been provided to the hearing officer and the appellant, and address other

[1778] *Id.*
[1779] *Id.*
[1780] *Id.*
[1781] 7 C.F.R. § 11.5(c)(2) (2009).
[1782] *Id.* §11.1.
[1783] NAD Hearing Guide, *supra* note 1696, at 42.
[1784] *Id.*
[1785] 7 C.F.R. §11.8(c)(4) (2009).
[1786] NAD Hearing Guide, *supra* note 1696, at 23.
[1787] 7 C.F.R. §11.8 (c)(5)(iii) (2009).
[1788] *Id.*
[1789] NAD Hearing Guide, *supra* note 1696, at 29.

administrative matters, such as the need for reasonable accommodations or translators.[1790] If a party or essential witness needs an interpreter, the hearing officer will arrange for the interpreter services at no cost to the requesting party.[1791]

The pre-hearing conference also provides an opportunity for NAD to review any questions concerning jurisdiction. The hearing officer is required to review whether there is any basis to suspend the hearing or dismiss the appeal due to jurisdictional or other issues. If the hearing officer determines that there is a dispute over jurisdiction, he or she will request that the agency explain why it believes that its action or failure to act does not constitute an adverse decision and why it believes there is no jurisdiction.[1792] The hearing officer will also require the appellant to explain why there is jurisdiction.[1793] The hearing officer must issue a written determination of jurisdiction within 30 days of the pre-hearing conference. If the hearing officer determines that NAD does not have jurisdiction, he or she must issue a written determination of lack of jurisdiction that explains the appellant's right of review to the NAD Director.[1794]

Advocates should be certain to attend the pre-hearing conference with their clients. Obviously, if there are still disputes about issues such as jurisdiction, the unrepresented client may be overwhelmed by the arguments presented by the agency representative and may lose the opportunity to proceed with the appeal. Even if no such disputes are present, unrepresented clients may stipulate to facts that are still in dispute and may not understand the importance of how the disputed issues are framed. Finally, the conference provides an opportunity for the advocate to ensure that scheduling conflicts are presented to the hearing officer and that important administrative matters such as the need for accommodations or translators are addressed.

At the conclusion of the pre-hearing conference, the hearing officer will prepare a report, which must be provided to all parties and placed in the record. The report will indicate all deadlines and any additional information that parties must provide, stipulations agreed to by the parties, whether a request has been made for a reasonable accommodation or an interpreter is required, and other matters addressed in the hearing.[1795]

9.3.4.9 Discovery

The parties may agree among themselves to use discovery to obtain evidence from each other. This can include depositions, interrogatories, and requests for document production. However, the hearing officer cannot compel discovery.[1796]

With the NAD Director's occurrence, the hearing officer can issue a subpoena requiring the production of certain evidence or documents not already in the hearing record.[1797] Either party to the appeal may request that a subpoena be issued requiring the production of certain evidence at any time that the case is pending before the NAD. However, a subpoena for the production of evidence or documents shall only be issued if the requesting party establishes that the evidence is necessary and reasonably calculated to lead to information that will affect the final determination or is necessary to fully present the case to the NAD.[1798]

Either party may also request a witness subpoena be issued by submitting a written request at least 14 days before the hearing. The NAD Director or hearing officer must issue the subpoena at least seven days prior to the hearing date. However, a witness subpoena will only be issued upon a showing that the witness possesses information that is pertinent and necessary for the disclosure of all relevant facts that could impact the determination, that the information can only be obtained through the witness' testimony and that the testimony cannot be obtained without a subpoena.[1799]

9.3.4.10 Time and Place of the Hearing

Time. The appellant has the right to have a hearing on any adverse decision within 45 days after the receipt of the appeal request by NAD, unless an informal review or mediation were requested

[1790] *Id.*
[1791] *Id.* at 28.
[1792] *Id.* at 22.
[1793] *Id.*
[1794] *Id.*
[1795] *Id.* at 23.
[1796] *Id.* at 25.
[1797] 7 C.F.R. §11.8(a)(2) (2009).
[1798] *Id.*
[1799] *Id.*

subsequent to filing the appeal request or the appellant has waived the right.[1800] The hearing officer must notify the appellant, the appellant's authorized representative, and the agency of the hearing date, time and place at least 14 days prior to the hearing.[1801] If the appellant requests a postponement of the hearing date that may require the hearing to be held outside of the 45-day limit, the appellant must sign a waiver.[1802] Similarly, if another party requests a postponement to a date that would exceed the 45-day limit, the appellant must agree.[1803] All requests for postponements to dates beyond the 45-day limit must be justified in writing.

As noted previously, if a party fails to appear at the hearing and no arrangements had been made for rescheduling the hearing, the hearing officer has the option to cancel the hearing unless the appellant can demonstrate good cause for the failure to appear. If the hearing officer cancels the hearing, he or she may treat the appeal as a "record review" and simply issue a determination based on the hearing record already developed.[1804] The hearing officer may also accept into the hearing record any evidence submitted by the parties who are present at the appeal or simply dismiss the appeal.

If the hearing officer accepts additional evidence into the record, a copy must be provided to the absent party. The absent party has ten days to provide a response to the additional evidence. The hearing may be rescheduled even if dismissed, if, as noted above, the absent party can demonstrate good cause for the nonappearance.[1805] Alternatively, the parties may agree to proceed without a hearing. In such cases, the hearing officer will add to the appeal record any evidence that was submitted by any party present at the hearing, provide a copy to the absent party, and allow the absent party ten days to respond to the additional evidence.[1806]

The appeals procedures contemplate that hearings will normally not take more than one day.[1807] All parties must be informed if it is anticipated that a hearing will require more than one day. Hearing officers are advised not to schedule hearings late in the day unless it is anticipated that the hearing can be completed the same day or the parties are available the next day.[1808] If justified by the circumstances, the hearing officer may continue a hearing to the following day, even if the parties were not advised of the possibility of a two-day hearing.[1809]

Place. The appellant has the right to have an in-person hearing before the hearing officer. Hearings are to be held in the state of residence of the appellant or at a location that is otherwise agreed to by the appellant, the agency and NAD.[1810]

Telephone conference calls. The appellant may request that the hearing be held by telephone conference, in lieu of an in-person hearing.[1811] The hearing process, however, will be the same as an in-person hearing, and the same format will be followed. For example, the hearing officer must ensure that everyone understands what is being said and is looking at the same documents at the same time. The hearing officer is also responsible for ensuring that each speaker is properly identified.[1812]

9.3.4.11 Presentation of Evidence and Burdens of Proof

Right to be represented. Appellants have the right to be represented at the hearing by another person, including an attorney.[1813] A decision with respect to who will represent the appellant should be made soon after a request for a hearing is filed. Depending on the complexity of the appeal and the skills of the individual, representation may be undertaken by the appellant, a friend, paralegal, or attorney.[1814] Since some appellants may not be sufficiently confident of their abilities or may be too emotionally involved in their case, outside representation may be advisable.

Previously, the NAS insisted that the appellant's representative, including an attorney, could

[1800] *Id.* § 11.8(c)(3).
[1801] *Id.*
[1802] NAD Hearing Guide, *supra* note 1696, at 29.
[1803] *Id.*
[1804] 7 C.F.R. § 11.8(c)(6) (2009).
[1805] *Id.*
[1806] *Id.*
[1807] *See* NAD Hearing Guide, *supra* note 1696, at 29, 41.
[1808] *Id.*
[1809] *Id.*
[1810] 7 C.F.R. 11.8(c)(2)(iii) (2009).
[1811] *Id.* § 11.8(2)(c)(5)(i).
[1812] NAD Hearing Guide, *supra* note 1696, at 28-29, 35.
[1813] 7 C.F.R. § 11.6(c) (2009); *id.* Part 1900, Subpart B, Ex. B-1.
[1814] *See id.* § 11.6(c); NAD Hearing Guide, *supra* note 1696, at 22.

not appear at the hearing without the appellant. It instructed its staff to consider 'as concluded' any appeal hearing where the appellant's representative appears without the appellant unless the appellant's failure to appear is for reasons beyond his or her control or a request for postponement is made with reasonable cause.[1815] Current NAD regulations, however, indicate that an authorized representative may appear on behalf of the appellant, without need for the appellant to be physically present. The regulations provide that the hearing officer may cancel the hearing for nonappearance "[i]f at the time scheduled for the hearing…the appellant… is absent, and no **appearance** is made on **behalf** of the such absent party..."[1816] The hearing guide also indicates that a representative may appear on behalf of the appellant, without the appellant's presence.[1817]

While it is generally preferable for the appellant to be present, in many cases, there is no justification for the requirement that the appellant be present at the hearing. For example, when there are no factual issues in dispute or when no facts within the appellant's knowledge are in dispute, there is no reason for the appellant to attend the hearing. However, advocates who do not anticipate the need for the appellant's attendance at the hearing should first be certain that the appeal record contains a copy of their declaration of representation. Advocates should also be certain that the hearing officer has been notified in advance, for example, at the prehearing conference, that the appellant is not expected to attend the hearing.[1818]

Presentation of evidence. The hearing is an informal proceeding at which the appellant has the burden of proving why the agency decision was erroneous. The appellant must meet this burden by a preponderance of the evidence.[1819] The appellant may support his or her claim with additional information or witnesses, including RD/RHS staff.

For example, the appellant must either show eligibility for the assistance sought or demonstrate that the agency's grounds for terminating or denying the assistance are unjustified. In particular, the appellant should show one of the following: that the decisionmaker applied the wrong regulation to make the determination; that the facts underlying the decision are not as they were perceived by the decisionmaker or even if perceived correctly, they do not lead to the conclusion reached; or that the decision was otherwise arbitrary.

Order of presentation. The hearing begins with an opening statement by the hearing officer, which identifies the officer, the parties, and the date, time and location of the hearing. The hearing officer will state that the hearing is being recorded and that parties may obtain a copy of the recording free of charge. The hearing officer will also ask everyone present to identify themselves by name and state why they are present. The hearing officer will administer any necessary oaths, swear in witnesses who are anticipated to testify, explain the hearing procedure, and identify any matters to which the parties have stipulated. Each party is then allowed to make an opening statement, with the appellant normally proceeding first. [1820]

Following the opening statements, the appellant has the right to present his or her evidence, including documents, witnesses, and arguments in support of his or her position.

In practice, the informality of the hearing process leads to a relaxation in the process of presenting evidence. Thus, the order for presentation of evidence, the questioning of witness, and the making of arguments is not always rigorously followed. The hearing officer presides over the hearing and ultimately, has control of proceedings.

The appellant may call any witness including, when appropriate, the decisionmaker or other agency staff.[1821] Any witnesses called by the appellant may be questioned by the agency during the appellant's presentation. After the appellant concludes, the agency may present its evidence by introducing documents and calling witnesses. The appellant may question the agency witnesses at the conclusion of their testimony. Each party has the opportunity to rebut the other's case.[1822]

In some instances, the hearing officer may need to reconvene the hearing at another date. For example, if the one of the parties or witnesses has a

[1815] 26 NAS NOTES 5-6 (Feb./Mar. 1992).
[1816] 7 C.F.R. § 11.8(C)(6) (2009)(emphasis added).
[1817] NAD Hearing Guide, *supra* note 1696, at 41.
[1818] *Id.*
[1819] 7 C.F.R. § 11.8(e) (2009).
[1820] NAD Hearing Guide, *supra* note 1696, at 35.
[1821] 7 C.F.R. § 11.8(c)(2)(5)(ii) (2009).
[1822] *Id.*

scheduling conflict that cannot be resolved or during the hearing, a new witness or new evidence has been identified that is necessary to reach a proper decision, a continuance may be necessary to obtain all of the relevant information and allow the parties sufficient opportunity to respond.[1823] Although the length of the postponement is at the discretion of the hearing officer,[1824] presumably the continuance date must be at the agreement of all parties and should take into consideration the 45 day time-limit for hearings. The hearing is usually completed by each party making a final argument summarizing his or her position.

Admissibility of evidence. Evidence may be received at the hearing regardless of its admissibility at a judicial proceeding.[1825] Therefore, any oral or documentary evidence that is reliable and pertinent to the issues or facts raised by the appellant or the agency should be received by the hearing officer. This does not mean that all evidence is admissible and that the appellant or his or her advocate should allow all testimony into evidence. If a witness or the agency seeks to admit evidence that merely discredits the character of the appellant but otherwise has no bearing on the decision, the appellant or the appellant's advocate should object and seek to limit the testimony to relevant matters. Similarly, the appellant or advocate should object to other testimony that is irrelevant to the request for assistance.[1826]

Hearsay testimony is a recurring problem in informal hearings. Because of the hearing's informality, it is technically not excludable.[1827] However, its use may violate the appellant's due process rights by denying him or her the right to confront and cross-examine adverse witnesses. In public housing grievance hearing cases, the courts have consistently held that reliance upon written or oral statements of others without making the declarant available for confrontation and cross-examination constitutes a denial of due process.[1828] There is no reason why the same argument should not prevail in NAD cases.

Another problem may involve the agency's use of evidence that was not previously made available to the appellant. Although the regulations do not specifically preclude the use of such information, there are several grounds upon which such information may be excluded from the hearing.

First, argue that the agency should not be allowed to rely on information that the appellant had no opportunity to review or rebut and request that the hearing be postponed until such time as your client has had an opportunity to review the material and prepare a response. Prior to the hearing, the parties are required to exchange copies of any documents they intend to introduce into evidence and a list of anticipated witnesses and a brief summary of their testimony, and to submit these documents and witness lists to the hearing officer.[1829] Therefore, there should rarely be a reason for the agency to attempt to present "new" information at the hearing, and the hearing guide recommends continuing or postponing the hearing in the event one of the parties misses the deadline for submission of documents or witness lists.[1830]

In the alternative, the appellant should seek to exclude the use of the information on the grounds that it is not part of the case record and therefore, may not become a basis for the decision by the hearing officer.[1831] The information should be excluded on due process grounds. In public housing grievance hearings, attempts by the public housing authority to introduce evidence not provided to ten-

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[1823] NAD Hearing Guide, *supra* note 1696, at 41.
[1824] *Id.*
[1825] 7 C.F.R. § 11.8(c)(2)(v)(ii) (2009).
[1826] *Id. See also* NAD Hearing Guide, *supra* note 1696, at 37.
[1827] 7 C.F.R. § 11.8(c)(5)(ii) (2009).
[1828] *See, e.g., Escalera v. New York City Hous. Auth.*, 425 F.2d 853 (2d Cir. 1970), *cert. denied*, 400 U.S. 853 (1970); *Caulder v. Durham Hous. Auth.*, 433 F.2d 998 (4th Cir. 1970); *Chase v. Binghamton Hous. Auth.*, 91 A.D.2d 1147 (N.Y. App. Div. 1983); *Buczko v. Lucas Metropolitan Hous. Auth.*, No. C-78-26 (N.D. Ohio Mar. 7, 1978), 11 CLEARINGHOUSE REV. 1013 (Apr. 1978) (No. 23,372); *Housing Auth. of Kansas City v. George*, No. 78- L-1097 (Kan. Ct. App. 1978), 12 CLEARINGHOUSE REV. 366 (Oct. 1978) (No. 25,046) (eviction dismissed on appeal on PHA's stipulation that, in the future, all complaining witnesses will be made available). *Loving v. Brainerd Hous. & Redev., Auth.* 2009 WL 294289 (D. Minn. Feb. 5, 2009)(slip op.)(only witness was PHA official without personal knowledge of the facts). *See also Billington v. Underwood*, No. 81-7978 (11th Cir. May 23, 1983) (Clearinghouse No. 28,992).
[1829] *See* 7 C.F.R. § 11.8(c) (2009). *See also* NAD Hearing Guide, *supra* note 1696, at 27.
[1830] *See* NAD Hearing Guide, *supra* note 1696, at 25.
[1831] *See* 7 C.F.R. § 11.10(c) (2009).

ant grievants have been roundly condemned by the courts as inconsistent with due process.[1832]

If the hearing officer allows the submission of such evidence, the regulations mandate that the appellant be given an opportunity respond. Once the hearing has been concluded, the hearing officer must leave the record open for at least ten days to allow either party to respond to new facts, information, arguments, or evidence presented or raised at the hearing.[1833]

9.3.4.12 The Case Record

The case record is developed by the hearing officer. The record is considered the official record of the appeal and will contain all of the evidence and information relied upon by the hearing officer in issuing a decision. The case record will also serve as the basis for any further review of the decision. Any party to an appeal may obtain a copy of the official case record.[1834] The Hearing Guide and regulations are silent on whether a party may obtain the copy free of cost.

Tape recording of the hearing. The hearing officer will make a tape recording of the hearing, which will become the official record of the hearing.[1835] Upon submission of a written request, the parties may obtain a copy of the official tape recording at no charge. In addition, any party may request that a verbatim transcript be made of the hearing and request that the transcript become the official record of the hearing. However, the requesting party must pay for the transcription service, must provide a certified copy of the transcript free of charge to the hearing officer, and must allow any other party to purchase a copy.[1836]

9.3.4.13 The Decision of the Hearing Officer

Hearing officers are required to issue decisions on cases within 30 days of the hearing date or within 30 days of the closing date of the hearing record in those cases where the hearing officer received additional information into the record from the appellant or the agency.[1837] The hearing officer may request that the NAD Director establish a later deadline if additional time is needed to consider the evidence introduced in the hearing.[1838]

Basis for decision. The hearing officer's decision must be based on the case record, the laws applicable to the matter at issue, the applicable regulations in effect on the date the agency issued the adverse decision, and generally applicable interpretations of such regulations and laws.[1839] While this approach seems generally clear, advocates should note that the Hearing Guide provides that the hearing officer is not limited to court decisions for determining how a law or regulation has been interpreted, but may also look to such sources as agency hearing guides or interpretations by the USDA Office of General Counsel (OGC) for interpretation of agency regulations.[1840] This effectively permits the hearing officer to base the decision on documents or information that may not have been introduced into the record or policies that may not be in writing and of which the appellant was never informed. Further, agency interpretations may not be legally correct; they may also be biased against the appellant.

At a minimum, at both the pre-hearing conference and at the hearing, advocates should demand clarification of which regulations or agency policies are applicable to the issue and whether the agency has issued any interpretations on the policies or regulations. This at least affords an opportunity to respond to an interpretation that appears biased or contrary to other laws or regulations.

Advocates should also be certain that the hearing officer adheres to the rule against *ex-parte* communications prohibiting any officer or employee of NAD from engaging in *ex-parte* communications regarding the merits of an appeal with **any** person having any interest in the pending appeal until a final determination has been made.[1841] Clearly, the hearing officer should not ask the agency to clarify a position or discuss how it has interpreted a

[1832] *Escalera v. New York City Hous. Auth*., *supra* note 1828, 425 F.2d at 862-63; *Caulder v. Durham Hous. Auth*., *supra* note 1828, at 1004.
[1833] 7 C.F.R. § 11.8(c)(7) (2009).
[1834] NAD Hearing Guide, *supra* note 1696, at 51.
[1835] 7 C.F.R. 11.8(c)(5)(iii) (2009).
[1836] *Id.*
[1837] *Id.* § 11.8(f).
[1838] *Id.*
[1839] *Id.* § 11.10(c).
[1840] NAD Hearing Guide, *supra* note 1696, at 47.
[1841] *See* 7 C.F.R. § 11.7 (2009).

regulation without providing all other parties notice and an opportunity to participate in the communication and an opportunity to respond. Further, any such consultation must be documented in the case record.

Arguably, the prohibition against *ex-parte* communications should also extend to consultations between the hearing officer and the OGC about interpretation of regulations or agency policy. The OGC opinions are not opinions issued by disinterested staff. The OGC attorneys advising the hearing officer are the same attorneys that advise and represent RD/RHS and other USDA agencies. Consequently, OGC opinions, which range over a wide spectrum of issues, may be biased in favor of the agency and against the appellant or potential appellant.

It is possible that decisions that rely on agency and OGC interpretations violate the appellants' due process rights. Generally, consider challenging decisions when they lack support in prior RD/RHS policy or are contrary to RD/RHS regulations or the authorizing statute. Also consider challenging any decision based on documents or information that your client did not have an opportunity to rebut on the ground that such a decision violates your client's due process rights.[1842]

Appraisal decisions. Appellants may submit their own appraisals in appeals involving RD/RHS appraisals, provided the appraisal was made by an appraiser who is a member of a national appraisal society and the appraisal was conducted in accordance with RD/RHS regulations on appraisals for the appropriate program.[1843]

9.3.4.14 Notice of Decision and Right to Review

The hearing officer's decision must be communicated to the appellant in writing with specific supporting reasons.[1844] The decision states whether the adverse decision is erroneous, and specifies the findings of facts and conclusions based on the applicable laws and regulations. A copy of the decision must be sent to the appellant, the appellant's authorized representative, and the agency.[1845] The decision must include a copy of the procedure for filing a request for a NAD Director's review.[1846]

The hearing officer's decision should include: a statement of the issues that are the basis of the dispute; a summary of the adverse decision; the names of the parties and the NAD case number; the name of the hearing officer; the agency that issued the adverse the decision, a clear statement of the applicable laws, regulations or other authorities; findings of fact and the hearing officer's conclusions; the determination of whether the agency erred; and a statement of the parties' rights to seek the NAD director's further review.[1847] The findings of fact and the hearing officer's conclusions are usually the essential part of the appeal determination. The hearing officer is an independent fact finder and is not bound by the agency's findings that were used to make the adverse decision.[1848] Therefore, advocates should be certain that the hearing officer's findings and conclusions are accurate and comport with the case record.

Advocates should also be aware that the appeal decision is limited to whether the agency's decision was erroneous. The hearing officer does not have authority to order the agency to take specific action even if a determination is made that the adverse decision was incorrect. For example, if the agency calculated the appellant's monthly payment schedule incorrectly, the hearing officer can issue a decision that finds that the payment schedule is incorrect or not in compliance with agency regulations. However, the hearing officer cannot instruct the agency on how to recalculate the payment scheme.[1849]

[1842] *See Caulder v. Durham Hous. Auth., supra* note 1828; *Escalera v. New York City Hous. Auth., supra* note 1828, 425 F.2d 853.
[1843] 7 C.F.R. Part 1900, Ex. B-4 (2009).
[1844] *See id.* §§ 11.8(f), 11.10 (2009); *See also* NAD Hearing Guide, *supra* note 1696, at 48.
[1845] 7 C.F.R. § 11.8(f) (2009).
[1846] *Id.*
[1847] NAD Hearing Guide, *supra* note 1696, at 48-49.
[1848] 7 C.F.R. § 11.10(a) (2009).
[1849] *See id.* § 11.9(e); NAD Hearing Guide, *supra* note 1696, at 50.

9.3.5 REVIEW OF THE HEARING OFFICER'S DECISION

Both the appellant and the agency have a right to seek a Director's review of the hearing officer's decision.

9.3.5.1 Appellant's Right to Review

If the appellant believes the decision is incorrect and would like a Director's review, he or she must submit a signed, written request, within 30 days after receipt of the decision. The request must specify the reasons why the appellant believes the determination is wrong. The appellant must also simultaneously submit the request for review, along with any new information to all other parties to the appeal.[1850]

The agency has 15 days from receipt of the decision to submit a request for review. The agency request must include not only the reasons why the agency believes that the decision is incorrect, but also must include citations to the statutes or regulations the agency believes the decision violates. The agency request may only be made by the agency head or a person acting in the capacity of agency head.[1851] Like the appellant, the agency must submit copies of the review request to all other parties to the appeal.[1852]

The NAD Director must promptly notify all the parties when the review request has been received. All other parties to the appeal have the right to submit a written response to the review request. The written response must be submitted within five business days of receipt of the appeal request.[1853]

9.3.5.1.1 Review Officer

The NAD Director need not personally conduct the review. He or she may delegate the review process to any Deputy or Assistant Directors of NAD. In such cases, however, the Deputy or Assistant Director's decision shall be considered to be the determination of the Director, and like a review issued personally by the Director, is final and not appealable.[1854]

9.3.5.1.2 Appellant's Burden of Proof on Review

NAD regulations do not state what burden of proof the appellant has on review. Presumably, the appellant has the same burden on review as in the initial appeal, namely, that the initial decision should be reversed or modified because it was factually incorrect or contrary to or inconsistent with agency regulations.

Basis for the decision. The NAD Director conducts a review of the Hearing Officer's decision by reviewing the agency record, the hearing record, the request for review, and any responses submitted to the review request. The Director also may accept additional information or arguments deemed necessary to issue a determination.[1855] The purpose of the review is to determine whether the hearing officer's decision is supported by substantial evidence.[1856] The Director must ensure that the hearing officer's decision is consistent with the laws and regulations of the agency.[1857] The Director may uphold, reverse, or modify the decision.[1858] The Director may also remand the matter back to the hearing officer. The Director's review is considered final, and is not appealable.[1859]

9.3.5.1.3 Notice and Timing of Review Decision

The Director must complete the review and issue a final determination no later than ten business days after receipt of the request for review by the agency and no later than 30 days after receipt of the request for review by the appellant.[1860] The determination notice should include, along with the Director's determination, a statement that the review is the final administrative action, unless the Director has remanded the case back to hearing officer.

[1850] 7 C.F.R. § 11.9(a)(1) (2009).
[1851] *Id.* § 11.9(a)(2).
[1852] *Id.* § 11.9(a)(3).
[1853] *Id.* § 11.9(c).
[1854] *Id.* § 11.9(d)(3).
[1855] *Id.* § 11.9(d)(1).
[1856] *Id.*
[1857] *Id.* § 11.10(c).
[1858] *Id.* § 11.9(d).
[1859] *Id.*
[1860] *Id.*

9.3.5.1.4 Request for Reconsideration

Either the appellant or the agency may request that the Director reconsider the determination.[1861] The requesting party must submit a written request to the Director within ten days of receipt of the Director's determination. The request must contain a detailed explanation why the determination is incorrect. The request should identify either a material error of fact that was made in the determination or identify how the determination is contrary to the law or regulation.[1862]

Once the Director receives a request for reconsideration, he or she will issue a notice to all the parties as to whether the request meets the criteria for a reconsideration request: namely that it has identified a material error of fact or misapplication of the law.[1863] If the request meets the criteria, the Director will include a copy of the request in the notice that is sent to the non-requesting parties. The non-requesting parties have five days from receipt of the notice to respond to the request for reconsideration.[1864]

The Director is required to issue a response to the reconsideration request with five days of receipt of the responses from the non-requesting parties. The Director can reverse or modify his or her original decision or remand the decision back to the hearing officer. A Director's decision, other than a remand back to the hearing officer, is considered the final decision of the Director and is not appealable.[1865]

9.3.6 EFFECT OF APPEAL DECISION

9.3.6.1 Timeliness

Whenever a hearing decision that reverses or modifies the initial decision or otherwise finds that the agency erred in making the adverse decision becomes final, the agency must implement the decision within 30 days after the effective date of the notice of the final determination.[1866]

If you represent a client who prevailed on an appeal and the decisionmaker is not promptly implementing the hearing decision, contact the decisionmaker and request that he or she do so. If you do not receive satisfaction, contact the decisionmaker's superiors and request that they take action. If that fails, consider litigation. While NAD does not have any inherent enforcement authority,[1867] all final NAD determinations are enforceable by a participant in any federal district court.[1868]

9.3.6.2 Effective Date of Appeal Decision

When an appeal is concluded and the original decision modified or reversed, the effective date of the action is the date of the filing of the application, the date of the transaction or event in question, or the original decision.[1869] This effectively authorizes Rural Development to provide the applicant with assistance retroactively to the date of the original decision. Thus, the regulations in effect at the time of the original decision should govern further disposition of the case, and loans made as a result of an appeal should bear the interest at the rate in effect on the date of loan approval or loan closing, whichever is lower.

9.3.6.3 Equitable Relief

If the agency is authorized to grant equitable relief to a program participant, the Director is also authorized to grant equitable relief in the same manner and to the same extent as the agency. While a hearing officer does not have the authority to grant equitable relief, the appellant's claim for equitable relief may itself be the basis for the adverse agency decision if the agency denied the claim. Thus, while the hearing officer may not grant equitable relief directly, the hearing officer may determine that the agency's denial of the request for equitable relief was erroneous.[1870]

Additionally, the appellant may raise a separate claim for equitable relief as part of the appeal of the adverse decision. The hearing officer may hear evidence and issue findings of fact on the issue

[1861] *Id.* § 11.11(a).
[1862] *Id.*
[1863] *Id.* § 11.11(b).
[1864] *Id.*
[1865] *Id.*
[1866] *Id.* § 11.12(b).
[1867] *See* NAD Hearing Guide, *supra* note 1696, at 50.
[1868] 7 C.F.R. § 11.13(a) (2009).
[1869] *Id.* § 11.12.
[1870] NAD Hearing Guide, *supra* note 1696, at 50-51.

of the claim for equitable relief, but is not permitted to make a recommendation on the claim.[1871] After the hearing officer's decision, the appellant will need to seek the NAD Director's review to determine if the record supports the appellant's claim for equitable relief, and if so, for the relief to be ordered.

The appellant may also separately request equitable relief as part of the request for a Director's review of the hearing decision, even if the claim was not made in the original appeal or during the hearing.[1872] If an appellant plans to request equitable relief at the Director level, it is important to ensure that the factual record developed by the hearing officer contains facts that will support such a claim. If there is not a sufficient factual basis to support a request for equitable relief, the Director may deny the request or remand the case to the hearing officer to develop the factual record on the claim.

9.3.6.4 Legal Effect of the Decision

As noted earlier, NAD may uphold, reverse, or modify an adverse agency decision. In addition, the NAD Director may grant equitable relief to the same extent that the agency is authorized to grant such relief. However, the final decision is administratively but not legally conclusive.[1873] Therefore, the appellant may seek both judicial enforcement, and judicial review of the NAD decision.[1874]

9.3.7 ATTORNEYS' FEES

After three federal circuit courts[1875] and one federal district court[1876] concluded that the NAD appeals process was subject to the Administrative Procedure Act (APA)[1877] and the Equal Access to Justice Act (EAJA), [1878] the Department of Agriculture published a final rule in the Federal Register in November 2009 stating that EAJA and USDA's implementing regulations will apply universally to NAD proceedings regardless of the judicial circuit in which the proceeding arises.[1879] The amendment of the regulations also states that the APA provisions generally applicable to agency adjudications are applicable to NAD proceedings.[1880] Accordingly, parties that prevail in the NAD appeals process are now eligible to seek attorneys' fees if they can show that the agency's position in the appeals process was not substantially justified.

As of this writing, it is not clear how NAD is awarding attorneys' fees in appeal cases, nor is it clear whether it will publish decisions awarding fees.[1881]

According to the USDA rule, the APA and EAJA are not applicable to the informal agency reviews of decisions[1882] that may precede the formal NAD appeal and to the NAD Director's review of the agency's determination[1883] that a particular decision is not reviewable.[1884]

9.3.8 JUDICIAL REVIEW OF NAD DECISIONS

9.3.8.1 Exhaustion

A crucial question for advocates is whether an administrative appeal always must be taken from an agency decision before judicial relief may be sought. As part of the legislation authorizing the reorganization of the Department of Agriculture and creating the National Appeals Division, Congress enacted legislation requiring persons eligible for USDA assistance to exhaust administrative remedies before challenging an agency action in judicial

[1871] *Id.*
[1872] *Id.* at 57.
[1873] *See* 7 C.F.R. § 11.13 (2009).
[1874] *Id.*
[1875] *Five Points Rd. Joint Venture* v. *Johanns*, 542 F. 3d 1121 (7th Cir. 2008); *Aageson Grain & Cattle* v. *USDA*, 500 F.3d 1038 (9th Cir. 2007); *Lane* v. *USDA*, 120 F.3d 106 (8th Cir. 1997).
[1876] *Rosenbaum* v. *USDA*, No. 07–02808 (S.D. Tex. May 1, 2009).
[1877] 5 U.S.C.A. 554 to 557 (West, WESTLAW, Current through P.L. 111-174 (excluding P.L. 111-148, 111-152, 111-159, and 111-173) approved 5-27-10).
[1878] *Id.* §§ 504.
[1879] 74 Fed. Reg. 57401 (Nov. 6, 2009) (Amending 7 C.F.R. § 11.4 (2009).
[1880] *Id.*
[1881] 7 C.F.R. Part 1, subpart J (2009).
[1882] 7 C.F.R. § 11.5 (2009).
[1883] *Id.* § 11.6(a).
[1884] 74 Fed. Reg. 57401 (Nov. 6. 2009).

proceedings.[1885] The administrative exhaustion requirement has been found to apply to claims that are subject to a determination by the NAD Director as to whether they are appealable.[1886] Thus, the general answer is that participants must exhaust administrative remedies before seeking judicial relief even if there is a question as to the appealability of their claim.

However, there may be instances where the administrative appeal process may not be appropriate or where an immediate challenge to an agency action is required, and some courts have permitted legal challenges to proceed, notwithstanding the exhaustion requirement. For example, the 4th Circuit has ruled that a facial challenge to an agency regulation does not require administrative exhaustion, because such cases are expressly outside of NAD's jurisdiction.[1887]

An appellant may also be able to use equitable claims such as estoppel to defend against an agency's attempt to dismiss the appellant's legal claim due to the failure to exhaust administrative remedies. Generally, claims of estoppel against the government or a government agency are disfavored, and the party asserting such a claim has a heavy burden of proving, among other factors, that the agency affirmatively engaged in misconduct that would cause the moving party severe injustice.[1888] However, an agency should not be able to misrepresent to the appellant the availability of the appeal process or other relief and then demand that the appellant exhaust the very administrative relief the agency denied in order for him or her to proceed in court. In fact, some courts have permitted plaintiffs to assert an estoppel defense to the agency's motion to dismiss.[1889]

The 9th Circuit has found that the exhaustion provisions of the NAD statute are merely a "codified requirement of exhaustion," and do not limit a court's subject matter jurisdiction over a plaintiff's claims where administrative remedies were not exhausted.[1890] Although the 9th Circuit generally will require compliance with the exhaustion requirement, it has found the exhaustion requirement does not apply to a suit that alleges a constitutional claim which is actionable and collateral to the substantive claim and the resolution of which does not further the purposes of administrative exhaustion.[1891] As courts are not uniform in their approach to challenges to the administrative exhaustion requirement, advocates should be careful to review the holdings of their particular federal circuit before proceeding to court in lieu of the administrative appeal process.

9.3.8.2 Time Limits for Seeking Judicial Review

A related question is what time limits, if any, there are to seek judicial review. The general answer is that the Administrative Procedure Act does not impose a time limit for seeking review of agency decisions. Therefore, the general six-year statute of limitations for bringing suits against the United States applies to judicial actions seeking review of agency decisions.[1892]

Given the long time that is available to commence judicial review, other considerations, such as the desire to forestall an impending nonjudicial foreclosure, are more likely to dictate when judicial review of an agency decision should be initiated. Even when no other considerations apply, it is not advisable to delay judicial review unduly because claims may become stale or moot.

9.3.8.3 Scope of Judicial Review

Courts generally have held that review of NAD decisions is an Administrative Procedure Act

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[1885] 7 U.S.C. § 6912(e) (West, WESTLAW (Current through P.L. 111-35 (excluding P.L. 111-31) approved 6-30-09).

[1886] *Bastek v. Federal Crop Ins. Corp.*, 145 F.3d 90 (2d Cir. 1998).

[1887] *Gold Dollar Warehouse, Inc. v. Glickman*. 211 F. 3d 93, 99 (4th Cir. 2000);7 C.F.R. §11.3(b) (2009)("[t]he procedures contained in this part may not be used to seek review of statutes or USDA regulations....").

[1888] *See United States v. Omdahl*, 104 F.3d 1143, 1146 (9th Cir. 1997).

[1889] *See In re Cottrell*, 213 B.R. 33, 37 (M.D. Ala. 1997).

[1890] *McBride Cotton and Cattle Corp. v. Veneman*, 290 F.3d 973, 980 (9th Cir. 2002).

[1891] *Id.*

[1892] 28 U.S.C.A. § 2401(a) ((West, WESTLAW (Current through P.L. 111-35 (excluding P.L. 111-31) approved 6-30-09). *See Sierra Club v. Penfold*, 857 F.2d 1307, 1315-16 (9th Cir. 1988); *Shiny Rock Mining Corp. v. United States*, 906 F.2d 1362, 1364-66 (9th Cir. 1990). Note that when the statute begins to run depends on whether the challenge is procedural or substantive. *See Utu Utu Gwaitu Paiute Tribe v. Department of Interior*, 766 F. Supp. 842, 844-47 (E.D. Cal. 1991).

review of an informal agency action which may be overturned only if it is found to be arbitrary and capricious, an abuse of discretion, or contrary to law.[1893] Normally, that standard of review is deferential, and there is a presumption of validity that attaches to the agency action.[1894]

Scope of judicial review. As with all reviews of agency actions, the scope of a court's review is limited to the agency record.[1895] Thus, courts will refuse to overturn decisions based on evidence that the appellant failed to submit at the hearing,[1896] and they are not likely to uphold agency decisions on grounds that were not relied upon by the agency in reaching the decision.[1897]

9.4 APPEAL RIGHTS OF BORROWERS WHOSE LOANS HAVE BEEN SOLD TO THE RURAL HOUSING TRUST 1987-1

Section 502 borrowers whose loans were sold to the Rural Housing Trust 1987-1 (RHT)[1898] are not entitled to appeal adverse decisions made by the RHT's subservicer, Chase Residential Mortgage Corporation (CRM) (formerly Chemical Residential Mortgage Corporation). Instead, they are entitled to appeal such decisions in accordance with a hearing process established by CRM.[1899] They are, however, entitled to seek a NAD review of hearing decisions made by CRM hearing officers in accordance with the regulations applicable to reviews of RD/RHS decisions.[1900]

There is little public information available about the scope or functioning of the CRM appeal process. Previously, CRM did not conduct appeal hearings in the various states where RHT loans were located. Instead, it conducted all hearings by phone.[1901]

Because of the unavailability of information, practitioners representing borrowers whose loans have been purchased by RHT should carefully review whether borrowers are routinely informed of their appeal rights, whether borrowers are accorded the right to review their files, whether the hearings are conducted by disinterested CRM staff, whether appellants have an opportunity to present additional information and to question CRM staff, and whether the hearings are based on the record. It is likely that one or more of these rights are not available to borrowers and that the CRM hearing process may violate borrowers' constitutional due process rights.

It is arguable that the mere availability of the NAD right of review is sufficient to meet a strict interpretation of a borrower's statutory right of review under Section 510.[1902] However, merely because the RHT appeal process meets the statutory mandate, it does not necessarily mean that it also meets the Constitution's due process requirements.[1903]

RHT borrowers may be able to challenge their inability to appeal CRM decisions under the

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[1893] *See, e.g.*,*Branstad v. Veneman*, 212 F. Supp. 2d 976, 988 (N.D. Iowa 2002); *Lane v. USDA*, 929 F. Supp. 1290, 1293 (D.N.D. 1996).

[1894] *See Branstad*, 212 F. Supp. at 989. *See Israel v. USDA*, 135 F. Supp. 2d 945 (W.D. Wis. 2001).

[1895] *See Jaeger v. Stephens*, 346 F. Supp. 1217, 1225 (D. Colo. 1971); *Lewis v. Butz*, 512 F.2d. 681, 683 (8th Cir. 1975).

[1896] *See, e.g., Western and Southern Life Insurance Co. v. Smith*, No. CA C-2-84-1867 (S.D. Ohio March 5, 1987), slip op. at 15, *aff'd*, 859 F.2d 407 (6th Cir. 1988) (Clearinghouse No. 44,239).

[1897] *See, e.g., James v. HUD*, No. 83-0295-C (S.D. Ala. Dec. 23, 1983) (Clearinghouse No. 35,808), slip op. at 7-8; *Young v. First Federal Savings and Loan Ass'n*, No. C79-658A, slip op. at 15-15 (N.D. Ga. Dec. 22, 1983) (Clearinghouse No. 45,108).

[1898] *See* § 1.2.5, *supra*.

[1899] 7 C.F.R. §§ 1900.53, 1957.6 (2009). In *Williams v. Lyng*, No. 176-153, slip op. at 20 (S.D. Ga. June 20, 1990), the court assumed, without investigation, that RHT borrowers are entitled to the same type of hearing procedure as FmHA borrowers and concluded that their due process rights are not violated by the fact that CRM's predecessor, Manufacturers' Hanover Servicing, Inc., is conducting the hearings. *Id.*, slip op. at 20. If, as it appears, RHT borrowers' hearing rights are substantially different, the court's conclusion should not be viewed as resolving the issue of whether RHT borrowers' due process rights are violated by CRM.

[1900] 7 C.F.R. § 1957.6 (2009). *See* § 9.3.5, *supra* (discussion of review of hearing decisions).

[1901] Arguably, RHT borrowers' inability to present information in person is a violation of their due process or equal protection rights.

[1902] *See* 42 U.S.C.A. § 1480(g) (West 2003). *See Brewer v. Madigan*, 945 F.2d 449, 453 (1st Cir. 1991) (the statute mandates only that borrowers be given notice of the adverse decision and an opportunity to present additional information to a person, other than the original decisionmaker, with the authority to reverse the decision). Arguably, the statutory provisions authorizing the NAD appeals process extend to RHT borrowers.

[1903] *See Goldberg v. Kelly*, 397 U.S. 254, 268 (1970) (the opportunity to be heard must be tailored to the capacities and circumstances of those who are to be heard).

NAD appeals procedure on the grounds that FmHA originally adopted the regulations limiting their appeal rights to the procedure adopted by CRM without publishing the regulations for prior rulemaking as required by the Administrative Procedures Act.[1904] FmHA's stated reason for publishing the regulations without prior rulemaking was that it was impractical to do so because of time constraints associated with the transfer of the loan servicing obligations from FmHA to CRM.[1905]

There are several reasons why this position should not withstand a challenge. First, FmHA sold the loans to RHT in September of 1987 and continued to service the loans and to provide borrowers the FmHA appeal rights for another two years pursuant to a contract with the RHT that called for the transfer of the servicing responsibilities to another agent starting in 1989.[1906] Thus, FmHA had two years in which to propose and adopt regulations dealing with RHT appeals, and its failure to do so on a timely basis does not constitute good cause to avoid the rulemaking process.

Second, once FmHA recognized that it failed to propose rules in accordance with the APA, it could have continued to provide RHT borrowers with the right to appeal CRM decisions under the FmHA appeals process until such time as it adopted new regulations in conformance with the APA's public rulemaking process. Finally, USDA itself had the opportunity to address this issue when it created new agencies such as RHS[1907] and amended its regulations in order to comply with the USDA Reorganization Act. However, the Department continues to retain only review and not hearing authority for these loans.[1908]

9.5 APPEAL RIGHTS OF APPLICANTS AND BORROWERS WITH SECTION 502 GUARANTEED LOANS

The NAD authorizing statute and regulations limit the rights of participants to appeal adverse decision to those made by agency staff.[1909] Decisions made by third parties, such as guaranteed lenders, are not appealable. Nonetheless, Section 510(g) of the Housing Act of 1949 [1910] grants appeal rights to any person who is denied assistance under Title V of that act or whose assistance under Title V is substantially reduced or terminated. Section 510 does not limit appeals to decisions made by agency staff, but extends the appeal right to decisions made by anyone with respect to any assistance under Title V of the Housing Act of 1949. Since Section 510 was not revoked or superseded by the 1994 legislation creating the NAD, RD/RHS must follow its mandates.

Interestingly, the RD Guaranteed Loan Regulations provide guaranteed borrowers and guaranteed lenders the right jointly to appeal adverse decisions made by RD/RHS that directly and adversely impact them.[1911] However, they deny borrowers the right to appeal any of the lender's decisions, even if the decisions require RD/RHS' concurrence.[1912] To exercise the right to appeal RD/RHS decisions, the borrower and lender must jointly execute a written request to appeal an alleged adverse decision made by RD/RHS, although the lender need not be an active participant in the appeal process.[1913]

Surprisingly, the regulations never require the lender or RD/RHS to advise borrowers of any decisions made by RD/RHS with respect to their loan, that borrowers may have a right to appeal those decisions, and that they must ask the lender to join them in the appeal.[1914] Accordingly, guaranteed borrowers are never advised of their appeal rights or given the opportunity to exercise those rights. Clearly, this is a violation of the borrowers' rights under the legislation creating the NAD appeals pro-

[1904] *See* 54 Fed. Reg. 47,957 (Nov. 20, 1989).
[1905] *Id.*
[1906] *See* Sub-Servicing Agreement between Manufacturers Hanover Agent Bank Services Corporation and Farmers Home Administration § 4.03(a) (Sept. 14, 1987).
[1907] 7 U.S.C. § 6943 ((West, WESTLAW (Current through P.L. 111-35 (excluding P.L. 111-31) approved 6-30-09).
[1908] 7 C.F.R. § 1957.1 (2009).
[1909] 7 U.S.C. § 6991 ((West, WESTLAW (Current through P.L. 111-35 (excluding P.L. 111-31) approved 6-30-09). 7 C.F.R. §11.1 (2009).
[1910] 42 U.S.C. § 1480(g) (West 2003).
[1911] 7.C.F.R. § 1980.399 (2009).
[1912] *Id.*
[1913] *Id.* § 1980.399(a)(1).
[1914] Advocates are urged to inquire whether RD/RHS was involved in any decisions made with respect to their loans. It appears that lenders often seek RD/RHS' approval for loan servicing with respect to loan modifications after a borrower has defaulted on a guaranteed loan.

cess, Section 510(g), and the borrowers' constitutional due process rights.[1915]

The RD/RHS regulations clearly deny borrowers the right to appeal any adverse decisions made by the lenders.[1916] While this may not be a violation of the NAD authorizing legislation, it clearly is a violation of § 510(g) in that it denies the due process rights of borrowers whose assistance under Title V of the 1949 Act is being denied, reduced or terminated.

Advocates who seek to challenge RD/RHS' denial of the right to appeal a lender's decision should be aware that RD/RHS has granted an appeal right to Section 502 direct loan borrowers whose loans were sold by FmHA to the 1987 Rural Housing Trust. In that instance, the appeal is conducted by the servicer of the trust, Chase Residential Mortgage. However, under RD/RHS regulations, the trust borrowers are entitled to seek a review of the servicer under the NAD Appeals process.[1917]

Advocates should also be aware that residents of Section 515[1918] Rural Rental Housing, which is financed and subsidized by RD/RHS, have a right under Section 510(g) to a grievance and appeals process of any adverse decision made by their landlords. It is incongruous for RD/RHS to argue that guaranteed borrowers do not have the same right to appeal adverse decisions made by their lender.

RD/RHS' position is clearly contrary to law, and the agency should be challenged for its violation.

[1915] *See, United States v. White,*429 F.Supp. 1245 (N.D. Miss. 1977), *aff'd,* 536 F.2d, 1386 (5th Cir. 1977), *vacated and remanded on other grounds,* 542 F.2d 1139 (5th Cir. 1977).
[1916] 7 C.F.R. § 1980.399(b) (2009).
[1917] *Id.* § 1957.6.
[1918] 42 U.S.C.A. § 1485 (West 2003).

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