



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

February 5, 2013

**MEMORANDUM NO:
2013-LA-1801**

Memorandum

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

Dane Narode
Associate General Counsel for Program Enforcement, CACC

Tanya E. Schulze

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

SUBJECT: Standard Pacific Mortgage, Inc., Irvine, CA, Allowed the Recording of Prohibited Restrictive Covenants

INTRODUCTION

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

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

¹ FHA identification number 11775

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

METHODOLOGY AND SCOPE

We reviewed 153² loans underwritten by Standard Pacific Mortgage with closing dates between January 1, 2008, and December 31, 2011. We conducted the audit work from the HUD OIG Phoenix, AZ, Office of Audit between June and November 2012. To accomplish our objective, we

- Reviewed prior HUD OIG audit reports with findings that included lenders allowing prohibited restrictive covenants;³
- Reviewed relevant FHA requirements set forth in 24 CFR (Code of Federal Regulations) Part 203 and HUD Handbooks 4000.2 and 4155.2;
- Reviewed a HUD OIG legal opinion pertaining to restrictive covenants;
- Reviewed a HUD management decision discussing prohibited restrictive covenants;
- Reviewed prior reviews conducted by the HUD Quality Assurance Division;
- Discussed the prohibited restrictive covenants with Standard Pacific Mortgage officials; and
- Obtained and reviewed FHA loan data downloaded from HUD's Single Family Data Warehouse⁴ and Neighborhood Watch systems.⁵

We analyzed the Single Family Data Warehouse data as of May 31, 2012, and separated the data into two categories: (1) loans that went into claim status and (2) loans that were still active. We selected a 100 percent review of the claim loans, 84 loans total, and elected to review a highly stratified attribute statistical sample of the 2,691 active loans. The stratified sample of the 69 loan samples was randomly selected and weighted by means of a computer program in SAS® using a seed value of 7. To meet the audit objective, we also

- Requested and received copies of the lender's FHA lender files for the loans selected for review;

² 84 claim loans and 69 statistically selected active loans

³ Audit report numbers 2009-LA-1018, 2010-LA-1009, and 2011-LA-1017

⁴ HUD's Single Family Data Warehouse is a collection of database tables structured to provide HUD users easy and efficient access to single-family housing case-level data on properties and associated loans, insurance, claims, defaults, and demographics.

⁵ Neighborhood Watch is a Web-based software application that displays loan performance data for lenders and appraisers by loan types and geographic areas, using FHA-insured single-family loan information.

- Interviewed some borrowers for loans where HUD paid a claim;
- Conducted Internet research, identified and queried applicable county recorders' offices, and searched Accurint⁶ to obtain and review recorded documents related to the sampled FHA-insured mortgages; and
- Compiled and summarized the loan data with corresponding prohibited restrictive covenants.

For the audit sample, the percentage and number of loans with unallowable restrictive covenants were computed based on the weighted sampling results and extended to the population using the "surveyfreq" procedure provided by SAS®. We used a nine-strata sample design to control for potential bias that might arise from varying rates of price escalation and varying resale demand based on population density. Of the selected samples, 5 had disallowed covenants, which projects to 7.33 percent, or 197.3 loans. To account for the statistical margin of error, we subtracted the standard error (80.55) times a t-score of 1.67. As a result, we can be 95 percent confident that at least 62.8 of the 2,691 loans had similar problems with unallowable restrictive covenants.

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

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

BACKGROUND

Standard Pacific Mortgage is a nonsupervised direct endorsement lender⁷ headquartered in Irvine, CA. It was approved to participate in HUD's FHA mortgage insurance program in December 2004. Its affiliate builder, Standard Pacific Homes, was the seller of the properties discussed in this review memorandum.

⁶ Accurint LE Plus accesses databases built from public records, commercial data sets, and data provided by various government agencies.

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

FHA, created by Congress in 1934, is the largest mortgage insurer in the world aimed at helping low- and moderate-income families become homeowners by lowering some of the costs of their mortgage loans. It is also the only government agency that operates entirely from its self-generated income, from mortgage insurance paid by homeowners, and costs the taxpayers nothing. FHA mortgage insurance encourages lenders to approve mortgages for otherwise creditworthy borrowers that might not be able to meet conventional underwriting requirements by protecting the lender against default. However, according to HUD-FHA requirements, the lender has the responsibility at loan closing to ensure that any conditions of title to the property are acceptable to FHA and that the mortgaged property will be free and clear of all liens other than the mortgage. Lenders are responsible for complying with all applicable HUD regulations and in turn are protected against default by FHA's Mutual Mortgage Insurance Fund, which is sustained by borrower premiums.

In the event of homeowner default, the FHA fund pays claims to participating lenders. To this end, lenders have a responsibility to ensure that the FHA fund is protected by approving only those loans that meet all eligibility requirements. The FHA fund capital reserve ratio has a congressional mandate of 2 percent. However, based on the 2012 annual report to Congress on the FHA fund,⁸ its capital reserve ratio had fallen below zero to a negative 1.44 percent. A Government Accountability Office report on the FHA fund stated, “[i]f the [capital] reserve account were to be depleted, FHA would need to draw on permanent and indefinite budget authority to cover additional increases in estimated credit subsidy costs.”⁹ Therefore, the FHA fund would no longer run on only self-generated income.

We reviewed a legal opinion¹⁰ from OIG's Office of Legal Counsel regarding the seller's restriction on conveyance of FHA properties. Counsel opined that the recorded agreements between the seller and borrowers would constitute a violation of HUD statutes, regulations, or handbook requirements. In its opinion, the Office of Legal Counsel specifically stated that 24 CFR 203.41(b)(iv), pertaining to consent by a third party, appears to violate HUD's regulations. In this case, the seller is considered a third party.

Additionally, we obtained a HUD management decision on the recommendations of a prior OIG audit¹¹ not related to Standard Pacific Mortgage. In the decision, HUD agreed that the execution of prohibited restrictive covenants is a violation of Federal regulations and FHA requirements and considered the violation a serious deficiency, stating that loans with prohibited restrictive covenants are ineligible for FHA insurance.

RESULTS OF REVIEW

Standard Pacific Mortgage did not follow HUD requirements regarding free assumability and liens when it underwrote loans that had executed and recorded agreements between Standard

⁸ Annual Report to Congress, Fiscal Year 2012 Financial Status, FHA Mutual Mortgage Insurance Fund

⁹ Government Accountability Office testimony, GAO-12-578T, Mortgage Financing, FHA and Ginnie Mae Face Risk-Management Challenges, issued March 29, 2012

¹⁰ The legal opinion was obtained during the review of a separate lender (2011-LA-1017) for a similar restriction contained in the FHA purchase agreement.

¹¹ Audit report 2011-LA-1017

Pacific Homes and the FHA borrower, containing prohibited restrictive covenants and liens in connection with FHA-insured properties. This noncompliance occurred because Standard Pacific Mortgage did not exercise due diligence and was unaware that the restrictive covenants recorded between Standard Pacific Homes and the borrowers violated HUD-FHA requirements. As a result, we found 90 FHA-insured loans (28 claim loans and 62 active loans) with a corresponding prohibited restrictive covenant and lien recorded with the applicable county recording office, and Standard Pacific Mortgage placed the FHA fund at unnecessary risk for potential losses.

Claim Loan Review Results

We identified and reviewed all 84 claim loans underwritten by Standard Pacific Mortgage,¹² limited to loans closed between January 1, 2008, and December 31, 2011. In our review of the applicable county recorders' documents, we identified unallowable restrictive covenants corresponding to 28 of the 84 claim loans with properties in Arizona and Florida. Of the 28 loans, 15 resulted in actual losses¹³ to HUD totaling \$1.53 million (see appendix C, table 1), and 13 resulted in claims paid totaling \$1.39 million, but the properties had not been sold by HUD (see appendix C, table 2).

Active Loan Sample Results

Additionally, we completed a random attribute statistical sample and selected 69 of 2,691 active loans within our audit period. In our review of the applicable county recorders' documents of the sampled active FHA loans, we identified an unallowable restrictive covenant corresponding to 5 of the 69 sampled active loans with properties in Arizona and Florida. The five loans were active with an unpaid principal balance of \$878,000 (see appendix C, table 3).

Based on a highly stratified sample, designed to minimize error and accommodate varying rates of price escalation and varying demand based on population density, 7.33 percent of the 69 weighted loan samples contained restrictive covenants, which are not allowed by HUD rules. Therefore, we can be 95 percent confident that at least 62 of the 2,691 active loans in our audit period had similar problems with unallowable restrictive covenants (see Scope and Methodology).

Restriction on Conveyance

For each FHA loan, the lender certifies on the Direct Endorsement Approval for HUD/FHA-Insured Mortgage, form HUD-92900-A, that the mortgage was eligible for HUD mortgage insurance under the direct endorsement program (see lender certification excerpts below).

¹² Based on HUD's Single Family Data Warehouse as of May 31, 2012

¹³ The actual loss is the calculated amount of loss resulting from the sale of a HUD property. The loss is calculated based on the sales price - [acquisition cost + capital income/expense (rent, repair costs, taxes, sales expenses, and other expenses)].

This mortgage was rated as an "accept" or "approve" by FHA's Total Mortgage Scorecard. As such, the undersigned representative of the mortgagee certifies to the integrity of the data supplied by the lender used to determine the quality of the loan, that a Direct Endorsement Underwriter reviewed the appraisal (if applicable) and further certifies that this mortgage is eligible for HUD mortgage insurance under the Direct Endorsement program. I hereby make all certifications required for this mortgage as set forth in HUD Handbook 4000.4

This mortgage was rated as a "refer" by FHA's Total Mortgage Scorecard, and/or was manually underwritten by a Direct Endorsement underwriter. As such, the undersigned Direct Endorsement underwriter certifies that I have personally reviewed the appraisal report (if applicable), credit application, and all associated documents and have used due diligence in underwriting this mortgage. I find that this mortgage is eligible for HUD mortgage insurance under the Direct Endorsement program and I hereby make all certifications required for this mortgage as set forth in HUD Handbook 4000.4

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

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

Additionally, 24 CFR 203.32 states that a "mortgagor must establish that, after the mortgage offered for insurance has been recorded, the mortgaged property will be free and clear of all liens other than such mortgage, and that there will not be outstanding any other unpaid obligations contracted in connection with the mortgage transaction or the purchase of the mortgaged property, except obligations that are secured by property or collateral owned by the mortgagor independently of the mortgaged property."¹⁴

Finally and of most significance, HUD Handbooks 4000.2, paragraph 5-1(B), and 4155.2, paragraph 6.A.1.h, both state that it is the lender's responsibility at loan closing to ensure that any conditions of title to the property are acceptable to FHA. In essence, it is the duty of the lender to ensure that FHA loans approved for mortgage insurance are eligible and acceptable according to FHA rules and regulations. The restrictive covenants identified placed a prohibited restriction on the conveyance by a third party of the FHA properties, conflicting with the lender's certification that the loans met HUD-FHA insurance requirements set forth in 24 CFR 203.41 (a)(3).

¹⁴ The CFR includes exceptions; however, the exceptions do not apply in this case.

HUD Handbook 4155.1, paragraph 4.B.2.b, states, “FHA security instruments require a borrower to establish bona fide occupancy in a home as the borrower’s principal residence within 60 days of signing the security instrument, with continued occupancy for at least one year.” However; these security instruments would be between the lender and borrower, not a third party like the seller. Extra emphasis must be placed on the fact that the conveyance of the property, during the occupancy period, was at the consent of the seller, which violated HUD-FHA requirements at 24 CFR 203.41(a)(3)(iv). The following are excerpts from two versions of the recorded restrictive covenants found between the seller, a third party to the FHA loans, and borrowers.

1.1 Restriction on Resale, Marketing or Rental of Property. Owner, for itself, its successors and assigns, hereby declares and agrees that it shall not sell, convey, market, lease, rent or otherwise transfer (collectively, “Transfer”) its rights, title, or interest in the Property during the period beginning on the date of recordation of this Covenant and expiring six (6) months from the date of recordation of this Covenant (the “Restriction Period”), without the prior written consent of Seller, which consent may be given or withheld in Seller’s sole and absolute discretion.

1. Use as Principal Residence for One (1) Year. Purchaser represents and covenants to Seller that: (i) Purchaser is purchasing the Property for use as Purchaser’s principal/second home residence; (ii) Purchaser will occupy the Property as Purchaser’s principal /second home residence upon the transfer of title to Purchaser (hereafter, the “Closing”); (iii) Purchaser will not transfer Purchaser’s rights under the Purchase Agreement nor enter into any agreement for the lease, sale or other transfer of the Property that would prevent Purchaser from occupying the Property as Purchaser’s principal/second home residence, or prevent Purchaser from holding fee title interest in the Property, from and after the Closing for a period of at least One (1) year (the “Occupancy Period”). Purchaser acknowledges that Seller has relied upon the foregoing representations as a material inducement to enter into the Purchase Agreement and would not have agreed to sell the Property to Purchaser without such representations.

The above examples illustrate the language contained in the restrictive covenants identified; specifically, that the property cannot be transferred from the buyer to another until the occupancy period is over “without the prior written consent of [Standard Pacific Homes], which consent may be given or withheld in [Standard Pacific Home’s] sole and absolute discretion,” which is contrary to the HUD-FHA free assumability requirements set forth in 24 CFR 203.41(a)(3)(iv).

We also identified lien language, which stipulated monetary damages to the seller in the event of a breach in the agreement (see excerpt below). A breach of the contract would include a borrower selling, leasing, or otherwise transferring the property during the occupancy period. In some instances, the restrictive covenant specifically stated that the buyer granted a lien to the seller, Standard Pacific Homes, which is contrary to 24 CFR 203.32.

2.1 Grant of Lien to Seller. Owner hereby grants to Seller a lien against the Property (the "Lien") to secure Owner's obligations hereunder. Seller may promptly initiate foreclosure proceedings to foreclose the Lien if Owner defaults in its obligation to pay the Liquidated Damages to Seller on the date that it or any of its successors or assigns Transfers the Property without Seller's prior written consent during the Restriction Period. Owner acknowledges that the Dispute Resolution Agreement Addendum attached to the Purchase Contract and the definition of "dispute" therein is not applicable to a default under this Declaration. Owner agrees that all of Seller's reasonable costs and expenses of foreclosure, including reasonable attorney's fees and interest at the rate of 15% per annum from the date of the Transfer of the Property, shall become additional indebtedness owed by Owner to Seller that is secured by this Lien. Owner hereby waives any homestead exemption or other exemption now or hereafter existing or enacted under either Arizona or Federal law.

The following are excerpts from three versions of the recorded restrictive covenants specifying liquid damages for conveying the property within the specific restriction period.

1.2 Liquidated damages. Owner acknowledges and agrees that if Owner breaches its obligation under Section 1.1 above, the damages sustained by Seller shall be difficult to calculate with any precision. Accordingly, if Owner or its successors or assigns Transfers any rights, title, or interest in the Property without Seller's prior written consent during the Restriction Period, Owner shall pay to Seller as liquidated damages the sum of \$5,000.00 concurrently with the Transfer of the Property (which Owner and Seller acknowledge is a reasonable estimate of Seller's actual damages and does not constitute a penalty) ("Liquidated Damages").

3. Transfer at or After Closing . Except for "hardship" situations described in Paragraph 5 of this Addendum, any sale, lease or other transfer of the Property by Purchaser at or after the Closing that would prevent Purchaser from occupying the Property as Purchaser's principal/second home residence, or prevent Purchaser from holding fee title interest in the Property, for the entire Occupancy Period, shall constitute a material breach of the Purchase Agreement, entitling Seller to receive liquidated damages from the Purchaser in the amount of \$20,000.00 as full and complete settlement for Purchaser's default under this Addendum. Purchaser and Seller agree that the exact nature of Seller's damages is and will be difficult to ascertain and that the foregoing liquidated damages is adequate and reasonable compensation to Seller in the event of Buyer's default.

1. USE AS PRINCIPAL RESIDENCE FOR ONE YEAR Buyer represents and warrants to Seller that Buyer is purchasing the Property for use as Buyer's principal residence. Further, Buyer represents and warrants to Seller that for a period of one year from the Closing, Buyer does not intend to: (a) purchase or take steps to purchase another home as a principal residence; (b) assign the Contract to another person; (c) advertise, list or otherwise offer the Property for sale or rent to others; (d) enter an agreement to sell or rent the Property; (e) take any other action which indicates to Seller that Buyer does not have a bona fide intention of residing in the Property as Buyer's principal residence for one year. If Buyer breaches this warranty or Buyer's representation is incorrect, Seller shall be entitled to any and all damages proximately caused thereby and the amount of the appreciation of the Property after the Closing. For the purposes of this Use and Occupancy Addendum, "appreciation" shall mean the difference between (a) the fair market value of the Property at the time of Buyer's sale thereof, less Buyer's customary costs of resale such as the broker's commission, escrow fees and title costs, and (b) the purchase price paid by Buyer to Seller for the Property plus the actual cost to Buyer of any improvements made by Buyer to the Property after the Closing.

2. TRANSFER BEFORE CLOSING Any assignment by Buyer or attempt by Buyer to transfer the Property before the Closing is both (a) a breach of the Contract, entitling Seller, at its sole election, to terminate the Contract and pursue all remedies authorized under the Contract, and (b) the failure of a condition precedent to Seller's obligation to sell the Property to Buyer. If Buyer breaches this Use and Occupancy Addendum and the sale of the Property to Buyer closes, Seller is entitled to seek damages for the breach of this Use and Occupancy Addendum.

Standard Pacific Mortgage officials stated that they were unaware that the restrictive covenants recorded between Standard Pacific Homes and the borrowers violated HUD-FHA requirements. In one discussion, Standard Pacific Mortgage officials informed us that they had reviewed the

restrictions on occupancy and believed these were consistent with and not in conflict with HUD-FHA requirements. Therefore, they allowed the use of Standard Pacific Homes' restrictive covenants on FHA properties. However, in some instances, the purchase contracts contained in the lender's FHA files contained language stating that the covenant did not apply to buyers that purchased the property using FHA financing (see excerpt below). Based on this information, we concluded that Standard Pacific Mortgage did not exercise due diligence, demonstrated by its failure to ensure that language in the recorded property agreements was appropriate and followed HUD rules and regulations. Standard Pacific Mortgage officials stated that the document was commonly used with other mortgage financing instruments and was mistakenly executed and recorded on the FHA loans.

3. COVENANT RESTRICTING RESALE, MARKETING OR RENTAL OF PROPERTY. The following covenant shall apply to any Buyer other than a Buyer that purchases the Property using FHA or VA financing:

(a) Buyer hereby agrees and covenants not to resell, market or rent the Property for a period of six (6) months after Closing. If Buyer resells, markets or rents the Property prior to the expiration of such six (6) month period, Buyer shall pay Seller damages in the amount of \$5,000.00 (which Buyer and Seller acknowledge is a reasonable estimate of Seller's actual damages and does not constitute a penalty). Buyer's covenant not to resell,

market or rent and its obligation to pay liquidated damages to Seller if Buyer breaches said covenant shall be set forth in a separate Declaration of Covenant (the "Covenant") that shall be executed by Buyer at Closing and shall be recorded upon Closing as an encumbrance upon the Property. The Covenant shall be subordinate to a first deed of trust or mortgage on the Property. The Covenant shall be substantially in the form set forth in Schedule A attached hereto and incorporated herein by this reference. Seller reserves the right to make revisions to Schedule A prior to Closing in order to accomplish the purpose of the Covenant.

Impact and Risk for Losses

We identified 90 loans (28 claim loans and 62 active loans) within our audit period that had unallowable restrictive covenants on the FHA-insured properties. The third-party agreements, which contained the prohibited restrictive covenants preventing free assumability of the property and liens between the seller and borrowers, violated HUD-FHA requirements set forth in 24 CFR 203.41 (a)(3)(iv) and 203.32, respectively, thereby materially impacting the insurability of the questioned loans, making the loans ineligible for FHA insurance. Additionally, the borrowers in the restrictive covenant agreements were restricted in their ability to rent, lease, sell, or otherwise convey the FHA properties. By allowing the restrictive conveyance agreements on FHA properties that at minimum appeared to hinder free assumability, Standard Pacific Mortgage may have forced borrowers with decreasing financial capability to remain in their property longer than they would have otherwise.

As a result, Standard Pacific Mortgage's failure to exercise due diligence placed the FHA fund at unnecessary risk for potential losses by approving ineligible properties for FHA insurance and restricting borrowers' ability to rent, lease, sell, or otherwise convey the FHA properties and stipulating unallowable liens for liquid damages for a breach of the agreement. Of most significance, insuring properties that are not eligible for mortgage insurance increases the risk to an FHA fund that is already facing dangerously low levels of funding. For the 90 loans identified, HUD would not otherwise see a loss on the uninsurable FHA loans, as they would not

have been approved for FHA insurance and would not be the responsibility of the FHA fund. For the 15 claim loans identified as ineligible for FHA insurance, HUD suffered a loss it should not have otherwise suffered.

Conclusion

Standard Pacific Mortgage did not follow HUD requirements regarding free assumability and liens when it underwrote loans that had executed and recorded agreements between Standard Pacific Homes and the FHA borrower, containing prohibited restrictive covenants and liens in connection with FHA-insured properties. We identified 90 loans (28 claim loans and 62 active loans) within our audit period that did not meet the requirements for FHA insurance, thereby rendering them ineligible for FHA insurance. Standard Pacific Mortgage's failure to exercise due diligence allowed prohibited restrictive covenants with liens on the FHA-insured properties, which rendered them uninsurable. These uninsurable loans placed the FHA fund at unnecessary risk for potential losses because HUD would not otherwise see a loss on loans not insured by the FHA fund. Of the 33 (28 claim loans and 5 sampled active loans) loans reviewed with prohibited restrictive covenants, 15 resulted in an actual loss to HUD of more than \$1.53 million. Another 13 of these loans had claims paid totaling more than \$1.39 million. The remaining five loans found with prohibited restrictive covenants had a total unpaid mortgage balance of more than \$878,000 with an estimated loss to HUD of more than \$544,000 (see appendix C).

RECOMMENDATIONS

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

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

We also recommend that HUD's Deputy Assistant Secretary for Single Family Housing require Standard Pacific Mortgage to pursue recommendations 1B through 1E after completion of recommendation 1A:

- 1B. Reimburse the FHA fund for the \$1,535,189 in actual losses resulting from the amount of claims and associated expenses paid on 15 loans that contained prohibited restrictive covenants and liens (see appendix C, table 1).
- 1C. Support the eligibility of \$1,390,235 in claims paid or execute an indemnification agreement requiring any unsupported amounts to be repaid for claims paid on 13 loans for which HUD has paid claims but has not sold the properties (see appendix C, table 2).
- 1D. Analyze all FHA loans originated, including the five active loans identified in this memorandum, or underwritten beginning January 1, 2008, and nullify all active restrictive covenants or execute indemnification agreements that prohibit it from

submitting claims on those loans identified. The five active loans with prohibited restrictive covenants had a total unpaid mortgage balance of \$878,979, which carries a potential loss of \$544,967¹⁵ that could be put to better use (see appendix C, table 3).

- 1E. Follow 24 CFR 203.32 and 203.41 by excluding restrictive language and prohibited liens for all new FHA-insured loan originations and ensure that policies and procedures reflect FHA requirements.

Appendix A

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

Recommendation number	Ineligible <u>1/</u>	Unsupported <u>2/</u>	Funds to be put to better use <u>3/</u>
1B	\$1,535,189		
1C		\$1,390,235	
1D			\$544,967
Total	\$1,535,189	\$1,390,235	\$544,967

- 1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law; contract; or Federal, State, or local policies or regulations.
- 2/ Unsupported costs are those costs charged to a HUD-financed or HUD-insured program or activity when we cannot determine eligibility at the time of the audit. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of departmental policies and procedures.
- 3/ Recommendations that funds be put to better use are estimates of amounts that could be used more efficiently if an OIG recommendation is implemented. These amounts include reductions in outlays, deobligation of funds, withdrawal of interest, costs not incurred by implementing recommended improvements, avoidance of unnecessary expenditures noted in preaward reviews, and any other savings that are specifically identified. If HUD implements our recommendations to indemnify loans not originated in accordance with HUD-FHA requirements, it will reduce FHA’s risk of loss to the fund. See appendix C for a breakdown, by FHA loan number, of the funds to be put to better use.

¹⁵ The potential loss was estimated based on HUD’s 62 percent loss severity rate, multiplied by the unpaid mortgage balance. The 62 percent loss rate was the average loss on FHA-insured foreclosed-upon properties based on HUD’s Single Family Acquired Asset Management System’s “case management profit and loss by acquisition” as of September 2012.

Appendix B

AUDITEE COMMENTS AND OIG'S EVALUATION

Ref to OIG Evaluation


Auditee Comments

Comment 1

Comment 2

Comment 3

Comment 4



STANDARD PACIFIC MORTGAGE

January 4, 2013

Tanya E. Schultz
Regional Inspector General for Audit
Region 9, Office of Inspector General
611 W. South Street, Suite 1160
Los Angeles, CA 90017

Re: Standard Pacific Mortgage, Inc., Irvine, CA
Draft Audit Report Dated December 17, 2012

Dear Ms. Schultz:

Standard Pacific Mortgage, Inc. ("**Standard Pacific Mortgage**") acknowledges receipt of the draft findings memorandum for the recent OIG audit of Standard Pacific Mortgage (the "**Draft Report**") and appreciates the opportunity to provide a written response. Standard Pacific Mortgage continually strives to originate quality mortgage products and audit reports such as yours assist us in furthering our quality initiatives.¹

To support its sweeping conclusion that 33 of the 153 OIG reviewed Standard Pacific Mortgage originated FHA loans were subject to unallowable restrictive covenants, the Draft Report erroneously lumps together multiple Standard Pacific Homes ("**seller**") contract documents that contain different terms. The Draft Report does not recognize that the specific provisions **in all but two** of these contract documents are not impermissible restrictive covenants at all and also does not consider that in 28 of the 33 instances identified by the OIG, Standard

¹ The Draft Report identifies two documents in support of its conclusions, neither of which has been provided to Standard Pacific Mortgage, nor are they publicly available. The first document is the legal opinion from the Office of Legal Counsel regarding its interpretation of 24 C.F.R. § 203.41(a)(3)(iv), and the second is "a HUD management decision on the recommendations of a prior OIG audit," Audit Report No. 2011-LA-1017. The Audit Report is publicly available; however, the "management decision" is not. If the HUD OIG intends to rely on these materials in support of its Report, then it is obligated to provide those materials to Standard Pacific Mortgage.

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Comment 5

Pacific Mortgage did not know and could not reasonably be expected to know that documents containing alleged restrictive covenants were being recorded. In addition, even if HUD were to conclude that unallowable restrictive covenants were recorded and that Standard Pacific Mortgage should have known about them, the demand for indemnification is still not warranted.

Comment 6

Seller's efforts to ensure that homebuyers were not using FHA financing to obtain loans for investment properties is consistent with HUD policy. Moreover, there is no evidence that any homebuyer was harmed by the alleged impermissible restrictions.

Comment 7

Comment 8

While Standard Pacific Mortgage does not agree with the OIG's position or its interpretation of the documents referenced in the Draft Report, in an effort to acknowledge the OIG's concerns and in Standard Pacific Mortgage's continuing desire to comply with agency interpretation of applicable rules and regulations, Standard Pacific Mortgage has taken a number of steps to ensure that FHA borrowers are not impeded by seller from selling or leasing their homes. To that end Standard Pacific Mortgage has verified with seller that:

- Seller has discontinued using use and occupancy addenda.
- Seller has written a letter to each homeowner who signed a use and occupancy addendum that has not expired by its terms informing them that the addendum does not restrict their ability to sell or lease their properties.
- Seller has recorded terminations for all unexpired recorded use and occupancy addenda.

A. **Only 2 of 153 Closings Analyzed by OIG Included Restrictive Covenants.**

Comment 9

(i) *Arizona Loans.* 28 of the loans identified in the Draft Report related to home sales by the seller's Arizona division (27 of the claim loans and 1 of the active loans). For each of these transactions, the homebuyer executed a document entitled "Declaration of Covenant

Comment 9

Restricting Resale, Marketing or Rental of Property" (the "**Non-FHA/VA Buyer Declaration**"). While this document contains a covenant by the homebuyer not to resell, market or rent the home for 6 months and an agreement that this covenant shall be recorded on the property at closing, the Declaration states that such "covenant shall apply to any Buyer **other than a Buyer that purchases the Property using FHA or VA financing**" [emphasis added]. See Attachment A hereto. The Non-FHA/VA Buyer Declaration attaches the document that is to be recorded against the property of homebuyers that do not use FHA or VA financing (referred to as "Schedule A"). Schedule A does not contain a carve out for FHA/VA financed homebuyers because the parties never intended to record Schedule A when the homebuyer was using FHA/VA financing.

Seller has informed Standard Pacific Mortgage that although seller did not intend to obligate homebuyers who were using FHA or VA financing (as evidenced by the Non-FHA/VA Buyer Declaration), a mistake was made and Schedule A was recorded by the title company for all homebuyers, including FHA/VA financed homebuyers.² The recorded Schedule A states:

As partial consideration to Seller by Owner for the purchase of the Property, **Owner agreed to enter into this Covenant** that provides, among other things, that Owner will not resell, market or rent the Property for six (6) months from the date of the recordation of this covenant containing a covenant not to resell, market or rent the home for 6 months. [Emphasis added]

Comment 10

Despite the mistaken recording of Schedule A, the properties sold to homebuyers using FHA/VA financing were never bound by a restrictive covenant because the Non-FHA/VA Buyer

² According to seller, the title company's typical process was to obtain the homebuyer's signature on Schedule A just before closing. The fact that Schedule A was signed after the execution of the Non-FHA/VA Buyer Declaration does not make it enforceable. Since the parties never intended Schedule A to be recorded, the execution and signing of the document amounted to a mutual mistake. As such, the document is not enforceable. A subsequently signed Schedule A is also not enforceable because it lacks consideration. The parties had already agreed to the terms of the contract and had agreed that Schedule A would not apply if the homebuyer used FHA or VA financing. Since no further consideration was given by seller to induce the subsequent signing of Schedule A, Schedule A cannot amend the Non-FHA/VA Buyer Declaration.

Comment 10

Declaration, which is the underlying agreement between seller and its homebuyers related to this topic, plainly states that the restrictive covenant **does not apply** to a homebuyer that purchases the property using FHA or VA financing. Since this document was not intended to be and, as a matter of contract law, never was enforceable against the homebuyer, it is not an unallowable restrictive covenant under 24 C.F.R. § 203.41(a)(3).

Comment 11

In addition, Standard Pacific Mortgage did not know Schedule A was being recorded and used closing instructions to ensure that any such recording would be disclosed by the title company. As part of its due diligence process, Standard Pacific Mortgage reviewed the home purchase contract, including the Non-FHA/VA Buyer Declaration, for each of the OIG reviewed loans. In each of these instances, Standard Pacific Mortgage properly concluded from the plain language of the Non-FHA/VA Buyer Declaration that the restrictive covenants contained in the document did not apply to properties that were to be purchased using FHA/VA financing. Standard Pacific Mortgage also provided closing instructions to the closing agent that included the following requirements:

Par 2: THERE MUST BE NO OTHER LIENS AGAINST THE PROPERTY OTHER THAN THOSE SHOWN ON PAGE 1, unless approved by us in writing.

Par 4: In examining title, if you find any violations of restrictions, easements, or encroachments, secure our approval prior to closing.

Par 17: Issue said form of Policy free from encumbrances except items of Preliminary Title Report...

Standard Pacific Mortgage did not approve the recording of Schedule A in writing and the closing agent did not seek to secure such approval. Further, Schedule A was not reflected in

Comment 3

Comment 4

Comment 5
Comment 12

Comment 13

the preliminary title reports and the title company issued final title policies that did not reflect Schedule A. Moreover, following receipt of the Draft Report, Standard Pacific Mortgage researched all 28 of the OIG reviewed Arizona closings and learned that Schedule A was recorded after the Standard Pacific Mortgage Deed of Trust.

Since these 28 OIG Arizona division reviewed loans did not include restrictive covenants and, even if they did, Standard Pacific Mortgage did not know, and could not have reasonably known, that they existed and had been recorded at the time such loans were offered for FHA insurance, Standard Pacific Mortgage is not responsible for providing indemnification relating to these loans under either 24 C.F.R. § 203.32 or 24 C.F.R. § 203.41. Moreover, the OIG may not extrapolate additional violations by referencing these loans.

(ii) *Tampa Loans*. 5 of the 153 loan files identified by the Draft Report related to closings by seller's Tampa division (1 of the claim loans and 4 of the active loans). In mid-2009, seller's Tampa division started using the Use and Occupancy attached hereto as Attachment B ("**Rep & Warranty Version**"). Seller and the homebuyer executed and recorded the Rep & Warranty Version in 3 of the 5 Tampa transactions. Seller has informed Standard Pacific Mortgage that the intent of this document was to ensure that at the time seller entered into the purchase contract with the homebuyer, it was the homebuyer's current intention to live in the property for one year. The plain language of the document reflects this intent:

Buyer **represents and warrants** to Seller that for a period of one year from Closing, Buyer **does not intend to**: (a) purchase or take steps to purchase another home as a principal residence; (b) assign the Contract to another person; (c) advertise, list or otherwise offer the Property for sale or rent to others; (d) enter an agreement to sell or rent the Property; (e) take any other action which indicates to Seller that Buyer does not have a bona fide intention of residing in the Property as Buyer's principal residence for one year. [Emphasis added]

Comment 13

This document does not contain a covenant to live in the home for one year. It merely states that buyer *intends* to live in the home for one year. If buyer's intent were to change after the funding of the FHA/VA loan for any reason or no reason, this provision does not prohibit the homebuyer from selling or renting the home at any time. Accordingly, the Owner Occupancy Agreement used by seller on 3 of the 5 Tampa transactions is not an unallowable restrictive covenant under 24 C.F.R. § 203.41(a)(3) and Standard Pacific Mortgage is not responsible for providing indemnification relating to these loans. Moreover, the OIG may not extrapolate additional violations by referencing these loans.

**Comment 5
Comment 12**

Standard Pacific Mortgage recognizes that the other two Tampa loans (Case Nos. 093-6736524 and 093-6695022) are restrictive covenants. However, for reasons explained in more detail in the Sections below, the Draft Report's demand for indemnity on these loans is also unwarranted. One of these restrictive covenants expired on May 1, 2010, and relates to a loan where no default has occurred. While a default has occurred on the other loan, the Draft Report provides no evidence that this loan went into default during the restriction period or that the borrowers' behavior was in any way influenced by the restrictive covenant.

Comment 14

B. The Provisions at Issue Are Consistent With HUD Policy.

While Standard Pacific Mortgage disagrees with the OIG's position that more than 2 of the documents identified contain restrictive covenants, the provisions identified are consistent with HUD policy. Indeed, there is a provision in the HUD standard mortgage that requires the borrower to occupy the property for at least one year. That provision provides:

Comment 6

**Occupancy, Preservation, Maintenance and Protection of the Property;
Borrower's Loan Application; Leaseholds**

Borrower shall occupy, establish, and shall use the Property as Borrower's principal residence within sixty days after the execution of this Security Instrument (or within sixty days of a later sale or transfer of the Property) and

shall continue to occupy the Property as Borrower's principal residence for at least one year after the date of occupancy, unless Lender determines that requirement will cause undue hardship for Borrower, or unless extenuating circumstances exist which are beyond Borrower's control. . . .

HUD Handbook 4155.2, Ch. 12, § A, Ex. 1. This provision strongly emphasizes HUD's interest in ensuring that FHA-insured loans are going to borrowers who intend to purchase properties as primary residences.

Comment 5

While Standard Pacific Mortgage concedes that restrictive covenants are not permitted under 24 C.F.R. § 203.41 and that no other liens are permitted under 24 C.F.R. § 203.32, Standard Pacific Mortgage believes that it is inappropriate and unfair to seek indemnification for loans based on provisions that are consistent with HUD's own policy or for purported liens that either no longer have legal effect or are being released immediately.

Comment 6

Comment 8

Comment 14

C. There Is No Evidence That Borrowers Have Been Harmed and Seller Has Removed Any Potential for Harm.

Comment 15

Comment 7

Comment 8

Comment 14

The OIG implies that borrowers were harmed as a result of the use and occupancy provisions recorded by seller. As set forth in more detail below, there is no evidence that any borrower has been harmed by the provisions identified. Moreover, seller has eliminated any potential for future harm from these provisions.

Comment 7

Comment 15

(i) *Provisions Intended to Protect, Not Harm Homebuyers.* Seller developed the use and occupancy provisions at a time when real estate investors were falsely representing themselves as owner-occupant homebuyers, only to close on the purchase of the property and then quickly flip the property to a new homebuyer or rent it out as an investment property. As the OIG is well aware, the practice of property flipping was a leading contributing factor to the sudden artificial inflation and subsequent severe deterioration of property values which

Comment 7
Comment 15

ultimately led to the housing bubble and economic conditions of today throughout our nation. Provisions which deter property flipping generally protect homeowners rather than harm them.³

(ii) *Homebuyers Were Not Forced to Remain in Their Homes.* While the general policy behind the owner occupancy provisions contained in seller's documents were intended to protect *bona fide* homebuyers within the community, the OIG contends that individual homebuyers might have been harmed if forced to remain in their property. However, the OIG has not provided evidence that homebuyers were forced to remain in their homes. Moreover, seller has informed Standard Pacific Mortgage that seller did not enforce the provisions recorded in conjunction with the 33 transactions identified by the Draft Report.

Comment 7
Comment 15

(iii) *Provisions Did Not Influence Borrowers' Behavior.* The OIG Draft Report fails to indicate or offer any evidence that the restrictive covenants in question influenced the behavior of any relevant borrower (such as influencing a borrower not to try to sell his or her house), which is a vital justification for the prohibition described at 24 C.F.R. § 203.41(b). To the contrary, the Draft Report speculates that the "restrictive conveyance agreements . . . appeared to hinder free assumability, [which] may have forced borrowers with decreasing financial capability to remain in their property longer than they would have otherwise." Draft Report at 9. The OIG's mere conjecture is insufficient to impose indemnification liability on Standard Pacific Mortgage.

Comment 5

Comment 7
Comment 15

(iv) *No Evidence That Defaults Occurred During the Purported Restriction Period.* 28 of the 33 recorded provisions identified by the Draft Report contained a six month period of applicability. The other 5 loan files contained a 12 month period of applicability. These time

³ The Draft Report should consider the potential exposure to the FHA fund that would result from the use of FHA-insured loans by property flippers and investors, which was the conduct sought to be stopped by the sellers' use of the recorded provision. HUD regulations prohibit the use of FHA loans to purchase non-owner occupied properties and HUD has restrictions on the re-sale of properties within one-year. See, e.g., HUD Handbook 4155.1, Ch. 4, § B; Mortgagee Letter 2006-14 (Property Flipping Prohibition Amendment).

Comment 7
Comment 8

Comment 7
Comment 8
Comment 13
Comment 14

Comment 8

periods have long since expired and the Draft Report fails to provide any evidence that the loans went into default during the applicable period.

(v) *Provisions Identified No Longer in Effect.* Standard Pacific Mortgage has confirmed that seller's Arizona division stopped the practice of recording Schedule A (the occupancy addendum mistakenly recorded in Arizona) to the purchase contract in mid-2009. Thus, the six-month restriction ended long ago and there is no current restriction on any of those properties. Further, while the Tampa division continued recording the Use and Occupancy Addendum until October 31, 2012, it is important to note that the Rep & Warranty Version discussed in Section A was used from mid-2009 until October 31, 2012. While Standard Pacific Mortgage does not believe the Rep & Warranty Version is a restrictive covenant, seller has nevertheless written to all homebuyers falling within the one year period to let them know that the document does not restrict the homebuyer's right to sell or lease the property. Seller also recorded a termination of the documents recorded in Tampa.

D. Standard Pacific Mortgage Has Already Taken Appropriate Remedial Actions

Standard Pacific Mortgage has taken a number of steps to ensure that unallowable covenants and prohibited liens will not be filed in connection with FHA loans. Specifically, Standard Pacific Mortgage has verified that:

- Seller has discontinued using a use and occupancy addendum.
- Seller has written a letter to each homeowner who signed a use and occupancy addendum that has not expired by its terms informing them that the addendum does not restrict their ability to sell or lease their properties.
- There are no unexpired recorded use and occupancy addenda that have not been terminated by seller.

Standard Pacific Mortgage also intends to conduct additional training with the seller regarding the restrictions on the use of unallowable covenants and prohibited liens in connection with FHA loans. In addition, Standard Pacific Mortgage will further enhance its standard closing instructions to closing agents to place in capital letters and bold text: "No second liens, or restrictive covenants, are to be placed on the property without prior approval by Standard Pacific Mortgage."

E. Conclusion

We trust that the information and documentation herein provided adequately addresses the finding in the Draft Report. While Standard Pacific Mortgage regrets the recording of the provisions identified in the Draft Report, 31 of the 33 provisions were not restrictive covenants and Standard Pacific did not know and could not reasonably be expected to know that 28 of these provisions were being recorded. Even if these provisions could be considered restrictive covenants, they were consistent with HUD policy and did not cause any increased liability or any losses to any borrowers or HUD. There is simply nothing in the Draft Report to support the OIG's conclusions that the recorded covenants had a "material impact" on the insurability of the loans or that Standard Pacific Mortgage "placed the FHA fund at unnecessary risk for potential losses." For the above-stated reasons, we ask that the HUD OIG accept the measures taken by Standard Pacific Mortgage to improve its practices and withdraw the findings set forth in the Draft Report.

Sincerely,



James Palda
President
Standard Pacific Mortgage, Inc.
Attachments

Comment 3
Comment 9
Comment 4

Comment 6

Comment 7
Comment 5

Comment 8

Comment 16

Attachment A
Non-FHA/VA Buyer Declaration



ADDENDUM TO PURCHASE CONTRACT
Occupancy/Investment Disclosure

This Addendum shall constitute an addendum to, and become a part of, that Purchase Agreement and Escrow Instructions (the "Contract") executed between Buyer and Seller pertaining to Lot # _____ at the _____

1. SELLER'S DISCLOSURE OF CURRENT MARKET CONDITIONS AND POSSIBLE ADVERSE EFFECTS ON BUYER'S HOUSE AND/OR PROPERTY.

Seller hereby advises Buyer that due to current market conditions there are a large percentage of buyers purchasing homes as investments. Seller hereby advises Buyer that non-owner occupied homes in the community owned by investors may have an adverse effect on the community and/or Buyer's House or Property, including but not limited to, the devaluation of Buyer's House or Property. Seller recommends that Buyer research his or her concerns prior to entering into a purchase contract with Standard Pacific Homes. Seller discloses that it has not and will not make any representations regarding the number of investors that have purchased or will be sold homes within Buyer's subdivision and/or surrounding community. Buyer hereby acknowledges that no guarantees or promises, either written or oral, have been made by Seller or Seller's representative(s) regarding non-owner occupied homes within the subdivision or community or their potential effect on Buyer's House, Property, subdivision or surrounding community.

2. REPRESENTATION REGARDING OCCUPANCY.

Buyer hereby represents and warrants that Buyer is purchasing the House to be owned and occupied by Buyer as Buyer's primary residence and not for investment purposes or rental and that Buyer hereby represents and warrants that, neither Buyer nor Buyer's spouse owns, directly or indirectly, any interest in, or any right to any part of the proceeds from the sale of or rental of, more than two other residential properties, either single family or multi-family units and/or dwellings, other than the House being acquired pursuant to this Contract. Buyer hereby acknowledges that Seller may check any governmental or other records to confirm that Buyer does not own more than two single family or multi-family units and/or dwellings at any time prior to Closing. Buyer acknowledges that should Seller discover through a credit inquiry, search of tax records or by any other means that Buyer owns more than two other residential properties as described herein, Seller may (but shall not be obligated to) by written notice to Buyer immediately cancel Buyer's Contract and keep all Earnest Money Deposits received as liquidated damages (which Buyer and Seller acknowledge is a reasonable estimate of Seller's actual damages and do not constitute a penalty). Buyer further represents and warrants that all but one other residential properties (single family or multi-family) owned in whole or in part, directly or indirectly, by Buyer must be sold prior to the Closing on the House being purchased from Seller. Should Buyer fail to close escrow on Buyer's additional residential properties (except that Buyer may still own one other residential property at the time of Closing) prior to the Closing on the House being purchased from Seller, Buyer shall be deemed in default of the Contract and Seller may (but shall not be obligated to) by written notice to Buyer immediately cancel the Contract and retain all Earnest Money Deposits as liquidated damages (which Buyer and Seller acknowledge is a reasonable estimate of Seller's actual damages and do not constitute a penalty).

Buyer's representations and warranties in the above paragraph are true and accurate and if Seller becomes aware through any source that any of Buyer's representations and warranties in the above paragraph are not correct (for example, but without limitation, Buyer is actively marketing the House for sale or rent, Buyer informs Seller's salesperson, or Buyer's lender indicates that Buyer is purchasing for investment purposes), Buyer shall be deemed in default of the Contract and Seller may (but shall not be obligated to) by written notice to Buyer immediately cancel the Contract and retain all Earnest Money Deposits as liquidated damages (which Buyer and Seller acknowledge is a reasonable estimate of Seller's actual damages and do not constitute a penalty). Buyer shall be deemed to be actively marketing the House for sale or rent if Buyer lists the House for sale, advertises the House for sale or rent, or solicits buyers or renters for the House. Additionally, Buyer understands that if Buyer is applying for FHA or VA financing, such misrepresentation on any FHA or VA application form may result in criminal penalties, including but not limited to a fine or imprisonment or both under the provisions of federal law. Buyer further acknowledges that it must renew its representations and warranties at Closing.

3. COVENANT RESTRICTING RESALE, MARKETING OR RENTAL OF PROPERTY. The following covenant shall apply to any Buyer other than a Buyer that purchases the Property using FHA or VA financing:

(a) Buyer hereby agrees and covenants not to resell, market or rent the Property for a period of six (6) months after Closing. If Buyer resells, markets or rents the Property prior to the expiration of such six (6) month period, Buyer shall pay Seller damages in the amount of \$5,000.00 (which Buyer and Seller acknowledge is a reasonable estimate of Seller's actual damages and does not constitute a penalty). Buyer's covenant not to resell,

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(Buyer Initials)

(Buyer Initials)

market or rent and its obligation to pay liquidated damages to Seller if Buyer breaches said covenant shall be set forth in a separate Declaration of Covenant (the "Covenant") that shall be executed by Buyer at Closing and shall be recorded upon Closing as an encumbrance upon the Property. The Covenant shall be subordinate to a first deed of trust or mortgage on the Property. The Covenant shall be substantially in the form set forth in Schedule A attached hereto and incorporated herein by this reference. Seller reserves the right to make revisions to Schedule A prior to Closing in order to accomplish the purpose of the Covenant.

(b) Seller may in its sole discretion based on proof satisfactory to Seller, waive the foregoing covenant under certain extreme circumstances. Buyer acknowledges and agrees that even under the circumstances listed below Seller has no obligation to waive the foregoing Covenant. These circumstances include, but are not limited to, the following:

- (i) A transfer resulting from the death of Buyer (or one of the Buyers);
- (ii) A transfer by Buyer where the spouse of Buyer becomes the only owner of the Property;
- (iii) A transfer by Buyer into a revocable inter vivos trust in which Buyer is a beneficiary;
- (iv) A transfer resulting from the decree of dissolution of marriage or legal separation or from a property settlement agreement incident to such decree;
- (v) The transfer, conveyance, pledge, assignment, or other hypothecation of the Property to secure the performance of an obligation, which transfer, conveyance, pledge, assignment or hypothecation will be released or reconveyed upon the completion of such performance; and
- (vi) The transfer by Buyer where (1) at the time of transfer Buyer is occupying the Property as Buyer's place of residence and (2) the transfer is necessary to facilitate Buyer's relocation of his place of residence in order to accommodate a job transfer required by Buyer's employer or to accommodate a change in employment whereby Buyer is required to drive more than fifty (50) miles one-way to Buyer's designated place of employment a minimum of four (4) days a week.

4. **AGREEMENT TO PROVIDE PROOF OF SALE AND CLOSING OF CURRENT PRIMARY RESIDENCE.** Buyer shall provide proof of closing Buyer's additional residential property prior to the Closing on the Home being purchased from Seller in the form of a HUD 1 statement (or other evidence satisfactory to Seller in its sole discretion) to either Seller or the branch of the title company at which Buyer is closing on their Standard Pacific Home (the "Title Company"). Buyer's failure to provide a copy of a HUD 1 statement (or other evidence satisfactory to Seller in its sole discretion) to Seller or the Title Company prior to the Closing will be deemed a default of the Contract by Buyer and Seller may (but shall not be obligated to) by written notice to Buyer immediately cancel the Contract and retain all Earnest Money Deposits as liquidated damages (which Buyer and Seller acknowledge is a reasonable estimate of Seller's actual damages and do not constitute a penalty). Notwithstanding any contrary provision contained herein, Buyer shall be entitled to own one other residential property at the time of Closing, provided that such residential property shall not be Buyer's primary residence.

5. **AGREEMENT TO MAKE FULL LOAN APPLICATION WITH STANDARD PACIFIC MORTGAGE.** Buyer shall submit a full and complete loan application with Standard Pacific Mortgage within five (5) business days after the date of the Contract. Buyer's failure to timely submit a complete loan application with Standard Pacific Mortgage within five (5) business days after the date of the Contract will be deemed a default under the Contract and Seller shall be entitled to cancel the Contract by written notice to Buyer and retain any Earnest Money Deposits made by Buyer as damages (which Buyer and Seller acknowledge is a reasonable estimate of Seller's actual damages and do not constitute a penalty). Notwithstanding the foregoing, so long as Buyer submits a full and complete loan application with Standard Pacific Mortgage, Buyer shall not be obligated or required to accept any mortgage loan offered by Standard Pacific Mortgage and Buyer, in its sole discretion, may finance Buyer's Home through a mortgage lender other than Standard Pacific Mortgage or purchase the Home without a mortgage loan.

6. **INTERPRETATION.** In the event of any conflict between the terms and provisions of this Addendum and the terms and provisions of the Contract attached hereto, the terms and provisions of this Addendum shall govern and control.

Buyer 1:

Name _____		Social Security Number _____	
Current Street Address _____	City _____	State _____	Zip _____
Current Employment Information			
Current Employer's Name _____	City _____	State _____	Employer's Phone Number (_____) _____
		(Buyer's initials)	(Buyer's initials)

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Job Title _____

Buyer 2:

Name _____ Social Security Number _____

Current Street Address _____ City _____ State _____ Zip _____

Current Employment Information

Current Employer's Name _____ City _____ State _____ Employer's Phone Number _____

Job Title _____

STANDARD PACIFIC OF ARIZONA, INC.

Buyer _____ Date _____ By _____ Broker _____ Date _____

Buyer _____ Date _____ By _____ Standard Pacific Sales Associate _____ Date _____

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(Buyers Initials) (Buyers Initials)

Standard Pacific of Arizona, Inc. is an Equal Opportunity Employer. Minorities and women are encouraged to apply.

**SCHEDULE A
TO PURCHASE CONTRACT**

When recorded, return to:

Standard Pacific of Arizona
6710 N. Scottsdale Rd, Suite 150
Scottsdale, AZ 85253
Attn: Closings Department

**STANDARD PACIFIC OF ARIZONA, INC.
DECLARATION OF COVENANT RESTRICTING RESALE, MARKETING OR RENTAL OF
PROPERTY**

THIS DECLARATION OF COVENANT RESTRICTING RESALE, MARKETING OR RENTAL OF PROPERTY (this "Covenant") is made this _____ day of _____, 200____ by _____ ("Owner"), and STANDARD PACIFIC OF ARIZONA, INC., a Delaware corporation ("Seller").

- A. Owner purchased the real property commonly known as _____ (the "Property") from Seller. The Property is described on Exhibit A attached hereto and incorporated herein by this reference.
- B. As partial consideration to Seller by Owner for the purchase of the Property, Owner agreed to enter into this Covenant that provides among other things, that Owner will not resell, market or rent the Property for six (6) months from the date of recordation of this Covenant.
- C. Upon execution, this Covenant shall be recorded in the records of the County Recorder for the county in which the Property is located.

**ARTICLE I
DECLARATION**

- 1.1 Restriction on Resale, Marketing or Rental of Property. Owner, for itself, its successors and assigns, hereby declares and agrees that it shall not sell, convey, market, lease, rent or otherwise transfer (collectively, "Transfer") its rights, title, or interest in the Property during the period beginning on the date of recordation of this Covenant and expiring six (6) months from the date of recordation of this Covenant (the "Restriction Period"), without the prior written consent of Seller, which consent may be given or withheld in Seller's sole and absolute discretion.
- 1.2 Liquidated damages. Owner acknowledges and agrees that if Owner breaches its obligation under Section 1.1 above, the damages sustained by Seller shall be difficult to calculate with any precision. Accordingly, if Owner or its successors or assigns Transfers any rights, title, or interest in the Property without Seller's prior written consent during the Restriction Period, Owner shall pay to Seller as liquidated damages the sum of \$5,000.00 concurrently with the Transfer of the Property (which Owner and Seller acknowledge is a reasonable estimate of Seller's actual damages and does not constitute a penalty) ("Liquidated Damages").
- 1.3 Covenant Runs with the Property. This Covenant shall run with the Property and shall bind and be a charge on the Property, Owner, and Owner's successors and assigns from the date hereof until the expiration of the Restriction Period.
- 1.4 Consideration. Owner's execution of this Covenant is in partial consideration for Seller's agreement to execute the purchase contract and deed by which the Property was conveyed by Seller to Owner.

**ARTICLE II
LIEN AND SUBORDINATION TO LENDER**

- 2.1 Grant of Lien to Seller. Owner hereby grants to Seller a lien against the Property (the "Lien") to secure Owner's obligations hereunder. Seller may promptly initiate foreclosure proceedings to foreclose the Lien if Owner defaults in its obligation to pay the Liquidated Damages to Seller on the date that it or any of its successors or assigns Transfers the Property without Seller's prior written consent during the Restriction Period. Owner acknowledges that the Dispute Resolution Agreement Addendum attached to the Purchase Contract and the definition of "dispute" therein is not applicable to a default under this Declaration. Owner agrees that all of Seller's reasonable costs and expenses of foreclosure, including reasonable attorney's fees and interest at the rate of 15% per annum from the date of the Transfer of the Property, shall become additional indebtedness owed by Owner to Seller that is secured by this Lien. Owner hereby waives any homestead exemption or other exemption now or hereafter existing or enacted under either Arizona or federal law.

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(Buyer Initials) (Buyer Initials)

2.2 Subordination to Lender. This Covenant shall be subordinate to the right of any holder of a first lien deed of trust or mortgage encumbering the Property.

ARTICLE III
LIEN AND SUBORDINATION TO LENDER

3.1 Seller's Exceptions. Seller may in its sole discretion based on proof satisfactory to Seller, waive the foregoing covenant under certain extreme circumstances. Buyer acknowledges and agrees that even under the circumstances listed below Seller has no obligation to waive the foregoing Covenant. These circumstances include, but are not limited to, the following:

- a. A transfer resulting from the death of any of the Owners;
- b. A transfer by Owner where the spouse of Owner becomes the only owner of the Property;
- c. A transfer by Owner into a revocable inter vivos trust in which Owner is a beneficiary;
- d. A transfer resulting from the decree of dissolution of marriage or legal separation or from a property settlement agreement incident to such decree;
- e. The transfer, conveyance, pledge, assignment, or other hypothecation of the Property to secure the performance of an obligation, which transfer, conveyance, pledge, assignment or hypothecation will be released or reconveyed upon the completion of such performance; and
- f. The transfer by Owner where (1) at the time of transfer Owner is occupying the Property as Owner's place of primary residence and (2) the transfer is necessary to facilitate Owner's relocation of his place of residence in order to accommodate a job transfer required by Owner's employer or to accommodate a change in employment whereby Owner is required to drive more than fifty (50) miles one-way to Owner's designated place of employment a minimum of four (4) days a week.

ARTICLE IV
MISCELLANEOUS

4.1 Remedies. In addition to its right of foreclosure under Section 2.1, Seller may exercise any equitable remedies to restrain or enforce this Covenant, including, without limitation, the right to initiate an action to enjoin any Transfer of the Property during the Restriction Period.

4.2 Governing Law and Venue. This Covenant shall be construed according to the laws of the State of Arizona, and venue for any action hereunder shall be in any court of competent jurisdiction located in the county in which the Property is located.

4.3 Severability. If any provision of this Covenant is held invalid or void by a court of competent jurisdiction, such provision shall be deemed severable from the remainder of this Covenant and shall in no other way affect the enforceability of any other provision herein.

4.4 Captions. The titles, headings, and captions used in this Covenant are for convenience of reference and are not to be interpreted to affect the meaning of any of the provisions herein.

OWNER

STANDARD PACIFIC OF ARIZONA, INC.

Date

By _____

Broker

Date

Date

(Buyers Initials) (Buyers Initials)

Revised: 5/1/07

STATE OF ARIZONA)
) ss.
COUNTY OF _____)

The foregoing instrument was acknowledged before me this _____ day of _____, 200____, by _____.

My commission expires: _____

Notary Public

STATE OF ARIZONA)
) ss.
COUNTY OF MARICOPA)

The foregoing instrument was acknowledged before me this _____ day of _____, 200____ by _____, an authorized representative of Standard Pacific of Arizona, Inc., a Delaware corporation, on behalf of the corporation.

My commission expires: _____

Notary Public

(Buyers Initials) (Buyers Initials)

Revised: 5/1/07

Attachment B
Rep & Warranty Version



STANDARD PACIFIC HOMES
USE AND OCCUPANCY ADDENDUM

PROJECT NAME: _____
PROPERTY: Lot or Unit: _____ Street Address: _____
BUYER: _____

THIS USE AND OCCUPANCY ADDENDUM ("Use and Occupancy Addendum") constitutes part of the foregoing Contract between Buyer and Seller pertaining to the Property.

Seller desires to sell the Property only to a buyer who will occupy the Property as that buyer's principal residence. Therefore, to induce Seller to agree to sell the Property to Buyer, Buyer represents, warrants and agrees as follows:

1. **USE AS PRINCIPAL RESIDENCE FOR ONE YEAR.** Buyer represents and warrants to Seller that Buyer is purchasing the Property for use as Buyer's principal residence. Further, Buyer represents and warrants to Seller that for a period of one year from the Closing, Buyer does not intend to: (a) purchase or take steps to purchase another home as a principal residence; (b) assign the Contract to another person; (c) advertise, list or otherwise offer the Property for sale or rent to others; (d) enter an agreement to sell or rent the Property; (e) take any other action which indicates to Seller that Buyer does not have a bona fide intention of residing in the Property as Buyer's principal residence for one year. If Buyer breaches this warranty or Buyer's representation is incorrect, Seller shall be entitled to any and all damages proximately caused thereby and the amount of the appreciation of the Property after the Closing. For the purposes of this Use and Occupancy Addendum, "appreciation" shall mean the difference between (a) the fair market value of the Property at the time of Buyer's sale thereof, less Buyer's customary costs of resale such as the broker's commission, escrow fees and title costs, and (b) the purchase price paid by Buyer to Seller for the Property plus the actual cost to Buyer of any improvements made by Buyer to the Property after the Closing.
2. **TRANSFER BEFORE CLOSING.** Any assignment by Buyer or attempt by Buyer to transfer the Property before the Closing is both (a) a breach of the Contract, entitling Seller, at its sole election, to terminate the Contract and pursue all remedies authorized under the Contract, and (b) the failure of a condition precedent to Seller's obligation to sell the Property to Buyer. If Buyer breaches this Use and Occupancy Addendum and the sale of the Property to Buyer closes, Seller is entitled to seek damages for the breach of this Use and Occupancy Addendum.
3. **NO UNREASONABLE RESTRAINT.** The purpose of this Use and Occupancy Addendum is to comply with Seller's intention to sell homes only to persons who will actually occupy them as their principal residences, to obtain a stabilized community of owner-occupied homes, and to prevent a shortage of available homes for permanent residents. Buyer agrees that the purposes of this Use and Occupancy Addendum are worthy of protection and that this Use and Occupancy Addendum does not constitute an unreasonable restraint upon alienation of the Property.
4. **SURVIVAL; SEVERABILITY.** All of the covenants contained in this Use and Occupancy Addendum shall survive the delivery and recordation of the deed conveying the Property from Seller to Buyer. The provisions of this Use and Occupancy Addendum are independent and severable, and a determination of invalidity or partial invalidity or enforceability of any one provision or portion hereof shall not affect the validity or enforceability of any other provision of this Use and Occupancy Addendum or the Contract.
5. **SUBORDINATION.** Buyer's violation of this Use and Occupancy Addendum shall not defeat or render invalid the lien of any first mortgage or deed of trust made in good faith and for value by Buyer. This Use and Occupancy Addendum is junior in priority and subordinate to the lien of any such first mortgage or deed of trust recorded concurrently with the deed conveying the Property to Buyer.
6. **NO THIRD PARTY BENEFICIARIES.** There are no third party beneficiaries to this Use and Occupancy Addendum.

[SIGNATURE PAGE FOLLOWS]

Buyer's Initials _____



IN WITNESS WHEREOF, the parties have executed this Use and Occupancy Addendum as of the date of Seller's acceptance below.

ACCEPTED BY:

SELLER:

BUYER:

STANDARD PACIFIC OF _____
a Florida general partnership

By Standard Pacific of _____
a Delaware corporation

By _____
Title: Authorized Representative

Date Signed by Seller: _____

Signature Date

Name

Signature Date

Name

Signature Date

Name

OIG Evaluation of Auditee Comments

- Comment 1** We disagree with Standard Pacific Mortgage’s request under footnote one. The two documents cited were used only to support that restrictive covenants have been reviewed by multiple parties and all have agreed they are unallowable and violate FHA rules and regulations. The legal opinion and management decision were obtained and reviewed after we conducted our own analysis and came to our own conclusion that HUD requirements were violated by the execution and recording of the restrictive covenants. Additionally, the documents were used to promote consistency between the recommendations contained within this audit memorandum and HUD actions taken against a lender in a similar situation.
- Comment 2** We disagree with the assertion that the audit memorandum erroneously lumps together multiple Standard Pacific Homes contract documents that contain different terms. The scope of our audit included a review of each type of contract document. We categorized the contracts as containing unallowable restrictive covenants based on the documents violating HUD’s free assumability requirements set forth in 24 CFR 203.41(a)(3) and lien provisions under 24 CFR 203.32. Additionally, we provided, in the body of the audit memorandum, excerpts of each set of verbiage violating these requirements. We determined it would be repetitive and unnecessary to include a copy of each of the 33 questioned documents when an excerpt of each version would suffice.
- Comment 3** Standard Pacific Mortgage takes exception, claiming the contract documents reviewed are not impermissible restrictive covenants. We disagree, as stated in the audit memorandum, the documents executed and recorded with the county recorders’ offices contained unallowable restrictive covenants – that at a minimum appear to – prevent free assumability of the FHA property and contain unallowable liens.
- Comment 4** We disagree that the OIG did not consider whether Standard Pacific Mortgage knew or reasonably could have been expected to know that the documents containing the restrictive covenants were being recorded. As evidenced by the audit memorandum, included in the Scope and Methodology section of the audit memorandum, we reviewed the lender responsibilities as well as its relationship with the seller. The following is an excerpt from the audit memorandum.

Standard Pacific Mortgage officials stated that they were unaware that the restrictive covenants recorded between Standard Pacific Homes and the borrowers violated HUD-FHA requirements. In one discussion, Standard Pacific Mortgage officials informed us that they had reviewed the restrictions on occupancy and believed these were consistent with and not in conflict with HUD-FHA requirements. Therefore, they allowed the use of Standard Pacific Homes’ restrictive covenants on FHA properties. However, in some instances, the purchase contracts contained in the

lender's FHA files contained language stating that the covenant did not apply to buyers that purchased the property using FHA financing... Based on this information, we concluded that Standard Pacific Mortgage did not exercise due diligence, demonstrated by its failure to ensure that language in the recorded property agreements was appropriate and followed HUD rules and regulations.

Comment 5 We disagree with Standard Pacific Mortgage's statement that indemnification is not its responsibility and would still be unwarranted even if HUD determined that unallowable restrictive covenants were recorded and it should have known about them. The FHA loans identified in this audit memorandum were determined to be ineligible for FHA insurance; therefore, any loss or claim tied to the loan presents an unnecessary loss to HUD's FHA insurance fund. As with any underwriting review, deficiencies identified, such as overstated income and understated liabilities, do not have to be the reason an FHA loan went into default or claim for HUD to seek indemnification. Rather, the deficiencies are used as evidence that the FHA loan should not have been FHA-insured. In the same regard, the audit memorandum identifies a significant material deficiency that deemed the identified loans ineligible for FHA insurance; thereby warranting recommendations for indemnification of the loans identified.

Based on our conclusions, it was our duty and obligation to HUD and other stakeholders to recommend HUD take necessary, appropriate action. In HUD's prior actions, it also deemed the deficiency significant enough to warrant indemnification. We believe the recommendations contained in the audit memorandum are appropriate given the materiality of the OIG finding. As stated above, the recorded prohibited restrictive covenants impacted the insurability of the reviewed loans. Standard Pacific Mortgage had a duty to ensure loans it approved for FHA insurance were in accordance with all HUD rules and regulations.

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


Comment 6 We disagree that the seller's efforts to ensure that homebuyers were not using FHA financing to obtain loans for investment properties was consistent with HUD policy. The FHA requirements do emphasize a one year occupancy period. However, we would like to emphasize that under 24 CFR 203.41(a)(3), for free assumability of the property, that there is a prohibition of a restriction where the conveyance of a property be subject to the consent of a third party, in this case the

seller. An example of such language is contained within the audit memorandum and additional excerpts from a recorded agreement are provided below to show more language contained within some of the agreements.

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THIS IS NOT A
CERTIFIED COPY

Exhibit A

 **STANDARD PACIFIC HOMES**
Making You Right At Home®

**ADDENDUM TO REAL ESTATE SALES CONTRACT
PURCHASER'S DECLARATION OF
OCCUPANCY AGREEMENT**

This Addendum is attached to and forms a part of the Real Estate Sales Agreement executed by Purchaser and Standard Pacific Homes (the "Seller" herein) on MARCH 29, 2009 for the purchase by Purchaser from Seller of the property described in the Contract (the "Property").

Purchaser acknowledges that it is the policy of the Seller to provide as many people as possible with the opportunity for home ownership, to promote stability in home ownership, and to discourage speculation. Therefore, Seller reserves the right to limit sales of homes to parties that intend to purchase the Property solely for investment and not as a primary residence.

Purchaser hereby declares:

A. I intend to purchase the Property for my primary or second home residence;

B. I intend to purchase the Property for investment only and do not intend to use it as my primary or second home residence.

A. THE FOLLOWING COVENANTS APPLY IF PURCHASER HAS DECLARED ITEM A

In order to induce Seller to agree to sell the Property to Purchaser, Purchaser declares and agrees as follows:

- Use as Principal Residence for One (1) Year.** Purchaser represents and covenants to Seller that:
(i) Purchaser is purchasing the Property for use as Purchaser's principal/second home residence;
(ii) Purchaser will occupy the Property as Purchaser's principal /second home residence upon the transfer of title to Purchaser (hereafter, the "Closing"); (iii) Purchaser will not transfer Purchaser's rights under the Purchase Agreement nor enter into any agreement for the lease, sale or other transfer of the Property that would prevent Purchaser from occupying the Property as Purchaser's principal/second home residence, or prevent Purchaser from holding fee title interest in the Property, from and after the Closing for a period of at least **One (1) year** (the "Occupancy Period"). Purchaser acknowledges that Seller has relied upon the foregoing representations as a material inducement to enter into the Purchase Agreement and would not have agreed to sell the Property to Purchaser without such representations.
- Transfer Prior to Closing.** Any assignment or other transfer of Purchaser's rights under the Purchase Agreement, or any lease, sale or other transfer of the Property prior to the Closing shall constitute: (i) a material breach of the Purchase Agreement, entitling Seller, at Seller's sole option, to terminate the Purchase Agreement and retain Purchaser's Deposit pursuant to the terms of the Purchase Agreement, and (ii) a failure of a condition precedent to Seller's obligation to sell the Property to Purchaser. The provision of this paragraph shall in no event limit the remedies available to Seller should Purchaser be otherwise in default under the Purchase Agreement.
- Transfer at or After Closing.** Except for "hardship" situations described in Paragraph 5 of this Addendum, any sale, lease or other transfer of the Property by Purchaser at or after the Closing that would prevent Purchaser from occupying the Property as Purchaser's principal/second home residence, or prevent Purchaser from holding fee title interest in the Property, for the entire Occupancy Period, shall constitute a material breach of the Purchase Agreement, entitling Seller to receive liquidated damages from the Purchaser in the amount of \$20,000.00 as full and complete settlement for Purchaser's default under this Addendum. Purchaser and Seller agree that the exact nature of Seller's damages is and will be difficult to ascertain and that the foregoing liquidated damages is adequate and reasonable compensation to Seller in the event of Buyer's default.

Purchaser's Initials: [REDACTED] Job # GH3/5

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4. **Notice of Transfer; Notices Generally.** Purchaser shall notify Seller of any sale, lease or other transfer of the Property by Purchaser during the Occupancy Period. Such notice shall be sent to Seller at least thirty (30) days prior to such sale, lease or other transfer. All notices that are given pursuant to this Addendum shall be in writing. Any notice sent by registered or certified mail, return receipt requested, shall be deemed given on the date of delivery shown on the receipt card. Notices delivered by the United States Express Mail, Federal Express, Airborne Express or another overnight courier that provides next business day delivery (the "Express Courier") shall be deemed given on the next business day after deposit of the same with Express Courier. Notice shall not be effective if sent by facsimile transmission. If notice is given or received on a Saturday, Sunday or legal holiday, or on a business day after 5:00 P.M., it shall be deemed given or received on the next business day. For purposes of notice, the addresses of the parties are as follows, which may be changed by five (5) days prior written notice:

To Seller: Standard Pacific Homes
 [Redacted]
 To Purchaser:
 Name & New Address
 [Redacted]

5. **Hardship Situations.** The following events shall be deemed to constitute "hardship" situations under which Purchaser may sell, lease or otherwise transfer (collectively, a "Transfer") its right title and interest in the Property prior to occupying and holding title to the Property for the Occupancy Period:

- a. A Transfer resulting from the death of Purchaser;
- b. A Transfer by Purchaser's spouse as a co-owner with Purchaser to the Purchase;
- c. A Transfer resulting from a decree of dissolution of marriage or legal separation or from a property settlement agreement incident to such decree;
- d. A Transfer by Purchaser into a revocable inter vivos trust in which Purchaser is beneficiary;
- e. A Transfer, conveyance, pledge, assignment or other hypothecation of the Property to secure the performance of an obligation, which transfer, conveyance, pledge, assignment or hypothecation will be released or re-conveyed upon the completion of such performance;
- f. A Transfer by Purchaser (where Purchaser is not self-employed) necessary to accommodate a mandatory job transfer required by Purchaser's employer;
- g. A Transfer by Purchaser after the death of Purchaser's spouse; or
- h. A transfer which, in the sole independent judgment of Seller, constitutes a "hardship" situation consistent with the intentions of this Addendum.

The provisions of this Addendum shall continue in full force and effect after any transfer described in subsections b, d and e, above.

6. **No Unreasonable Restraint.** Purchaser acknowledges and agrees that the purpose of this Addendum is to comply with Seller's intention to sell homes only to persons who will actually occupy the homes as their principal/second home residence, create a stabilized community of owner-occupied homes, and prevent a shortage of homes for permanent residents. Purchaser further acknowledges and agrees that the provisions and restrictions set forth in this Addendum do not constitute an unreasonable restraint upon alienation of the Property.

7. **Survival Severability.** All of the representations and covenants contained herein shall survive the delivery and recordation of the deed conveying the Property from Seller to Purchaser. The provisions of this Addendum shall be independent and severable, and determinations of the invalidity, partial invalidity or enforceability of any one provision or portion thereof shall not affect the validity or enforceability of any other provision of this Addendum of the Purchase Agreement.

Purchaser's Initials: [Redacted] Job # GH3/5

* Names redacted for privacy reasons.

Comment 7 Standard Pacific Mortgage's assertion that there is no evidence that any homebuyer was harmed is not relevant. The scope of our audit was to identify the presence of unallowable restrictive covenants and to determine if those restrictions violated HUD rules and regulations. To that end, we concluded that there were unallowable restrictive covenants, which are identified in this audit

memorandum, which violated Federal statute and were not eligible for FHA insurance. Therefore, any loss or claim tied to the loan presents an unnecessary loss to HUD's FHA insurance fund. See also comment 5.

Comment 8 We acknowledge and appreciate Standard Pacific Mortgage's steps taken to comply with applicable rules and regulations as a result of this review. Documentation evidencing corrective actions should be provided to HUD during audit resolution. HUD will review the adequacy and implementation of Standard Pacific Mortgage's corrective actions during the audit resolution process to determine if they were sufficient.

Comment 9 Standard Pacific Mortgage stated that the unallowable restrictive covenants were not intended to be recorded with FHA financing, however, it affirmed that they were indeed recorded. Whether intended or not, the unallowable restrictive covenants were recorded with FHA financed mortgage loans, violating HUD's rules and regulations as stated in the audit memorandum. As the lender, Standard Pacific Mortgage carries the burden to ensure all loans that receive FHA mortgage insurance are eligible and meet all HUD rules and regulations.

For clarification, the audit memorandum finding is based on the executed and recorded documents at the applicable county recorders' offices that are publicly available. The Non-FHA/VA Buyer Declaration and Rep & Warranty Version documents referred to by Standard Pacific Mortgage are not the same documents and do not contain the same language as the restrictive covenant documents recorded at the county recorders' offices.

Of most significance, the documents referred to by Standard Pacific Mortgage in attachment A, Non-FHA/VA Buyer Declaration, of its response contained one version of the purchase agreement (Schedule A to Purchase Contract or Declaration of Covenant Restricting Resale, Marketing or Rental of Property) that included the unallowable restrictive covenants, which were executed and recorded with the applicable county recorders' offices. Standard Pacific Mortgage preceded this document in its response with an Addendum to Purchase Contract Occupancy/Investment Disclosure, which contained the language excluding FHA/VA financed properties. However, the Addendum to Purchase Contract Occupancy/Investment Disclosure was not an executed and recorded document with the county recorders' offices. Therefore, there appeared to be no executed and recorded agreement with the county recorders' offices that excludes the FHA financed properties from the agreed restrictive covenants.

Comment 10 We acknowledge Standard Pacific Mortgage's claim that the Schedule A was not legally enforceable because it lacks consideration. Any records or information related to this claim should be provided to HUD during the audit resolution. To clarify, the existence of the publicly executed and recorded documents containing the restrictive covenants is in question and not the legality of said documents. See also comments 3 and 9.

Comment 11 Standard Pacific Mortgage provides information stating that controls were in place to prevent the recording of prohibited restrictive covenants on FHA loans. However, the recording of such restrictions were still allowed to occur. Based on Standard Pacific Mortgage's response, it appears that a breakdown in communication and internal control allowed the recording of prohibited restrictive covenants. Whether intentional or not, Standard Pacific Mortgage, as the lender, is responsible for ensuring the loan and its title instruments meet all HUD rules and regulations. As stated in the audit memorandum, HUD Handbooks 4000.2, paragraph 5-1(B), and 4155.2, paragraph 6.A.1.h, both state that it is the lender's responsibility at loan closing to ensure that any conditions of title to the property are acceptable to FHA. In essence, it is the duty of the lender to ensure that FHA loans approved for mortgage insurance are eligible and acceptable according to FHA rules and regulations. See also comment 4.

Comment 12 We disagree with Standard Pacific Mortgage's assertions that we may not extrapolate additional violations by referencing these loans. If an unallowable restrictive covenant was found on a statistically selected random sample items (active loan review) these loans are projectable to the universe of the loans (see Scope and Methodology section of the audit memorandum). As stated in the New York Law Journal's article The Use of Statistical Sampling as Evidence, by George Bundy Smith and Thomas J. Hall,

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

To clarify, the audit memorandum recommendations do not include a request for indemnification of any active loans projected to have similar unallowable restrictive covenants. Rather, recommendation 1D of the audit memorandum, limited the indemnification of active loans to the five sampled and reviewed loans where an unallowable restrictive covenant was found, but the recommendation also allows the lender to nullify active loans with active restrictive covenants instead of executing loan indemnifications.

Comment 13 Standard Pacific Mortgage included in its response Attachment B Rep & Warranty Version. We do not take exception to the language in these agreements that the borrower occupy or intend to occupy the FHA financed property; however, we take issue with the language contained within the agreements that

specify that if the property is conveyed within the occupancy period that a breach of contract would occur resulting in damages owed to the seller. As stated in the audit memorandum, the prevention of free assumability of the FHA property and liens are violations of HUD's requirements. The documents identified in the audit memorandum were obtained through public record inquiries are unallowable restrictive covenants. See also comment 9.

Comment 14 We acknowledge Standard Pacific Mortgage's recognition that the two Tampa FHA loan numbers 093-6736524 and 093-6695022 had restrictive covenants. However, we disagree with Standard Pacific Mortgage that the unallowable restrictions do not warrant indemnification. Although the two loans in question have an expired restriction and no loan default, respectively, the presence of the restrictive covenant should have prevented them from reaching the point of receiving FHA mortgage insurance. Recommendation 1D of the audit memorandum first seeks to ensure that any active unallowable restrictive covenants on the five active loans be terminated. Indemnification on the five loans that are active is recommended only where the active unallowable restriction is not terminated. See also comment 5.

Comment 15 We disagree with Standard Pacific Mortgage's statement that the audit memorandum implies borrowers were harmed. The audit memorandum states that the appearance of unallowable restrictive covenant may have impacted borrowers in their decision making or ability to convey their property. See also comment 7.

Comment 16 We acknowledge Standard Pacific Mortgage's efforts to adhere to HUD's rules and regulations and appreciate the consideration given to the audit findings. However, the finding and recommendations remain unchanged as the response and supporting documentation do not fully address the deficiencies cited. With regard to recommendation 1B and 1C, the FHA loans identified were determined to be ineligible for FHA mortgage insurance. With regard to recommendations 1D and 1E, Standard Pacific Mortgage should provide documentation evidencing corrective actions taken to HUD during audit resolution. HUD will review the adequacy and implementation of Standard Pacific Mortgage's corrective actions to determine adequacy. See also comments 5 and 8.

Appendix C

SUMMARY OF FHA LOANS REVIEWED

Table 1 - Actual loss to HUD
Claim loan review results

FHA loan number	Recommendation 1B – actual loss to HUD¹⁶
023-2623614	\$ 98,995
023-2694003	80,954
023-2709846	118,012
023-2737614	108,438
023-2739962	110,065
023-2745583	101,603
023-2769226	90,198
023-2809302	129,163
023-2884798	53,346
023-2890770	98,206
023-2931245	135,021
023-2931750	111,243
023-2963543	109,864
023-2991777	82,323
023-3170701	107,758
Total	\$ 1,535,189

¹⁶ The actual loss to HUD was obtained from HUD's Single Family Data Warehouse in November 2012.

Table 2 - Claims paid, loss unknown
Claim loan review results

FHA loan number	Recommendation 1C – claims paid but no actual loss known¹⁷
023-2618236	\$ 114,106
023-2618252	106,310
023-2618269	153,972
023-2624416	95,448
023-2685546	101,314
023-2719049	103,229
023-2736116	143,263
023-2741806	119,762
023-2751458	84,152
023-2768640	124,402
023-2858180	89,638
023-2890373	108,565
093-6736524	46,074
Total	\$ 1,390,235

¹⁷ The claims paid values were obtained from HUD’s Neighborhood Watch system in November 2012.

Table 3 - Potential loss to HUD
Active loan sample results

FHA loan number	Unpaid mortgage balance¹⁸	Recommendation 1D – potential loss on active loans¹⁵
023-2771367	\$ 246,428	\$ 152,785
093-6695022	251,938	156,201
093-6888630	148,667	92,174
093-7049064	112,221	69,577
093-7345094	119,725	74,230
Total	\$ 878,979	\$ 544,967

¹⁸ The unpaid mortgage balance for each loan was obtained from HUD’s Single Family Data Warehouse in November 2012.