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Banks and Banking- Housing and Home Finance - Scope of Insurance Coverage of Banks Under National Housing Act

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RECENT DECISIONS

BANKS AND BANKING—HOUSING AND HOME FINANCE—SCOPE OF INSURANCE COVERAGE OF BANKS UNDER NATIONAL HOUSING ACT—Borrower executed a promissory note to dealer payee, who assigned it to defendant bank. After default by borrower, plaintiff United States paid to defendant the unpaid balance in accordance with the terms of their insurance contract under Title I of the National Housing Act.[1] The note was then transferred to plaintiff for collection. In an action by the United States against the borrower for the amount due, it was held that the note could not be enforced because of fraudulent misrepresentation by the dealer in acquiring the note, of which the insured bank and transferee government had constructive knowledge. Plaintiff then commenced the present action against the bank to recover the money paid under the insurance contract, alleging breach of warranty that the note qualified for insurance.[2] On appeal from a judgment for plaintiff, *held,* affirmed. A note which is unenforceable against the borrower is not eligible for insurance when its invalidity results from fraudulent acts by a dealer who is authorized by the lending institution to obtain the note.[3] *Citizens National Trust and Savings Bank of Los Angeles v. United States,* (9th Cir. 1959) 270 F. (2d) 128.

The Federal Housing Commissioner is authorized to issue whatever regulations are necessary to define the government's liability for notes insured under the National Housing Act.[4] These regulations are part of the insurance contract between the Federal Housing Administration and the lending institution and must be complied with to qualify the note for insurance.[5] Regulation 201.2 (a)[6] requires that a note be valid and enforceable against the borrower to be eligible for coverage. Defendant's contention in the principal case was that despite the note's invalidity its insurability should not be affected so long as the bank made the loan without actual notice of the note's defects, provided the note was good on its face.[7]

[1] 48 Stat. 1246 (1934), 12 U.S.C. (1958) §1703. Section 1703 (a) provides in part: "The Commissioner is authorized . . . to insure banks . . . and other such financial institutions . . . against losses which they may sustain as a result of loans and advances of credit, and purchases of obligations representing loans and advances of credit . . . for the purpose of financing alterations, repairs, and improvements upon or in connection with existing structures . . . by the owner thereof."

[2] United States v. Citizens Nat. Trust and Savings Bank of Los Angeles, (S.D. Cal. 1958) 166 F. Supp. 410.

[3] Although the holding is actually restricted to situations where the bank had constructive knowledge of the dealer's fraudulent acts, the court's opinion strongly implies that validity and enforceability against the borrower are to be considered absolute requirements for insurance of the note in all instances.

[4] 48 Stat. 1246 (1934), 12 U.S.C. (1958) §1703 (g).

[5] See Federal Housing Administration v. Morris Plan Co., (9th Cir. 1954) 211 F. (2d) 756.

[6] 24 C.F.R §201.2 (a) (1959).

[7] Principal case at 133. Defendant relied partially on 24 C.F.R. §201.5 (b), which asserts in part: "If after the loan is made, an insured who acted in good faith discovers

The court, relying solely[8] on a construction of regulation 201.2 (a), rejected this argument and indicated that good faith is immaterial if the note was not in fact valid and enforceable against its maker. The policy considerations behind the court's decision are clear. The FHA insurance program from its inception has been characterized by high-pressure sales tactics by dealers who have induced home-owners to finance property improvements through FHA loans.[9] Often the borrower was in fact a poor credit risk who had been misled into believing the government would save him from liability in case he defaulted on payments.[10] The need to protect the borrower from these abuses is reflected clearly in the rationale of a number of decisions in which the government or bank has been denied the rights of a holder in due course when the insured note was acquired through misrepresentations by the dealer.[11] The regulations also are explicit in placing on the lending institution the burden of policing the transaction between the dealer and borrower. Before making a loan, the insured bank must not only obtain satisfactory proof that the borrower is a respectable credit risk[12] but also must investigate the reliability, financial responsibility, and facilities of the dealer to perform satisfactorily the work to be financed.[13] The principal case, in placing the risk of the dealer's dishonesty solely on the lending institution, offers maximum protection to the borrower in this respect. However, the desire to protect the borrower from unscrupulous business practices should not be emphasized to such an extent that the primary purpose of the act is disregarded. Congress enacted the insurance program to encourage loans for the construction and rehabilitation of private housing.[14] Obviously the fulfillment of this goal is dependent upon voluntary participation in the program by credit institutions. If a bank

any material misstatements . . . by the dealer . . . , the eligibility of the note for the insurance shall not be affected." The court determined that the impact of regulation 201.2 (a), note 6 supra, was not vitiated by this language.

8 No cases have previously decided this question. In an analogous decision, United States v. de Vallet, (D.C. Mass. 1957) 152 F. Supp. 313, the court held the government could recover money mistakenly paid under the insurance contract even though defendant bank did not realize the endorser's signature was forged until after the loan was made. Compare Ferguson v. Union Nat. Bank, (4th Cir. 1942) 126 F. (2d) 753, where the bank was allowed partial recovery under the insurance contract even though the borrower used part of the loan for purposes not authorized by the regulations.

9 S. Rep. 1472, 83d Cong., 2d sess., pp. 9-17 (1954). See also "Investigation of FHA and VA Housing Programs," Final Report from the Subcommittee on Housing of the Committee on Banking and Currency 35-39 (1952).

10 Ibid.

11 E.g., United States v. Bland, (D.C. Md. 1958) 159 F. Supp. 395, affd. (4th Cir. 1958) 261 F. (2d) 109; Botzum Bros. Co. v. Brown Lumber Co., 104 Ohio App. 507, 150 N.E. (2d) 485 (1957); United States v. Klatt, (S.D. Cal. 1955) 135 F. Supp. 648. But see United States v. Brownlee, (E.D. N.Y. 1958) 168 F. Supp. 42; United States v. Hansett, (2d Cir. 1941) 120 F. (2d) 121.

12 24 C.F.R. §201.5 (1959).

13 24 C.F.R. §201.8 (1959).

14 See principal case at 133. Cf. 24 C.F.R. §200.3 (1959).

cannot assure itself of full protection after complete preliminary investigation of both dealer and borrower, unwillingness to extend credit on this basis would undoubtedly be increased. However, the interpretation of the act and supporting regulations made by the court here does not leave the credit institutions without adequate means of protecting themselves. The FHA insurance program permits banks either to make loans directly to the homeowner or indirectly through the dealer.[15] Seemingly it is only in the latter instance that the bank must assume the complete risk of the note's invalidity. If the loan is made directly to the borrower, the problems of intermediate dealer dishonesty are obviated. The bank can guarantee the insurability of the note by full adherence to the regulations and without the additional concern of supervising the activities of the dealer. It is in this regard that the principal decision can be defended. The encouragement it affords banks to make direct loans tends to circumvent many of the problems which arise when the dealer sets out to recruit borrowers for the program. At the same time the actual availability of FHA loan funds is not substantially affected, and there is no need for a court to sacrifice the broader purposes of the act in favor of the more limited interests of the individual homeowner.

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[15] See language of National Housing Act in 12 U.S.C. (1958) §1703 (a), quoted in note 1 supra.