Date: June 23, 1994 O.G.C. Precedent 15-94

From: General Counsel (021)

Subj: VA's Right to Subrogation on a Loan Guaranty Claim; XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX

To: Chairman, Board of Veterans' Appeals (01)

QUESTION PRESENTED:

May the Secretary enforce a right to subrogation with respect to a guaranteed housing loan on which VA paid a claim if VA failed to provide the veteran with notice of a transferee's default?

COMMENTS:

1. With respect to any VA guaranteed home loan closed before January 1, 1990, when VA pays the holder of a defaulted loan a claim on the guaranty, "the Secretary shall be subrogated to the rights of the holder of the obligation to the extent of the amount paid on the guaranty." 38 U.S.C. § 3732(a)(1). Veterans whose loans for conventionally built homes were closed after December 31, 1989, are not liable to the Secretary for a loss on the loan except in case of fraud, misrepresentation, or bad faith. 38 U.S.C. § 3703(e)(1). This opinion, therefore, does not apply to veterans who are exempt from liability by section 3703(e)(1).

2. By regulation, VA has established two methods by which obligors on guaranteed loans may be liable to the Secretary following foreclosure by the private loan holder and claim payment by VA. First, "[t]he Secretary shall be subrogated to the contract and the lien or other rights of the holder to the extent of any sum paid on a guaranty . . . ." 38 C.F.R. § 36.4323(a). All obligors, including veterans, spouses, and persons who assumed the loan, may be liable to VA under subrogation.

3. "Subrogation" is defined as "The substitution of one person in the place of another with reference to a lawful claim, demand or right, so that he who is substituted succeeds to the rights of the other in relation to the debt or claim, and its rights, remedies, or securities. [Citations omitted.] The lawful substitution of a third party in place of a party having a claim against another party." BLACK'S LAW DICTIONARY 1279 (5th ed. 1979). As subrogee, VA acquires the rights of the foreclosing holder,

but no more. If the obligor is not liable under State law to the holder, no subrogation debt is due VA.

4. In addition, "[a]ny amounts paid by the Secretary on account of the liabilities of any veteran guaranteed [by VA] . . . shall constitute a debt owing to the United States by such veteran." 38 C.F.R. § 36.4323(e). This second basis for liability, known as indemnity, makes a veteran liable to the Government without regard to whether or not the veteran is liable to the lender under State law. United States v. Shimer, 367 U.S. 374, 381 (1961). Carter v. Derwinski, 987 F.2d 611 (9th Cir. *en banc* 1993), *cert. denied* 114 S.Ct. 78 (1993).

5. A number of recent court decisions have held that VA's right to indemnity may be denied if VA fails to provide the veteran with notice of the foreclosure. *See*: United States v. Whitney, 602 F. Supp. 722 (W.D. N.Y. 1985). United States v. Murdock, 627 F. Supp. 272 (N.D. Ind. 1985). Vail v. Derwinski, 946 F.2d 589 (8th Cir. 1991), *op. modified and reh'g denied,* 956 F.2d 812 (8th Cir. 1992). This situation normally arises when the veteran has sold the property which secured the loan to a third party who assumed the loan. The foreclosing loan holder may have served the current owner-occupant with notice of the foreclosure, but not the original veteran. The veteran claims that the first time he or she learned about the assumer's default and the foreclosure is when VA attempted to collect the debt.

6. In Whitney the court ruled that VA could not collect a debt against a veteran who was never notified of an assumer's default and the subsequent foreclosure. The court held that, under New York law, the veteran needed to be made a party to the foreclosure proceeding in order for the holder to be able to collect a deficiency. The holder's failure to serve the veteran and make him a party to the foreclosure defeated VA's right to subrogation.

7. In addition, the court ruled that under the due process clause of the Fifth Amendment to the Constitution the veteran was entitled to notice of the foreclosure. Relying on the Supreme Court's decisions in Mullane v. Central Hanover Bank and Trust Company, 339 U.S. 306 (1950) and Mennonite Board of Missions v. Adams, 462 U.S. 791 (1983), the court held that the veteran had a substantial property interest which would be significantly affected by the foreclosure, since VA intended to hold the veteran liable under indemnity for any deficiency following the foreclosure sale. "Since [the veteran] clearly has a legally protected property interest in the outcome of the

foreclosure, the [veteran] is constitutionally entitled to notice reasonably calculated to apprise him of its pendency." 602 F. Supp. at 732. Even though the VA's right to indemnity is not dependent on the loan holder's right to collect a debt, the court concluded that VA's failure to provide for notice to the veteran represented "the Government's intimate complicity in the violation of [the veteran's] . . . constitutional rights." Id. at 734. Accordingly, VA's right to indemnity was defeated. Id.

8. Vail was originally brought as a class action challenging VA's right to indemnity on certain loans in Minnesota where a private lender would be precluded, under State law, from collecting a deficiency from the borrower. The district court initially ruled against VA. Vail v. Derwinski, 742 F. Supp. 1039 (D. Minn. 1990). On appeal, the Eighth Circuit "modified" the ruling below. Relying on Shimer, the court ruled that VA's right to indemnity is not dependent on the loan holder's right to a deficiency under State law. Citing Mullane, Mennonite Board, and Whitney, the court held that VA could enforce its indemnity debt regulation only if the VA has made a good faith effort to provide reasonable personal notice to the veteran prior to the foreclosure sale. Vail v. Derwinski, 946 F.2d 589 (8th Cir. 1991), *op. modified and reh'g denied*, 956 F.2d 812 (1992). *Cf.* Boley v. Brown, 10 F.3d 218 (4th Cir. 1993) (veteran who was not notified of the foreclosure hearing but received actual notice from VA 6 days prior to the foreclosure sale and took no action to challenge the foreclosure after receiving such notice is liable to VA under indemnity).

9. Following the ruling by the Eighth Circuit in Vail, cross-motions for summary judgment were filed in the district court. VA argued, inter alia, that certain form letters routinely used by VA in Minnesota (and nationwide) satisfied the reasonable notice requirement of the Eight Circuit's opinion. On January 14, 1994, the district court issued an order. Vail v. Brown, 841 F. Supp. 909 (D. Minn. 1994). The court found that VA's procedures and regulations satisfied due process. The court upheld the validity of debts of veterans to whom VA had sent its standard form letter. (The plaintiff class has filed a notice of appeal of this decision on remand.)

10. In Vail, Boley, and Whitney, the veteran would not have been liable to VA under subrogation. The case which is the subject of your inquiry arose in Florida. The VA District Counsel, Bay Pines, Florida, believes, under that State's law, a veteran may be liable to a private holder

notwithstanding the lack of advance notice of the foreclosure.

11. The District Counsel also relies on Jensen v. Turnage, 782 F. Supp. 1527 (M.D. Fla. 1990) which upheld a VA indemnity debt notwithstanding lack of advance notice to the veteran of the foreclosure. The Jensen court expressly declined to follow Whitney. 782 F. Supp. at 1531. Citing Shimer and Jones v. Turnage, 699 F. Supp. 795 (N.D. Cal. 1988), *aff'd sub nom.* Jones v. Derwinski, 914 F.2d 1496 (9th Cir. 1990), *cert. denied* 111 S. Ct. 1309 (1991), the Jensen court, correctly in our view, held that VA's right to indemnity is governed by Federal law, and may not be impaired by State law. 782 F. Supp. at 1531. The court, therefore, held that the veteran was liable for indemnity notwithstanding the fact that he was not made a party to the original foreclosure proceeding. The Jensen court mentions the veteran's contention that, under Florida case law, since he conveyed all his interest in the mortgaged property to a third person, he would be a necessary party to the foreclosure if a deficiency were sought by the private holder. 782 F. Supp. at 1530. The court does not, however, analyze Florida law or state whether the veteran's interpretation of Florida law is correct.

12. To the extent that Whitney may be read as holding that a loan holder's failure to comply strictly with State notice requirements may defeat VA's right to indemnity (see 602 F. Supp. at 729-730), this office believes Whitney is in error. We note that the court in Boley expressly held that VA's right to indemnity did not incorporate North Carolina's notice requirements. 10 F.3d at 222. Nevertheless, this office finds Jensen unpersuasive. Although Whitney was based in part on New York law, the Whitney court also held that Federal constitutional due process considerations provided an independent basis for denying VA the right to indemnity. Similar constitutional concerns were a sufficient basis for the Eighth Circuit in Vail to deny VA indemnity from class members to who VA neither gave nor attempted to give notice. Jensen does not, however, address the due process issue.

13. Our review of the case law compels us to conclude that, with regard to a proceeding such as foreclosure, "which will affect an interest in . . . property" veterans have a constitutionally protected right to "notice reasonably calculated, under all the circumstances, to appraise [affected veterans] . . . of the pendency of the action and afford them an opportunity to present their objections." Mennonite Board, 462 U.S. at 795 (quoting Mullane, 339 U.S. at 314). The requirement for notice

assumes that VA knows or can reasonably ascertain the veteran's address. Mennonite Board, 462 U.S. at 800. Whitney, 602 F. Supp. at 732.

14. The case law contains nothing to suggest that veterans do not have the same constitutional due process protections with regard to a claim by VA under subrogation. On the contrary, Mullane requires notice in "any proceeding which is to be accorded finality . . . ." 339 U.S. at 314 (emphasis added). Mennonite Board stated that notice is required "prior to an action which will affect an interest in . . . property . . . ." 462 U.S. at 795. It, therefore, appears clear that when VA knows about a foreclosure and VA expects to hold the veteran liable under subrogation, VA is constitutionally required to notify the veteran, assuming the veteran may reasonably be located.

15. This leads to the question of the consequences if VA fails to either provide notice of the foreclosure or make reasonable efforts to locate the veteran. Subrogation, as we stated above, gives VA the same rights, but only the same rights, as the foreclosing holder who has received a guaranty claim payment from the Secretary. Where an *in rem* foreclosure has occurred and the original veteran was not made a party to the foreclosure, we doubt that under the law of any State the veteran is liable for the deficiency by operation of law. In states where debt collection is possible, we believe the holder would have the right to bring a subsequent action for a deficiency against the veteran. VA thus becomes subrogated to the right to bring an action for a deficiency.

16. As a Federal department, VA is held to a higher standard than nongovernmental entities. Constitutional due process requirements do not apply to private action. Jackson v. Metropolitan Edison Company, 419 U.S. 345, 349 (1974). If VA knew the foreclosure was pending (since 38 U.S.C. § 3732(a) and 38 C.F.R. §§ 36.4315(a), 36.4317, and 36.4319(a) require holders to notify VA of defaults and pending foreclosures, such knowledge on VA's part must be assumed) and knew or could reasonably have ascertained the identity and whereabouts of the veteran, VA's failure to provide notice would be a constitutional defense to any action VA brings. In these cases, VA should not administratively pursue collection based on the holder's theoretical right to institute an action.

17. If, on the other hand, the holder has obtained an *in personam* judgment against the veteran prior to the VA paying a claim, we believe VA may collect on the judgment. In order to obtain a judgment, the holder must have served

the veteran. The veteran then would have had an opportunity to present any defense, including lack of notice, in court. At the time of foreclosure, a private contract existed between the veteran and the loan holder, and the holder's foreclosure did not constitute Government action. *See:* Rank v. Nimmo, 677 F.2d 692, 701-702 (9th Cir. 1982), *cert. denied* 459 U.S. 907 (1982). The judgment clearly establishes the veteran's liability to the holder under the private contract, and VA merely becomes, by operation of law, an assignee of that private judgment. Generally, a judgment can only be modified by petitioning the court which entered the judgment for a modification. The veteran may, however, argue before the Board of Veterans' Appeals and the Court of Veterans Appeals that the court lacked jurisdiction over either the veteran or the subject matter, thus the judgment should not be given full faith and credit. *See:* Smith v. Derwinski, 1 Vet. App. 267, 276-278. The veteran trying to collaterally attack a judgment in this manner will face a heavy burden. Id. at 278.

18. This opinion assumes that in most cases where VA has failed to provide the veteran with notice of the foreclosure, the holder has likewise failed to provide such notice. As a matter of basic constitutional law, we believe VA has a duty to provide notice to veterans of the consequences vis-à-vis VA of the impending foreclosure even if the holder has already notified the veteran of the proceedings. Nevertheless, in instances where there is evidence that the holder notified the veteran of the foreclosure and VA did not, the case should be reviewed to determine if under all the circumstances the holder's notice was sufficient to apprise the veteran of the pendency of the action and afford the veteran an opportunity to protect his or her interests. Unless there is a reasonable showing that, if the veteran had received additional notice from VA, the veteran could and would have taken additional action that might have materially affected his or her liability, the holder's notice should be considered sufficient to satisfy due process. *See:* Boley, 10 F.3d at 222-223.

19. While you did not specifically ask for our opinion on this issue, we believe we should also briefly discuss what constitutes acceptable notice. VA procedures call for mailing VA Form Letter 26-251 to veterans who have sold their property when the transferee is in default and foreclosure appears likely. Vail, 841 F. Supp. at 914. (The full text of this form letter is quoted in footnote 10 of the Vail opinion.) Although the issue of lack of notice to the veteran is not likely to arise when the veteran

continues to own and occupy the home, similar notification is provided such veterans. Id. The Vail court found that these form letters satisfy due process. As we noted above, the plaintiff class has filed a notice of appeal in Vail. Unless other guidance is provided by the appellate courts, this office concurs with the district court in Minnesota and is of the opinion that the standard VA form letters provide sufficient notice.

HELD:

Veterans who obtain a VA guaranteed loan have a constitutionally protected right to receive notice of a foreclosure proceeding that will affect their rights and liabilities. When a third party assumer defaults on the loan, VA must notify the original veteran obligor of the impending foreclosure, provided VA knows or can reasonably ascertain the veteran's address. If VA fails to provide the required notice, VA may not collect a debt from the veteran under subrogation, unless the private loan holder obtained a personal judgment against the veteran prior to VA paying the guaranty claim, or the holder provided the veteran with reasonably sufficient notice. The judgment may be subject to collateral attack in the VA appeals process if the court lacked jurisdiction to render that judgment. VA Form letter 26-251 is deemed to satisfy the notice requirement.

Mary Lou Keener