



U.S. Department of Agriculture
Office of Inspector General
Northeast Region
Audit Report

RURAL BUSINESS-COOPERATIVE SERVICES
BUSINESS AND INDUSTRY
GUARANTEED LOAN
OTTOMAN CUSTOM PROCESSORS INC. AND
PENTHOUSE REALTY COMPANY, LLC
STATE OFFICE
HARRISBURG, PENNSYLVANIA



Report No.
34004-06-Hy
SEPTEMBER 2000



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Northeast Region - Audit

Suite 2-2230

5601 Sunnyside Avenue, Stop 5300

Beltsville, Maryland 20705-5300



DATE: September 27, 2000

REPLY TO

ATTN OF: 34004-06-Hy

SUBJECT: Rural Business-Cooperative Services, Business and Industry Guaranteed Loan, Ottman Custom Processors, Inc. and Penthouse Realty Company, LLC

TO: Nancy Spiker
Acting State Director
Rural Development

This report presents the results of the subject audit. The written response, dated August 31, 2000, has been incorporated into the Findings and Recommendations section of the report. The complete text of the response is attached as exhibit B.

We agree with action planned for the report recommendation, however, we are not able to reach management decision. The action needed to reach management decision on the recommendation is identified in the Findings and Recommendations section of the report.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the specific corrective action taken or planned and the timeframes for implementation of the recommendation for which a management decision has not yet been reached. Please note that the regulation requires a management decision to be reached on all findings and recommendations within a maximum of 6 months from report issuance.

We appreciate the assistance you and your staff provided to us during our review.

/s/
MARLANE T. EVANS
Regional Inspector General
for Audit

EXECUTIVE SUMMARY

RURAL BUSINESS COOPERATIVE SERVICE BUSINESS AND INDUSTRY GUARANTEED LOAN OTTOMAN CUSTOM PROCESSORS, INC. AND PENTHOUSE REALTY COMPANY, LLC AUDIT REPORT NO. 34004-06-Hy

RESULTS IN BRIEF

At the request of officials from the Rural Development State Office in Harrisburg, Pennsylvania, we conducted an audit of a \$7 million guaranteed Business and Industry

loan made to Ottoman Custom Processors, Inc. and Penthouse Realty Company, LLC (the borrowers). The borrowers obtained the loan from the State Street Bank and Trust Company (the lender) on August 28, 1996, secured with a 70 percent loan guarantee from Rural Development. On March 9, 1999, Rural Development advised the Office of Inspector General that the borrower had defaulted on the loan and subsequent appraisals of the borrowers' machinery and equipment showed a large discrepancy in the original machinery and equipment appraisal.

Our review of documentation for this loan disclosed that the Rural Development State Office complied with program requirements regarding processing, servicing, and liquidating the loan. However, the lender did not meet its responsibilities in processing the loan. The lender did not assure that an independent appraisal of the borrower's machinery and equipment was obtained to value the machinery and equipment used as security for the loan. We found that the borrower prepared the appraisal used by the lender to show adequate collateral was obtained to secure the loan. Since the loan processed by the lender did not contain adequate security and the borrower defaulted on the loan, the Government's guarantee was exposed to a loss of about \$4.2 million. The lender complied with program requirements regarding the servicing and liquidating the loan.

KEY RECOMMENDATION

We recommend that Rural Development take action to void the guarantee, in consultation with the Office of General Counsel.

AGENCY RESPONSE

In its August 31, 2000, response to the official draft report, Rural Development officials agreed with the finding and recommendation as presented. Applicable portions of the response are incorporated, along with our position, in the Findings and Recommendations section of the report. The full text of the response is included as exhibit B of the report.

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INTRODUCTION

BACKGROUND

The Rural Business-Cooperative Service (RBS), which succeeded the Rural Business and Cooperative Development Service and Rural Development Administration, was established by Public Law 103-354, the Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994. The mission of the RBS is to enhance the quality of life for all rural residents by assisting new and existing businesses and cooperatives through partnerships with rural communities. This mission is accomplished, in part, through the Business and Industry (B&I) Guaranteed Loan Program.

The B&I Guaranteed Loan Program is administered by RBS through the national office and 47 Rural Development State Offices (SO). The purpose of the B&I Guaranteed Loan Program is to improve the economic and environmental climate in rural communities. This purpose is achieved by bolstering existing private credit through the guarantee of quality loans that will provide lasting community benefits. On the other hand, the guarantees are not intended for marginal or substandard loans. As of September 30, 1996, 1,053 loans totaling \$1.2 billion had been made. For fiscal year 2000, the estimated program level was \$1 billion.

Generally, the total amount of Agency loans to one borrower cannot exceed \$10 million. This limit includes the guaranteed and unguaranteed portions, the outstanding principal and interest balance of any existing Agency guaranteed loans and any new loan requests. The Administrator, with the concurrence of the Under Secretary for Rural Development, may grant an exception to the \$10 million limit under certain circumstances. Total guaranteed loans to one borrower may not exceed \$25 million under any circumstances. Generally, the maximum guarantee percentages are 80 percent for loans of \$5 million or less, 70 percent for loans between \$5 million and \$10 million and 60 percent for loans exceeding \$10 million.

Ottman Custom Processors, Incorporated (Inc.) located in Sutton, Massachusetts, was a processor and marketer of specialty meat and poultry products for the food service, home delivery, export and wholesale club industries. Ottman Custom Processors, Inc. sought to expand its' existing business into new product lines and markets. The structure of the expansion of operations included the formation of Penthouse Reality Company, LLC. Penthouse Realty Company, LLC was formed to take ownership of the real

estate and be a co-borrower with Ottman Custom Processors, Inc. The same principals owned these companies.

On August 28, 1996, Ottman Custom Processors, Inc. and Penthouse Realty Company, LLC (the borrowers) obtained a Rural Development B&I loan from State Street Bank and Trust Company (the lender) located in Boston, Massachusetts. Rural Development guaranteed 70 percent of the \$7 million loan. The loan was closed on August 26, 1996. The loan was for the purchase of the assets of East Benton Packing T/A Penthouse Meat Company in Dalton, Pennsylvania and Chef's Pride Foods, Inc. in Dunmore, Pennsylvania.

The loan went into default on August 13, 1997, and in April 1998, the lender sought and obtained a State Court Receiver to oversee the borrower's business operations. Because of the default, the lender also obtained updated appraisals. Subsequently, the borrower went out of business and all security for the loan was liquidated except real estate in Sutton, Massachusetts. The loan has an outstanding principal balance of almost \$6 million.

OBJECTIVES

Our objectives were to review and evaluate: (1) The Rural Development SO and lender compliance with B&I Guaranteed Loan Program requirements and conditions from the pre-application process to the disbursement of the loan proceeds, (2) the Rural Development SO and lender compliance with B&I Guaranteed Loan Program servicing and/or monitoring requirements, and (3) the Rural Development SO and lender compliance with B&I Guaranteed Loan Program liquidation requirements and procedures as they related to the borrower's guaranteed loan.

SCOPE

Our review covered the \$7 million B&I guaranteed loan made to the borrower. The loan period was from August 26, 1996 to the present. In addition, prior periods were also reviewed as necessary. We performed audit fieldwork at the Rural Development SO in Harrisburg, Pennsylvania, at the lender's office in Boston, Massachusetts, and at a storage locker located in Foxboro, Massachusetts, in which the Receiver maintained the borrower's records. We also obtained and reviewed records related to a machinery and equipment appraisal completed by M&M Equipment Corporation, an appraisal company located in Skokie, Illinois.

In order to gain access to lender, borrower, and appraiser records, we were required to provide subpoenas. We issued an Office of Inspector General (OIG) subpoena on August 5, 1999, to obtain and review records maintained at the lender. We also issued an OIG subpoena on October 18, 1999, to obtain and review the borrowers' records maintained in Foxboro, Massachusetts. Finally, we issued an OIG subpoena on October 18, 1999, to obtain and review records maintained by M&M Equipment Corporation.

Our audit fieldwork was performed from June 1999 to May 2000 and was conducted in accordance with generally accepted government auditing standards.

METHODOLOGY

To accomplish our objectives, we reviewed: (1) Rural Development instructions, policies and procedures related to the B&I Guaranteed Loan Program, (2) Rural Development SO records related to the borrower's loan, (3) the lender's records related to the borrower's loan, (4) the borrower's loan records and (5) records related to a machinery and equipment appraisal completed by M&M Equipment Corporation. We also interviewed officials from the Rural Development SO, the lender, the lender's counsel, M&M Equipment Corporation and the receiver.

FINDING AND RECOMMENDATION

CHAPTER 1	LENDER DID NOT OBTAIN AN INDEPENDENT APPRAISAL OF COLLATERAL USED TO SECURE LOAN
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FINDING NO. 1

The lender's review of the collateral provided to secure the Business and Industry (B&I) guaranteed loan was inadequate. The lender did not ensure that an independent appraisal was obtained to value the machinery and equipment used to provide security for the loan. As a result, the loan processed by the lender did not contain adequate security and exposed the Government's 70 percent guarantee on the loan to a loss of \$4.9 million. Since the borrower has defaulted on the loan (\$6.0 million), the projected loss to the Government is approximately \$4.2 million.

By signing the Lender's Agreement, the lender agreed to be subject to all requirements of the applicable subpart of Title 7 of the Code of Federal Regulations, part 1980, and any future amendments of the regulation not inconsistent with the agreement.¹

Rural Development instructions provide that the lender is responsible for seeing that proper and adequate collateral is obtained and maintained in existence and/or on record to protect the interest of the lender, the holder, and Rural Development.² Instructions also require that appraisal reports be prepared by independent qualified fee appraisers on all property that will serve as collateral. The appraisers are to give their opinion regarding the current market value of the collateral and the purpose for which the appraisal will be used. The lender is responsible for ensuring that appropriate appraisals are made.³ Also, the lender is responsible for determining that appraisers have the necessary qualifications and experience to make the appraisals.⁴

¹ USDA-FmHA Form FmHA 449-35, paragraph XVIII, revised February 1990.

² RD Instruction 1980-E, paragraph 1980.443(a), dated February 25, 1987.

³ RD Instruction 1980-E, paragraph 1980.444(a), dated October 17, 1988.

⁴ RD Instruction 1980-E, paragraph 1980.444(b), dated February 25, 1987.

On August 28, 1996, the borrower obtained a \$7 million B&I guaranteed loan from the lender that carried a 70 percent guarantee. The loan was secured by a first mortgage on real estate and a first security interest in all fixed assets of the borrower. A second security interest in inventory, accounts receivable, and general intangibles was also obtained.

The lender contracted for the real estate appraisals, however, it allowed the borrower to obtain and furnish the appraisal for the machinery and equipment. This appraisal valued the machinery and equipment at \$4,227,995. Of this amount, 80 percent was considered the collateral value. When the loan was determined to be in default, the lender contracted with an appraisal company to determine the forced liquidation value of the borrower's machinery, equipment, and vehicles. This appraisal showed a value of \$593,725. Because of this large discrepancy, the lender determined that the borrower had originally provided a document that had not been prepared by an appraiser. The lender prepared a suspicious activity report and notified Rural Development that they had submitted the report to the Financial Crime Enforcement Network.

The lender obtained affidavits from two individuals regarding the appraisal provided by the borrower to obtain the loan. These affidavits stated that the appraiser did not prepare the appraisal document submitted by the borrower. One affidavit stated that they were asked to create equipment lists for use in an appraisal of the borrower's assets. The affidavit also stated that this individual informed the borrower that many of the tools, parts and machinery listed were damaged, rusted or otherwise unusable. The affidavit stated that direction was given by the borrower to include these items on the equipment list.

In the other affidavit the individual stated that they were asked to help create an appraisal document valuing the company's assets. In creating this document, this individual was asked to retype information contained in an appraisal furnished by an appraisal company. As the document was being retyped, the borrower requested additional appraisal information be added to the document. Once completed, the borrower provided the appraisal company letterhead to print the appraisal. This individual was also required to add a statement that all equipment was in good working condition.

The lender used this appraisal prepared by the borrower and did not follow up with the appraiser to request a certification that the appraisal was prepared by them and that the values reflected were true and correct. We interviewed the lender officials on September 16, 1999, to gather information regarding their policies and procedures for obtaining appraisals of machinery and equipment. They informed us that their bank policy was to allow the loan recipient to obtain the appraisal. They said, however, that this

policy was not in writing. The lender officials also said that there was no reason for them to check the qualifications of the appraiser or to followup on the appraisal, therefore, they did not contact the appraiser.

We interviewed the appraiser on September 13, 1999, and January 27, 2000, to clarify the borrower's request for an appraisal of machinery and equipment and to verify the accuracy of the appraisal provided to the borrower.

The appraiser from M&M Equipment Corporation informed us that the borrower contacted them to request a desktop appraisal of the machinery and equipment for Ottman Custom Processors, Inc. and Penthouse Realty Company, Inc. based on in-place values. The appraiser stated that an in-place value appraisal gives the highest value as it is based on the estimated amount in which the property might exchange between a willing buyer and seller. Both buyer and seller would intend the equipment to continue in operation at the same facility. The appraiser also said that values for the machinery and equipment would be less in a market value appraisal.

Regarding the appraisal, the appraiser said that it was completed in their office based on listings of equipment provided by the borrower. The appraiser said that they did not know whether the equipment was in good condition or if the equipment existed. The appraiser said that a desktop appraisal could not be used to accurately value a company's equipment. The appraiser also said that in this type of appraisal the equipment is never viewed and total reliance is placed on the information provided by the company. Also, the appraiser said that they did not know the borrower was going to use this appraisal in connection with obtaining a loan. Further, the appraiser said that the lender did not contact them regarding this appraisal.

Since the lender allowed the borrower to control the complete process of the appraisal for the machinery and equipment, the lender had no assurance that the appraisal document provided by the borrower was prepared by a qualified appraiser or if the values shown on the appraisal represented the market value of the borrower's machinery and equipment. Rural Development personnel agreed that the lender did not meet program requirements regarding obtaining an appraisal on the borrowers' collateral for the loan.

RECOMMENDATION NO. 1

Take the appropriate action to void the loan note guarantee of \$4.2 million, in consultation with the Office of General Counsel.

Agency Response

Rural Development advised that it fully supports the OIG revised recommendation and the SO is working with the Office of the General Counsel (OGC) to recover the amount of loss occasioned by State Street Bank's failure to obtain an independent appraisal on the collateral that secured the guaranteed loan. In the event the OGC indicates that we should pursue full recovery for misrepresentation of the value of the collateral, we will proceed accordingly.

OIG Position

We agree with the actions planned. To reach management decision, Rural Development needs to provide documentation of the OGC determination. If it is determined that recovery is required, documentation should be provided showing that an accounts receivable has been established to recover improper payments.

GENERAL COMMENTS

Our review of documentation for this loan disclosed that the Rural Development State Office complied with program requirements regarding processing, servicing, and liquidating the loan. We also found that the lender complied with program requirements regarding servicing and liquidating the loan.

EXHIBIT A – SUMMARY OF MONETARY RESULTS

Finding Number	Recommendation Number	Description	Category
1	1	The lender did not obtain adequate collateral to secure the loan. Loan guarantee should not be honored.	Questioned Loan of \$4.2 Million Recovery Recommended

EXHIBIT B – AUDITEE RESPONSE TO DRAFT REPORT



United States Department of Agriculture
Rural Development

Rural Business-Cooperative Service • Rural Housing Service • Rural Utilities Service
Washington, DC 20250

AUG 31 2000

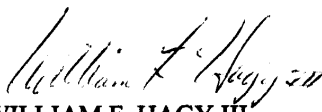
SUBJECT: Business and Industry Guaranteed Loan Program
Ottman Custom Processors, Inc., and Penthouse Realty Company, LLC
Office of Inspector General Audit Number 34004-06-HY

TO: Office of Inspector General
Northeast Region - Audit

ATTN: Marlene T. Evans
Regional Inspector General for Audit

As discussed during the teleconference with Business Programs Servicing Division Director Carolyn C. Parker, we fully support the Office of Inspector General revised recommendation. Our State Office is currently working with the Office of the General Counsel (OGC) to recover the amount of loss occasioned by State Street Bank's failure to obtain an independent appraisal on the collateral that secured the guaranteed loan. In the event that OGC indicates that we should pursue full recovery for misrepresentation of the value of the collateral, we will proceed accordingly. We are also requesting management decision on this recommendation.

If additional information is needed, please contact Carolyn C. Parker, Director, Business Programs Servicing Division, 202-690-4103, or F. Lee Patterson, Community and Economic Development Program Director, 717-237-2287.


WILLIAM F. HAGY III
Deputy Administrator
Business Programs