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

REQUEST AUDIT OF B&I GUARANTEED LOAN IN LOUISIANA

Audit Report No.
34099-5-Te
SEPTEMBER 2003

UNITED STATES DEPARTMENT OF AGRICULTURE
OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20250

DATE: September 30, 2003

REPLY TO
ATTN OF: 34099-5-Te

SUBJECT: Request Audit of B&I Guaranteed Loan in Louisiana

TO: John Rosso
Administrator
Rural Business-Cooperative Service

THROUGH: John Purcell
Director
Financial Management Division

This report presents the results of our audit of a B&I Guaranteed Loan in Louisiana. The RBS Administrator's response to the draft report, dated September 25, 2003, is included as exhibit E with excerpts and the Office of Inspector General's (OIG) position incorporated into the relevant sections of the report.

Based on the response, management decision was reached on Recommendation No. 2. Follow your internal agency procedures in forwarding final action correspondence to the Office of the Chief Financial Officer, Planning and Accountability Division (OCFO/PAD).

Management decisions could not be reached for Recommendations Nos. 1 and 3. Documentation and/or actions needed to reach management decisions for these recommendations are described in the OIG Position section of the report.

Please furnish the information needed to reach agreement on the management decisions for the recommendations within 60 days. Please note that Departmental Regulation 1720-1 requires a management decision for all recommendations within a maximum of 6 months from the date of report issuance, and final action to be taken within 1 year of each management decision.

We appreciate the courtesies and cooperation extended to us by members of your staff during the audit.

/s/ M. T. Evans (for)
RICHARD D. LONG
Assistant Inspector General
for Audit

EXECUTIVE SUMMARY

REQUEST AUDIT OF B&I GUARANTEED LOAN IN LOUISIANA AUDIT REPORT NO. 34099-5-Te

RESULTS IN BRIEF

The Rural Business-Cooperative Service (RBS) National Office (NO) requested that we review a $9 million Business and Industry (B&I) loan in Louisiana to determine if the lender properly processed and serviced the B&I guaranteed loan. The NO was concerned because such a large loan had failed within a year from loan closing. We determined the lender was negligent in the loan making and servicing of the guaranteed loan. In some instances, the NO and the Rural Development State Office (SO) approved the actions of the lender. Overall, the lender failed to follow Rural Development instructions and to practice reasonable and prudent lending practices. As a result, the borrower defaulted on the loan in less than 1 year, and RBS paid $5,585,136 on the loan guarantee.

Specific findings are listed below:

- The lender disbursed $5.3 million of initial loan funds without having sufficient collateral and failed to obtain any additional collateral to cover a subsequent $950,000 advance.

- The lender failed to ensure that the borrower had title to collateral that it pledged in order to obtain another loan advance of $400,000.

- Collection of $119,195 of accounts receivable pledged as collateral was not applied to the loan balance or used to buy replacement collateral.

- The lender failed to account for $384,065 of collateral during liquidation.

- The lender did not ensure that fair market value was obtained for the liquidated assets.

- The lender improperly released individual B from a personal guarantee of the $9 million loan.

During our review, the involved parties did not make certain administrative and financial records available to us. Despite this limitation, we were able to gather sufficient evidence to allow us to arrive at a conclusion regarding loan servicing and certain items of the loan approval process. Furthermore, we cannot be certain that all discrepancies involving the subject loan transactions and the subsequent loan collateral liquidation have been identified.

The total effect of the lender's negligence resulted in a loss to the Government of $5.5 million. However, because the SO improperly authorized and approved the majority of the lender's actions, recovery of $4,202,835 is not recommended. RBS may pursue recovery of the total amount or any additional amounts it deems appropriate, based on the information in this report and any other information or knowledge the agency may have of the lender's actions. (See exhibit C for details on specific amounts.)

KEY RECOMMENDATIONS

In consultation with the Office of the General Counsel (OGC), we recommend that Rural Development recover $1,382,301 in loss claims paid to the lender. Rural Development should also review the lender's past and present performance in United States Department of Agriculture (USDA) loan programs to determine whether the lender's participation in USDA programs shows a pattern of negligence. The RBS NO also needs to determine whether the corrective actions implemented to improve the management of the Louisiana B&I Guaranteed Loan Program will adequately prevent further deficiencies in loan making and servicing similar to the problems identified in this report.

AGENCY RESPONSE

The agency's response dated September 25, 2003, is included as exhibit E of the report. We have incorporated applicable portions of the response along with our position in this section and in the Findings and Recommendations sections of the report. In summary, the agency will consult with OGC to determine if there is sufficient legal basis for the lender to repay $1,382,301, or an appropriate amount of the loan loss guarantee that is legally recoverable. Also, the agency evaluated the lender's past and current participation in loan programs and determined there was no pattern of negligence. Further, the agency believes it has taken and/or planned sufficient steps to prevent similar problems identified in this report.

OIG POSITION

Although we disagree with many of the agency's comments regarding Finding No. 1, we agree with the agency's planned action to consult with OGC to determine if there is sufficient legal basis to recover the $1,382,301. We will need additional documentation to reach management decisions for both Recommendations Nos. 1 and 3. The specific documentation needed is recorded in the OIG Position sections for the applicable recommendations in the report. We accept the agency's management decision for Recommendation No. 2 that the lender's past and current participation in loan programs has not shown a pattern of negligence.

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INTRODUCTION

BACKGROUND

The purpose of the B&I Guaranteed Loan Program is to improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural communities with a population of less than 50,000. B&I guaranteed loans achieve this purpose by bolstering the existing private-credit structure through the guarantee of quality loans, which provide lasting community benefits. It is not intended that the guarantee authority would be used for marginal or substandard loans, or for the relief of lenders having such loans. RBS guarantees 60 to 90 percent of the loan, depending on the loan amount.

The lender is responsible for making and servicing the entire loan and for taking all actions that a prudent lender would perform in approving and servicing its own portfolio of loans that are not guaranteed. The loan note guarantee is unenforceable by the lender to the extent any loss is occasioned by negligent servicing or failure to obtain the required security interest regardless of the time at which the USDA acquires knowledge of the foregoing.

The borrower received a $9 million B&I loan guaranteed by RBS at 80 percent. The loan was closed on September 4, 1998. The borrower used the loan proceeds to purchase the business assets of an existing corporation (corporation A) and provide working capital for the business. Both corporation A and the borrower were in the business of manufacturing portable, blast-resistant buildings for the petroleum and chemical industries. Some of the buildings were leased to third parties while other buildings were custom manufactured on a contractual basis for sale to third parties. Corporation A was approved to receive a $3 million B&I loan but withdrew the request 2 days after the borrower's $9 million loan was approved.

The borrower ceased doing business in June 1999, only 10 months after loan closing. The last payment on the loan note was made in June 1999. As of the date of our review, the bankruptcy proceedings involving the borrower had not been completed. The bankruptcy trustee has initiated a civil suit against the accounting firm that performed confirmation of certain assets of corporation A. The results of the suit are pending.

The chief financial officer (CFO) and 10-percent owner of corporation A that sold its assets to the borrower was formerly a vice president and senior loan officer of the lender. Also, the individual overseeing the liquidation of the borrower's assets was also the CFO and general manager of the corporation purchasing the assets (corporation B) and owned a 10-percent interest in the borrower's corporation. In addition, one of the members of the lender's board of directors was a relative of one of the principal owners of the borrower that received the guaranteed loan from the lender.

OBJECTIVE

Our objective was to determine if the lender properly made and serviced the B&I guaranteed loan.

SCOPE

The RBS NO requested that we conduct a review of a Louisiana B&I guaranteed loan. The results of this audit may be included as part of a nationwide review of the B&I Guaranteed Loan Program. We conducted the fieldwork from February 2001 through May 2003. Coverage included all documentation relating to the loan in question, starting with the loan application dated June 1, 1998.

During our review, the involved parties did not make certain administrative and financial records available to us. Despite this limitation, we were able to gather sufficient evidence to allow us to arrive at a conclusion regarding loan servicing and certain items of the loan approval process. Furthermore, we cannot be certain that all discrepancies involving the subject loan transactions and the subsequent loan collateral liquidation have been identified.

We conducted this audit in accordance with the Government Auditing Standards issued by the Comptroller General of the United States.

METHODOLOGY

To accomplish the audit objective, we interviewed SO personnel, lender and borrower representatives, the bankruptcy trustee and his legal counsel, and other related personnel as needed. We reviewed Rural Development's SO loan files and the lender's loan files to determine if the lender had complied with Rural Development instructions, the loan conditional commitment, loan agreement, and lender's certification.

Also, we reviewed all available administrative and financial records on file at the trustee's office pertaining to the bankruptcy of the borrower.

FINDINGS AND RECOMMENDATIONS

CHAPTER 1	LENDER DID NOT EXERCISE PRUDENT LENDING PRACTICES

FINDING NO. 1

The lender did not properly approve, service, or liquidate the $9 million guaranteed B&I loan that was approved for the borrower. This lender failed to ensure that (1) the loan was fully secured prior to loan approval and issuance of loan funds, (2) proceeds from the collection of accounts receivable were applied to the loan or used to purchase replacement collateral, and (3) sufficient documentation was available to show the disposition of all assets. This occurred because of the lender's negligence and failure to practice reasonable and prudent lending practices. As a result, Rural Development paid a loss claim to the lender totaling $5,585,136. We are only recommending recovery of $1,382,301 of this total because the SO had approved a majority of the lender's actions contributing to the total loss to the Government. (See exhibit A.)

Rural Development instructions specify that lenders are responsible for obtaining valid evidence of debt and collateral in accordance with sound lending practices.[1] The instructions also state that the lender is responsible for making and servicing the entire loan and for taking all actions that a prudent lender would perform regarding its own portfolio of loans. The loan note guarantee and Rural Development instructions state that the loan note guarantee will be unenforceable by the lender to the extent any loss is occasioned by negligent servicing or the failure to obtain the required security, regardless of the time at which USDA acquires knowledge of the foregoing.[2] Negligent servicing is defined as the failure to perform those services that a reasonably prudent lender would perform in servicing its own portfolio of nonguaranteed loans.[3] Rural Development instructions provide that "it is the responsibility of the lender to ascertain that all requirements of

[1] Rural Development Instruction 4279-A, section 4279.30, dated December 23, 1996. (See also Title 7, Code of Federal Regulations (CFR), chapter XLII, part 4279, subpart A, section 4279.30, paragraph (a), revised January 1, 1998.)
[2] Rural Development Instruction 4287-B, section 4287.107, dated December 23, 1996. (See also Title 7, CFR, chapter XLII, part 4287, subpart B, section 4287.107, revised January 1, 1998.)
[3] Rural Development Instruction 4279-A, section 4279.2(a), dated December 23, 1996. (See also Title 7, CFR, chapter XLII, part 4279, subpart A, section 4279.2, paragraph (a), revised January 1, 1998.)

making, securing, servicing, and collecting the loan are complied with."[4] The lender, in signing the conditional commitment agreement, agreed to abide by and fulfill the requirements of the Rural Development instructions cited in the agreement. The conditional commitment specifically cites the provisions of the instructions to which the lender will be held accountable.

The following conditions show the poor servicing actions and lack of prudent lending practices by the lender that contributed to the loss claim payment of $5,585,136.

A. Loan Funds Totaling $6.2 Million Were Disbursed Without Sufficient Collateral

There was insufficient collateral to protect the Government's security interests at the time of the disbursement of the initial loan funds. This occurred because, although the lender certified to Rural Development that the borrower had the required collateral to secure the guaranteed loan, the lender failed to ensure that the required collateral was actually owned by the borrower. The lender based its determination of the collateral value on an appraisal that included property totaling over $1 million that was not owned by the borrower or would not be part of the collateral purchased to secure the initial $5.3 million disbursement. Three days later, the lender started the process to advance $950,000 that the borrower used, in part, to purchase the property not included originally. This, in effect, restored the collateral needed for the $5.3 million. However, the lender failed to obtain additional collateral for the $950,000.

Rural Development instructions and regulations provide that lenders will be responsible for ensuring that appraisal values accurately reflect the value of the collateral.[5] The conditional commitment, dated August 24, 1998, provided that the lender must assure that the owners have good and marketable title to all required security in connection with this loan.[6] The lender's agreement provides that the guarantee "will be unenforceable by the lender to the extent any loss is occasioned by * * * failure to obtain the required security regardless of the time at which USDA acquires knowledge of the deficiency."[7]

On September 4, 1998, a B&I loan to the borrower was closed for $9 million, of which $7.2 million was guaranteed by RBS. At the time of loan closing, the borrower received a $5.3 million disbursement so that it could

[4] Rural Development Instruction 4279-A, section 4279.1(b), dated December 23, 1996. (See also Title 7, CFR, chapter XLII, part 4279, subpart B, section 4279.1, paragraph (b), revised January 1, 1998.)
[5] Rural Development Instruction 4279-B, section 4279.144, dated December 23, 1996. (See also Title 7, CFR, chapter XLII, part 4279, subpart B, section 4279.144, revised January 1, 1998.)
[6] Conditional Commitment (Form 4279-3, revised October 1996) signed by the State Director on August 24, 1998.
[7] Lender's Agreement (Form 4279-4, revised October 1996).

purchase the assets of corporation A. The borrower's purchase agreement and the May 30, 1998, appraisal identified the assets that would secure the disbursement. The borrower provided the lender with the May 30, 1998, appraisal which identified the value of corporation A's assets used to secure the $5.3 million loan disbursement. Based on this appraisal, the lender established the value of the assets as $5.3 million and disbursed the $5.3 million in loan funds as directed by the borrower.

<u>Overstated Appraisal Should Have Been Detected By Lender</u>

During our review of the loan files, we found that the asset appraisal had problems that should have been detected by the lender and corrected prior to loan approval and disbursement of any loan funds. In addition, the lender had other information available that should have been used to validate the accuracy of the May 30, 1998, asset appraisal, as follows:

> The appraisal included assets (equipment and portable buildings) that were not pledged as collateral for the initial loan disbursement but that were used by the lender to increase the initial disbursement of funds to $5.3 million. Corporation A did not own the subject assets at the time of the loan appraisal. The assets were valued at $1,032,900 in the May 30, 1998, appraisal.
>
> The loan file indicated that an accounting firm performed a review of assets reportedly owned by corporation A. The lender did not obtain a copy of the report to verify that the assets the borrower said it would buy from corporation A and used as collateral for the $5.3 million loan advance were actually owned by corporation A. A draft copy of the accounting firm's report we obtained confirms that corporation A did not own $1,032,900 worth of assets shown on the subject appraisal.
>
> The lender could not explain why these assets, which were not shown on the purchase agreement but were on the May 30, 1998, appraisal, were included in the value of the security property. If the lender had exercised care and reconciled the property shown in the borrower's purchase agreement to that listed in the appraisal, the equipment and buildings included in error (totaling $1,032,900) would have been identified.
>
> The borrower had enlisted the work of business acquisition specialists in connection with the purchase. We found no documentation that the lender utilized such work in validating the appraisal values or confirming title to the property that was listed on the appraisal of assets for corporation A.

These conditions represent negligence on the part of the lender. The failure by the lender to ensure that the collateral identified in the appraisal was accurate and complete shows the lack of due diligence on the part of the lender.

Subsequent Loan Advance Is Used To Purchase Collateral Used to Justify the First Loan Advance

On about September 7, 1998, 3 days after the initial loan disbursement of $5.3 million, the borrower requested a second loan advance of $950,000 that included $650,000 for the borrower's purchase of $1,032,900 of assets. These were part of the same assets that the lender had previously represented to Rural Development as owned by corporation A and used to secure the initial $5.3 million loan advance. This, in effect, restored the collateral needed for the initial advance. However, the lender failed to obtain additional collateral for the $950,000 advance.

When the borrower eventually bought the assets on September 30, 1998, they were bought from two other companies, not corporation A. Therefore, corporation A did not own the $1,032,900 of assets when the lender obtained the conditional commitment from Rural Development on August 24, 1998. However, the lender represented to Rural Development that corporation A did own those assets when it (a) filed its loan request, (b) used the May 30, 1998, appraisal to represent that it had enough collateral to secure the loan, and (c) signed the conditional commitment to obtain the $5.3 million loan disbursement.

We believe the lender did not fulfill the primary responsibility of ensuring that title to loan collateral was unencumbered and that it adequately secured loan funds advanced to the borrower. We believe a prudent lender would not have failed in meeting those very basic lender responsibilities, which would be basic to any loan portfolio. The net effect of the lender's negligence resulted in insufficient collateral of $950,000. Therefore, we recommend recovery of $760,000 ($950,000 x 80 percent).

B. Borrower Did Not Have Title To Collateral

On December 4, 1998, the borrower requested a $400,000 loan advance and pledged mineral rights to oil and gas as collateral. The borrower provided the lender with a royalty deed, dated September 4, 1998, signed by one of the owners[8] of the mineral rights and prepared by the borrower's legal counsel, which transferred the mineral rights to the borrower. The value of

[8] One of the two owners of the mineral and gas rights was also a part owner of the borrower using the mineral and gas rights as collateral to obtain the additional loan advance.

the mineral rights was estimated at $525,000 based on the information provided by the borrower, the borrower's attorney, and the original owner of the rights. As a result, a $400,000 loan advance was approved and funds disbursed to the borrower. The lender did not require the borrower to provide an appraisal that validated the value assigned to the mineral rights prior to advancing the loan funds.

In September 1999, during loan liquidation, the lender discovered that the royalty deed was not legally valid because all owners did not sign it. The owner that did not sign was the relative of an individual (individual B) that was also an owner of the mineral rights. Individual B was also an owner of the borrower through stock ownership of a corporate entity.

We also found that the SO did not require the lender to obtain a personal guarantee of the relative. The waiver was approved based on an unaudited financial statement from individual B, which the relative reportedly refused to sign. As stated before, the relative's missing signature on the reported lien and title documents involving the mineral assets prompted the lender's legal counsel to conclude that the subject title and lien had not been perfected. Possession of the relative's personal guarantee may have been a method of enforcing the title and lien and subsequent liquidation of the mineral assets to pay part of the defaulted loan.

The oversight of not having all owners sign the royalty deed was that of the borrower's attorney. The lender allowed the borrower to use its own attorney rather than use the bank's attorney, which was not the lender's normal way of doing business. The lender decided not to pursue a claim against the borrower's attorney or the insurance company of the attorney, even though Rural Development had recommended pursuing those actions.

In preparation for making a loss claim on the loan note guarantee, the lender had the mineral rights appraised and found the appraised value, as of October 1, 1999, to be $115,383, not $525,000.

Rural Development staff stated that they "concurred in the advance with the assumption that the advance was properly secured." Rural Development also stated that "the $525,000 was never estimated by the bank, but merely a value the debtor (i.e., borrower) expressed." A prudent lender would have independently determined a fair market value of the proposed loan collateral and requested independent legal counsel to perfect the lien. Allowing the borrower to use its own attorney to perfect the lien rights was not the lender's normal banking practice. The fact that the collateral in question was reportedly valued at over $500,000 should have further highlighted the need to determine the value of the asset versus merely accepting the borrower's statement of value.

The lender did not recover any of the $400,000 loan advance and filed a $227,693 ($400,000 – $115,383 x 80 percent) claim against the loan guarantee. We do not believe it was reasonable or prudent for the lender to rely on the borrower, the borrower's attorney, or the original owner of the mineral rights to ensure that the lender's and the Government's interests were fully protected. Therefore, since the lender failed to follow Rural Development instructions and to practice reasonable and prudent lending practices, we do not believe it was eligible to file a claim against the loan guarantee for the loss related to this loan advance. Rural Development should recover the $227,693. (See exhibit B.)

C. Collection Of Accounts Receivable Was Not Applied To The Loan Balance Or Used To Buy Replacement Collateral

The lender did not require the borrower to apply monies collected from accounts receivable (pledged as loan collateral) against the outstanding loan balance or to buy replacement collateral of an equal value. On October 30, 1998, the borrower requested a $119,195 loan advance. This loan advance was secured by $148,994 in accounts receivable due on a $446,982 contract to construct portable buildings for a petroleum company. On November 6, 1998, the lender accepted the receivables as collateral and advanced $119,195 (80 percent of the $148,994). The accounts receivable were collected on or about December 15, 1998. However, the funds were deposited into the borrower's primary checking account and not applied to the loan balance or used to buy replacement collateral.

Program regulations state that lenders may release collateral with a cumulative value of up to 20 percent of the original loan amount without agency concurrence, if the proceeds generated are used to reduce the guaranteed loan or to buy replacement collateral.[9]

A smaller loss claim would have resulted if the proceeds of accounts receivable were applied against the outstanding loan principal or used to buy replacement collateral of an equal value. The lender stated that the use of the accounts receivable proceeds for normal business operating expenses reduced the subsequent need for additional loan advances. Whether that is true or not, the lender's actions to allow the borrower to divert the proceeds from the collection of accounts receivable to its primary checking account left the guaranteed loan undercollateralized by $148,994. Rural Development instructions specifically require that lenders maintain the same level of collateral existing at loan closing throughout the life of the loan. In allowing the borrower to use the collections for business expenses instead of

[9] Title 7, CFR, chapter XLII, part 4287, subpart B, section 4287.113, paragraph (b), revised January 1, 1998.

applying them to the loan balance or buying replacement collateral, the lender compromised the loan collateral position.

Rural Development stated that this was an approved use of loan funds in accordance with the conditional commitment provided the lender had adequate collateral. However, the issue here is not a question of whether or not the advance should have been made but rather if the collateral could be disposed of without collateral of equal value replacing it. Therefore, the lender did not ensure that the borrower maintained adequate collateral as specified in the conditional commitment. The lender allowed the collateral level to be compromised when the borrower disposed of the collateral.

A loss of $95,356 (80 percent of $119,195) was paid by Rural Development due to the lender's failure to apply these proceeds to the outstanding loan balance. Rural Development should recover the $95,356. (See exhibit B.)

D. <u>Lender Failed To Account For All Collateral During Liquidation</u>

We compared the list of collateral securing the borrower's loan with the list of collateral sold during the liquidation process. Based on this comparison, we found the lender had not accounted for $384,065 in collateral property. We were unable to determine the current location of the collateral or whether it had been disposed of during the liquidation process. In addition, the lender, borrower, corporation B (who was buying portions of the liquidated assets of the borrower), and other third parties were unwilling to provide records that we had requested to verify the location of the collateral.

Rural Development instructions state, "The Lender is responsible for the recommended liquidation methods for maximum collection possible on the indebtedness and the justification for such methods, including recommending action * * * for acquiring and disposing of all collateral."[10] Program regulations, regarding loan loss determinations, provide that the lender must ensure "that all of the collateral has been accounted for and properly liquidated and that liquidation proceeds have been * * * applied correctly to the loan."[11]

We found that the lender did not properly account for the following equipment during the liquidation process.

[10] Rural Development Instruction 4287-B, section 4287.157(d), dated December 23, 1996. (See also Title 7, CFR, chapter XLII, part B, subpart B, section 4287.157, paragraph (d), revised January 1, 1998.)
[11] Title 7, CFR, chapter XLII, part 4287, subpart B, section 4287.158, paragraph (c), revised January 1, 1998.

Figure 1: Collateral Unaccounted For At Liquidation

IDENTIFICATION NUMBER	DESCRIPTION	VALUE AT CLOSING	VALUE ON LIQUIDATION APPRAISAL
Bldg. 117	Portable Building (Six-Man Sleeper)	$92,000	Not listed
Bldg. 112	Portable Building (10x40 Server)	120,000	Not listed
Bldg. 131	Portable Building (Six-Man Sleeper)	100,000	$5,000
Gen. 313	75-Watt Generator	60,000	Not listed
Fld. 918	Flood Lights	769	Not listed
Fld. 919	Flood Lights	769	Not listed
Fld. 920	Flood Lights	769	Not listed
Fld. 921	Flood Lights	769	Not listed
Dis. 914	Distribution Panel	900	Not listed
Dis. 915	Distribution Panel	900	Not listed
Fld. 924	Flood Lights	769	Not listed
Fld. 925	Flood Lights	769	Not listed
Fld. 926	Flood Lights	769	Not listed
Fld. 927	Flood Lights	769	Not listed
Fld. 928	Flood Lights	769	Not listed
Fld. 929	Flood Lights	769	Not listed
Fld. 930	Flood Lights	775	Not listed
Fuel 515	500 Gal. Fuel Tank	1,800	Not listed
	TOTALS	**$384,065**	**$5,000**

The fact that the lender had not performed a reconciliation of assets during the liquidation process demonstrates negligence on the part of the lender.

Through discussions with the borrower and a review of records, we found that building No. 117, valued at $92,000, had been destroyed by a fire. The borrower had received insurance proceeds of $82,000 on the loss. The lender was unaware of this fact because it had not performed a reconciliation of assets and accounted for all property on the list of collateral.

Building No. 131 was listed on the original loan appraisal as a six-man sleeper with a value of $100,000. It was listed on the liquidation appraisal as a two-man sleeper with office with a value of only $5,000. We were unable to account for this significant difference. Because of the difference in the value of the property and physical description of the property, we do not believe the lender has adequately accounted for the original collateral (listed as building No. 131 and valued at $100,000).

We believe the lender should be held accountable for the value of this collateral. While the lender may have been unaware of the building that was destroyed by fire (value of $92,000), the lender should have reconciled and accounted for all the collateral property ($384,065 - $92,000 = $292,065).

Rural Development agreed with the issue of the $92,000 building. They stated, “Any collection from the insurance company could be considered a future recovery.” We continue to believe that collection must be made from the insurance company. However, Rural Development never responded to the remaining $292,065 ($384,065 - $92,000) of the missing loan collateral.

Loan requirements provide that the lender sell all collateral assets during loan liquidation and apply the proceeds to the loan balance. We believe that requirement has not been fulfilled. Also, the “hereafter acquired” clause of the financing statement secured a lien on all personal property assets of the borrower after loan closing. We are not aware of any “additional” collateral that would fall outside of the “hereafter acquired” clause. The Rural Development response did not define or identify the additional collateral. Neither the lender nor Rural Development has disputed the fact that the above-referenced loan collateral had not been sold as part of the loan liquidation process.

Because the lender failed to properly account for the collateral property, Rural Development should not have paid excess losses claimed by the lender totaling $384,065. We recognize that $92,000 of that amount is represented by the destroyed building, for which insurance only paid $82,000. However, the insurance proceeds were not used to help pay the defaulted loan. Therefore, we recommend recovery of $299,252 [$384,065 - $92,000 (destroyed building) + $82,000 (insurance proceeds)=$374,065 x 80 percent]. (See exhibit B.)

In summary, the lender’s negligence and lack of due diligence warrants a decision as to whether or not the lender should remain eligible for future Government programs. Rural Development officials told us that the lender’s past B&I loan performance during the 1980s was not good, but it is currently considered satisfactory with all B&I loans being paid current, with the exception of the subject loan. They stated that the lender had good performance in other USDA guaranteed loan programs.

Rural Development provided us with documentation to support that the lender’s guaranteed loans with USDA are current. This information disclosed that most of the lender’s guaranteed loans are current. The defaulted loan discussed in this report represents the single largest guaranteed loan in the lender’s portfolio. As such, Rural Development still needs to assess the lender’s loan making and servicing actions to determine whether the lender's continuing participation in guaranteed loans is in the best interest of the Government.

RECOMMENDATION NO. 1

In consultation with OGC, recover $1,382,301 of the loan loss guarantee paid to the lender. (See exhibit B.)

Agency Response

The RBS NO and Louisiana SO will consult with OGC to determine if there is sufficient legal basis for the lender to repay $1,382,301, or an appropriate amount (based on a reconciliation referenced earlier in its response) of the loan loss guarantee that is legally recoverable. See exhibit E for the agency's complete response to this recommendation.

OIG Position

Although we disagree with many of the agency's comments regarding Finding No. 1, we agree with the planned actions. However, to reach management decision, we will need documentation of OGC's determination, and, upon a finding of legal sufficiency, a copy of the demand letter for collection of any amount determined legally recoverable.

RECOMMENDATION NO. 2

Evaluate the lender's past and current participation in USDA loan programs. Determine if the lender's participation shows a pattern of negligence.

Agency Response

Rural Development has evaluated the lender's past and current participation in loan programs, including those associated with the Farm Service Agency (FSA). Rural Development determined that the lender's participation showed no pattern of negligence. See exhibit E for the agency's complete response to this recommendation.

OIG Position

We accept management decision. In our opinion, final action has been taken.

CHAPTER 2	RURAL DEVELOPMENT TOOK INSUFFICIENT ACTIONS TO OVERSEE THE LENDER'S ACTIVITIES

FINDING NO. 2

The SO did not provide sufficient oversight of the lender's actions to make certain that such actions were reasonable and prudent and to ensure the Government's interests were adequately protected. Although the lender advised the Rural Development SO staff about sensitive issues, it did not follow up to assure the lender properly addressed these issues. The SO also did not obtain and properly evaluate sufficient documentation from the lender before acting on the lender's recommendations. We concluded that proper oversight of the lender by the SO could have prevented some of the losses cited in this report. Although we question the total loan loss of $5,585,136 that was paid by Rural Development, we recommended recovery of only $1,382,301 from the lender in finding No. 1. We are not recommending recovery of the remaining $4,202,835 because of inadequate monitoring of the lender by the SO. (See exhibit C for details of specific amounts involved.)

Agency instructions state that the State Director has the primary responsibility for ensuring that the lender is servicing the loan in a prudent manner as required by the lender's agreement, the instructions governing the program, and loan documents.[12]

In July 1999, the lender informed SO officials that the loan was in default. Based on instructions from the SO, the lender developed a plan of liquidation and submitted it to the SO for evaluation on July 20, 1999. The State Director subsequently reviewed the loss claim and, on December 4, 2000, informed the Rural Development Acting Administrator that the lender "complied with all agency regulations and instructions in originating, closing, advancing, servicing, and liquidating" the loan. The State Director recommended approval of the loss claim along with reimbursement of legal expenses associated with the liquidation.

During our review, the involved parties did not make certain administrative and financial records available to us. Despite this limitation, we were able to gather sufficient evidence to allow us to arrive at a conclusion regarding loan servicing and certain items of the loan approval process. Furthermore, we cannot be certain that all discrepancies involving the subject loan

[12] Internal instructions attached to Rural Development Instruction 4287-B, section 4287.107, dated December 23, 1996.

transactions and the subsequent loan collateral liquidation have been identified.

Due to limitations on the scope of our review and the scope of participation by the Rural Development SO staff in the respective matters in question, we were unable to align negligence strictly with the lender. Therefore, we are not recommending recovery of the remaining $4.2 million of the loss.

The following items are those deficiencies that directly relate to the loan loss claimed by the lender in which actions, or lack thereof, by the Rural Development SO staff contributed to the amount of the overall loss paid to the lender. We evaluated the available documentation of actions taken by the SO staff and conducted subsequent discussions with staff members about the facts of each action.

A. Overvalued Loan Collateral Used At Loan Closing

The loan appraisal, dated May 30, 1998, for the initial loan disbursement to the borrower, valued proposed collateral property at $5.3 million. Another appraisal we obtained of the same collateral, which was performed on February 24, 1998, for a $3 million B&I loan to corporation A through another bank, valued the same property at $3.4 million, a disparity of $1.9 million. The Rural Development loan application file of corporation A for the $3 million loan had been destroyed. The bank, lender, and Rural Development SO staff could not provide us with a reasonable explanation for the withdrawal of corporation A's $3 million loan application. It had already been approved but was withdrawn in favor of the borrower's $9 million loan application, which was approved 2 days earlier using the same collateral (with only a few minor differences).

We know that two different appraisals for two different loans were performed about 3 months apart, arriving at a $1.9 million difference in valuation. However, no further details are currently known for these loans, either prior to or during this period. We associated this deficiency with a loan loss of $1.9 million, as shown in exhibit C.

B. Accounts Receivable Serving As Collateral Disposed Of Without Application To The Loan Balance

Collateral for the initial loan disbursement included about $2 million of accounts receivable with a balance of $1.4 million existing at liquidation. The borrower collected about $952,450 of such accounts receivable from loan closing through June 1999, when the borrower discontinued operations. Due to the fact that these account collections occurred during the 10-month life of the loan and constituted disposal of loan collateral without documented replacement of collateral of equal value, we believe such collections by the borrower should have been applied to loan principal. We believe the overall loan loss may have been reduced by $952,450 if the referenced accounts receivable collections had been applied to the loan balance. Thus, the amount of $952,450 is included in exhibit C as part of the $4.2 million loan loss being questioned.

C. <u>Accounts Receivable Disposed Of During Liquidation Were Not Applied to the Loan</u>

We found that $485,268 of accounts receivable was collected by the borrower and deposited to another bank during July and August 1999. Receivable collections prior to June 1999 had been deposited to an account at the lender. The borrower discontinued operations in June 1999 and sold the business to corporation B on September 3, 1999. Individual A had established the account at the other bank and, as CFO of corporation B as well as the borrower, directed the use of the funds for expenses of plant operations by corporation B. It should be noted that corporation B controlled the borrower's discontinued business operations during this period, although formal transfer did not occur until September 3, 1999. Since these proceeds were derived from an asset (accounts receivable) existing at the time that business operations discontinued, we believe the collections should have been applied to loan principal.

The questionable nature of allowing the borrower to collect on accounts receivable, after discontinuing business and allowing the proceeds to be utilized by corporation B, caused us to question the portion of the loan loss associated with this deficiency. The amount of $485,268 is included in the total of the loan loss we are questioning. (See exhibit C.)

D. <u>Accounts Receivable Balance At Liquidation Improperly Classified As Worthless</u>

Accounting records of the borrower were needed to determine the final disposition of accounts receivable serving as loan collateral. Corporation B received the $1.4 million in accounts receivable during liquidation with the lender classifying the accounts as "worthless." No value was placed on the accounts by the lender. Corporation B paid no compensation for the accounts. The accounts receivable were transferred to corporation B as part of the transfer of assets discussed in this report. Records we obtained from third parties show that at least a portion (about $324,000) of these receivables was indeed collected. The lender did not take control and collect on the accounts receivable itself, nor did the lender avail itself of the common business practice of selling the accounts receivable to a company that specializes in buying accounts receivable. The questionable circumstances involving the transfer of $1.4 million of accounts receivable to corporation B caused us to question this entire amount.

The borrower and lender did not account for the proceeds from the accounts receivable. Also, the SO staff did not require the borrower or the lender to account for the proceeds from such accounts. The lender had the responsibility to account for all loan collateral, such as the proceeds from the referenced accounts receivable. The SO staff could have prevented the loan loss resulting from this deficiency if they would have initiated specific control measures to ensure that the proceeds were applied to the loan balance. However, such controls were not pursued by the SO staff even when it was obvious, through the normal course of business, that the accounts were being collected by the borrower. The SO staff continues to believe that proceeds from accounts receivable serving as loan collateral did not need to be applied to the outstanding loan balance as it was collected. We believe that the loan loss could have been reduced by at least the amounts collected on the accounts receivable by the borrower. The lender's responsibility to account for loan collateral (the accounts receivable) was not fulfilled. Since the Rural Development SO staff had not adequately monitored the lender regarding the disposal of the collateral and subsequent use of the proceeds, we are questioning the $1.4 million.

E. <u>Borrower Shareholder Released From A Personal Guarantee</u>

Although very little information about the personal guarantor of the loan was submitted to the SO for evaluation, Rural Development authorized the lender to release the individual from his personal guarantee. This individual showed a net worth of over $3 million on his personal financial statement prior to loan closing, with over $200,000 in annual income. The individual also reported investment interests valued at $150,000 in two other business enterprises. The SO did not obtain any information about the nature of this individual's assets or income.

The release of this shareholder from his personal guarantee was recommended by the lender and accepted by Rural Development based solely on the nonverified personal financial information provided by the shareholder. Information in the loan file indicated the individual had some ability to pay on the loan, but the SO staff did not ask the lender for further information justifying the lender's request for the release. Although Rural Development instructions require that the lender and the agency must obtain and evaluate complete financial information before releasing a personal guarantee, this release was authorized with no verified financial data from the shareholder.

We concluded that any loan losses remaining after asset liquidation could have been recovered from the shareholder through action on the personal guarantee granted as part of the loan closing requirements. After considering the effects of the other monetary amounts discussed in this finding, and itemized in exhibit C, we concluded that the amount of $476,090 relates to the improper release of the shareholder from the personal guarantee. (See exhibit D.)

In summary, although program regulations provide that the lender has primary responsibilities for loan making and servicing, Rural Development functions in an oversight capacity ensuring that the lender fulfills those responsibilities. In this case, while it is apparent that the lender has not fulfilled the required responsibilities of a prudent lender, it is also apparent that Rural Development did not effectively monitor the loan approval process, the lender's servicing, and collateral liquidation actions. As a result, we are not recommending recovery of $4,202,835 of the loan guarantee.

Rural Development officials stated that a corrective action plan has been implemented to improve management of the B&I Guaranteed Loan Program in Louisiana.

RECOMMENDATION NO. 3

Provide documentation evidencing that the action plan has been implemented and has been sufficient to prevent similar problems identified in this report.

Agency Response

The RBS NO and the Louisiana SO believe that the current plan of increased staffing, education, and awareness of loan making/servicing issues is sufficient to prevent similar problems identified in this report. Specifically:

- RBS has increased underwriting awareness among loan specialists concerning receivables serving as collateral.

- RBS agreed to strengthen appraisal standards in its September 4, 2003, response to Audit Report No. 34601-15-Te. (Note: In the OIG Position for this report, we stated that the agency's response did not address the recommendation.)

- Louisiana SO has implemented a policy of "no consideration" for corporate or personal releases until all collateral is liquidated and the lender adequately documents the inability to collect in the form of a compromise settlement or through a deficiency judgment.

- In response to BPAR findings in 2003 for increased servicing, the Louisiana State Director increased the staff to a Program Director and four loan specialists.

- Also, at the national level, RBS now requires all loan specialists in every State to complete the CD-ROM-based "Analyzing Financial Statements," along with analyzing an applicant's financial statements using Moody's Financial Analyst software.

- In addition, the Louisiana SO periodically enrolls employees in commercial lender training courses offered by outside professional training sources.

See exhibit E for the agency's complete response to this recommendation.

<u>OIG Position</u>

We agree with the agency's actions. However, to reach management decision, we need timeframes for the implementation of the actions listed above in the agency's response. In addition, the agency needs to provide specific controls, procedures, or policies, including any associated records, documents, or forms that will be used to implement these corrective actions.

GENERAL COMMENTS

Our review found that the lender and Rural Development were remiss in their duties involving the subject loan. Due to limitations on the scope of our review and the nature of the items noted herein, we were unable to assign a specific dollar amount by which each deficiency may have contributed to the overall improper loan loss paid to the lender. Notwithstanding, Rural Development needs to consider, assess, and take action on, as appropriate, the following deficiencies to determine their individual and overall contribution to the loan loss.

- The lender relied on a May 30, 1998, appraisal to advance $5.3 million to the borrower based on limited 3 to 5 months of income and expense data, even though much more useful 2-year information should have been known to, and used by, the lender.

- The May 30, 1998, appraisal was based, in part, on a random sample of over 25 percent of the property shown on the purchase agreement. However, it did not identify the property inspected and the value of that property.

- The appraiser noted all equipment was in good to excellent condition. However, this proved to be inaccurate as the borrower reported, shortly after loan closing, that some equipment was in poor to nonfunctional condition.

- The SO staff's guidance to the lender was to develop a servicing action plan to address the allegations of whether corporation A owned the collateral that the borrower would purchase from corporation A and use as collateral for the loan. The lender did not take such actions nor did the SO request any information from the lender to ensure a proper servicing action plan was developed and implemented.

- The lender and the SO allowed one individual who had financial interests in both the seller (borrower) and buyer of the borrower's liquidated assets to negotiate the sale that resulted in $2,070,336 worth of assets being sold for $872,500.

- The SO authorized the lender to advance the borrower $1.3 million 3 months before liquidation. However, the borrower had incurred

$5.5 million in losses for the past 2 calendar years and had a negative equity position of $2 million. The borrower used stock as collateral for the advance. Neither the SO nor the lender validated the value of the stock. Based on the borrower's financial condition, the stock was worthless.

- Another corporation (corporation C) purchased a major portion of the borrower's assets at liquidation. The borrower chose corporation C without the lender's oversight. Corporation C refused our request for information to determine if the sale was at arm's-length. Corporation C bought $1,056,395 of the borrower's assets for $1.4 million.

- The lender and SO approved the borrower's rental of a manufacturing facility from a corporation owned by a relative of one of the borrower's owners. The relative was also on the lender's board of directors. The borrower paid for $1 million of improvements to his relative's facility. Since the borrower had little other revenue coming into the business, it is probable that guaranteed loan funds were used to pay for these improvements. The bankruptcy court trustee also questioned why these large expenditures, which occurred right before the borrower's default, were not otherwise used to resolve the borrower's financial problems.

EXHIBIT A– SUMMARY OF MONETARY RESULTS

FINDING NUMBER	RECOMMENDATION NUMBER	DESCRIPTION	AMOUNT	CATEGORY
1	1	Lender Did Not Adequately Service The Loan	$1,382,301 1/	Questioned Loan- Recovery Recommended
2	3	Agency Took Insufficient Actions To Oversee Lender's Activities	4,202,835 2/	Questioned Loan – No Recovery
		TOTAL	**$5,585,136**	

1/ See exhibit B for a detailed listing of the funds recommended for recovery.
2/ See exhibit C for a detailed listing of the funds not recommended for recovery.

EXHIBIT B – FUNDS TO BE RECOVERED

Based upon the findings in this report, we are recommending RBS recover loan guarantee payments from the lender. These are detailed in the following table:

FINDING NUMBER	DESCRIPTION	AMOUNT OF FUNDS QUESTIONED	AMOUNT TO BE RECOVERED (80% OF AMOUNT)
1A	Funds Disbursed Without Sufficient Collateral	$ 950,000	$ 60,000
1B	Borrower Did Not Have Title To Collateral (Paid For Mineral Rights That Had An Invalid Title)	284,617	227,693
1C	Accounts Receivable Payments Not Applied Against Loan Balance	119,195	95,356
1D	Lender Failed To Account For All Collateral During Liquidation	374,065	299,252
	TOTAL	**$1,727,877**	**$1,382,301**

EXHIBIT C – QUESTIONED FUNDS NOT RECOMMENDED FOR RECOVERY

Based upon findings during the review, we are not recommending that RBS recover certain loan guarantee payments already made to the lender. These items are detailed in the following schedule:

Description	Amount of Funds Questioned	Recovery Amount Not Recommended (80 Percent of Amount)
Overvalued Loan Collateral Used At Loan Closing	$1,900,000	$1,520,000
Accounts Receivable Serving As Collateral Disposed Of Without Application To The Loan Balance	952,450	761,960
Accounts Receivable Disposed Of During Liquidation Were Not Applied To The Loan	485,268	388,214
Accounts Receivable Balance At Liquidation Improperly Classified As Worthless	1,439,736	1,151,789
Individual B Improperly Released From Liability On Loan Guarantee *	476,090	380,872
Total	**$5,253,544**	**$4,202,835**

* See exhibit D for computation of loss attributed to these questioned funds.

EXHIBIT D – COMPUTATION OF LOAN LOSS ATTRIBUTED TO IMPROPER RELEASE OF A SHAREHOLDER FROM PERSONAL LIABILITY ON THE LOAN

DESCRIPTION	AMOUNT OF FUNDS QUESTIONED	GOVERNMENT GUARANTEE (80 PERCENT OF AMOUNT)
Amount Of Loss Questioned But Not Recommended For Recovery (See Exhibit C)	$5,253,544	$4,202,835
Less:		
Over-Valued Loan Collateral Used At Loan Closing	1,900,000	1,520,000
Accounts Receivable Serving As Collateral Disposed Of Without Application To The Loan Balance	952,450	761,960
Accounts Receivable Disposed Of During Liquidation Were Not Applied To The Loan	485,268	388,214
Accounts Receivable Balance At Liquidation Improperly Classified As Worthless	1,439,736	1,151,789
Total Amount Of Loss Attributed To Improper Release Of Shareholder	**$ 476,090**	**$ 380,872**

EXHIBIT E – AGENCY RESPONSE TO DRAFT REPORT

USDA

United States Department of Agriculture
Rural Development

SEP 25 2003

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

SUBJECT: Rural Business-Cooperative Service
Requested Audit of B&I Guaranteed Loan - Moon Ventures, LLC
Audit Number 34099-5-TE

TO: John M. Purcell
Director,
Financial Management Division

This is in response to the official draft findings and recommendations of the above-captioned audit dated September 4, 2003.

Rural Business-Cooperative Service (RBS) and Rural Development Louisiana believe it is important to note some factors not explicitly discussed in the audit. First, the oil and gas business is a substantial economic factor in rural Louisiana, and it is a highly volatile industry reflective of and the victim of global financial and economic conditions. When world-wide prices of crude are high all the associated sectors and the related financial institutions benefit, and the contrary is true. Second, during the liquidation process much of the negotiations regarding accounts receivable sales were not within our control as the Bankruptcy Court held precedence. Last, third parties not involved in a Business and Industry (B&I) Guaranteed Loan are not obligated to open their records to auditors.

Our response to each of the Recommendations is as follows:

Recommendation No. 1:

In consultation with Office of the General Counsel (OGC) recover $1,382,301 of the loan loss guarantee paid to the lender.

Response:

Finding No. 1 indicates the lender did not properly approve, service, or liquidate the $9 million B&I Loan that was approved for the borrower. The report asserts the lender failed to ensure that: (1) the loan was fully secured prior to loan approval and issuance of loan funds, (2) proceeds from the collection of accounts receivable were applied to the loan or used to purchase replacement collateral, and (3) sufficient documentation was available to show the disposition of all assets.

Many of these findings listed in the report as (A-D) were addressed in previous meetings held with the lender, the lender's counsel, Louisiana B&I Program Director, and Office of Inspector General (OIG) Auditor. The results of the meetings and conversations were further summarized in an April 9, 2002, letter to OIG from the lender's counsel. The letter clearly responds to each item of concern, which are virtually the same items listed in the report.

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Secretary of Agriculture, Washington, DC 20250

received
9/25/03

Item (A) in Finding No. 1, indicates loan funds totaling $6.2 million were disbursed without sufficient collateral. This is not the case. It is true that items on the appraisal list were erroneously there; however, other items purchased with the same value had not been included in that appraisal. The lender's counsel previously documented that shortly after the time of closing, the borrower learned that the collateral in question was not owned by the seller, but two unrelated entities. The borrower negotiated the purchase of that collateral for $914,000 and simultaneously, the lender agreed to fund a total of $950,000 for both working capital and the purchase of this collateral. At the time, October, 1998, this new collateral held an appraised value of approximately $1,032,900. The lender's counsel documents in the April 9, 2002, letter that the original sale included items that were not listed on the funding appraisal and those items totaled approximately $1,009,770. Therefore, the lender asserts, and RBS concurs, they did not over fund or disburse without sufficient collateral. This action restored the collateral identified for the $5.3 million advance, and as documented, also secured the $950,000 advance.

Additionally, Finding 1, Item A, indicates the lender advanced funds using an appraisal that overstated the total value by $1,032,900. This restates the same fact pattern discussed above. The appraisal included assets (equipment and portable buildings) that were not included in the transfer of assets and therefore, not considered collateral for the initial loan disbursement. The lender recognizes this fact and documents that additional collateral, not listed in the original funding appraisal, was taken as security. The lender's legal counsel documents in their letter dated April 9, 2002, that the initial advance was adequately secured without this equipment and portable buildings.

The report mentions that the lender provided the borrower a subsequent loan advance to purchase collateral used to justify the first loan advance. Again, this is the same issue and fact pattern discussed above and in lender's legal counsel letter of April 2, 2001. The lender previously documented the discovery of the appraisal error but indicated that the advance was adequately collateralized with additional equipment listed on the sale agreement but not listed on the funding appraisal. The lender documents the value of the additional collateral at the time of funding was $1,009,770. This amount covered the discrepancy in the appraisal versus the sales agreement.

Item (B) in Finding No. 1 asserts the lender did not have correct title to collateral. The lender advanced additional working capital funds for which the lender required additional collateral in the form of mineral interests owned by the majority owner of the borrower.

The lender provided a letter dated December 4, 1998, to Louisiana requesting concurrence in advancing $400,000 for working capital needs specifically secured by a first lien priority in mineral interests. The letter provided an attachment with an addendum indicating the mineral interests had a value of $525,000. The lender documented that the loan was adequately collateralized after proper discounting factors were applied. The bank asserts that the $525,000 was never estimated by the bank, but merely a value the debtor expressed. Whatever the case, Louisiana concurred in the advance with the assumption that the advance was properly secured. Upon liquidation, RBS required the lender to obtain a mineral valuation to be included in the liquidation plan. The lender provided an appraisal indicating a value of $115,383. The lender later determined they did not have a proper lien due to the fact that the debtor's spouse did not sign the lien instrument. Louisiana requested the lender to pursue collection from the closing agent and the lender declined to do so. Louisiana advised the loss claim would be reduced by the value of the minerals due to the lender failing to obtain proper lien position. The lender appealed and Louisiana was upheld. The lender then requested a review of the hearing officer's decision which was ultimately upheld. We will pursue this loss claim. The audit states the lender should pay back the *prorata* share on the difference in the amount advanced and the appraised value. Had the lender pursued the collection from the closing agent, it would have been for only the appraised value of the minerals at time of liquidation.

Item (C) in Finding No. 1, indicates the lender did not require the borrower to apply monies collected from accounts receivable (included in the loan collateral) against the outstanding loan balance or to buy replacement collateral of an equal value. The report mentions that a working capital advance in the amount of $119,195 was made secured by $148,994 in accounts receivable due on a $445,982 contract to construct portable buildings for a petroleum company. The borrower collected the receivables and deposited the funds in their primary checking account instead of reducing the loan balance or buying replacement collateral. As mentioned in previous responses, this action was an approved use of funds and considered permanent working capital financing. Working capital generally includes the use of funds to create and then liquidate receivables in an on-going fashion. Working capital funds were unrestricted and did not require the lender to collect receivable payments through a lock box system or otherwise direct the application of those funds. As stated by the lender's previous response, the working capital funds were not considered a revolving line of credit, wherein all payments are deposited in a lock box and paid on the line of credit. The funds were used in on-going operations which include generating and liquidating receivables as well as other operational activities.

As a result of this finding and the risk involved in advancing working capital funds on loans partially secured by accounts receivable, RD Louisiana will create specific language in all new conditional commitments. This language will direct a loan covenant requiring a certain dollar level of performing receivables if receivables are included in collateral. Also, as RBS stated in our September 4, 2003, response to Audit Report No. 34601-15-TE, RBS issued an unnumbered letter, "Business and Industry Guaranteed Loan Program Appraisals and Appraisal Review Checklist,"on November 14, 2002. RBS is also in the process of issuing an AN to clarify the intent of our appraisal regulations. Both documents address the necessity of adequate discounting and control of various collateral categories but were not in force when the subject loan guarantee was issued.

Item (D) in Finding No. 1 indicates the lender failed to account for all collateral during liquidation. Louisiana and RBS agree with the audit finding in that several items were not accounted for during and after the liquidation. At a minimum, additional documentation is needed to reconcile the differences in the description of collateral at loan approval versus liquidation. RBS will consult with Office of the General Counsel (OGC) to determine if collection, as recommended, is warranted and defensible.

RBS and Louisiana will consult with OGC to determine if we have sufficient legal basis for the lender to repay $1,382,301, or the appropriate amount (based on reconciliation referenced above) of the loan loss guarantee that is legally recoverable. We request management decision.

Recommendation No. 2:

Evaluate the lender's past and current participation in USDA loan programs. Determine if the lender's participation shows a pattern of negligence.

Response:

As mentioned in previous correspondence, the lender currently holds four outstanding loan note guarantees. This includes the borrower's credit. Of the four loan note guarantees, three are paying as agreed and considered current. The only delinquent account is the borrower addressed in the audit.

According to the historical data, the lender faced losses with six B&I accounts in the early to mid-1980s. The accounts were primarily oil and gas service companies and an agricultural implement manufacturer. Both industries were severely depressed during this time frame. The losses totaled $3,284,499.59. The loan officer handling the account addressed in this audit was not employed with the lender during the time of the previous losses mentioned.

The lender had kept Louisiana informed throughout the current liquidation process. Although several items of concern are noted in the audit, neither Louisiana nor RBS recognize a pattern of negligence by the lender regarding accounts presently in the RBS portfolio. Additionally, the lender participates on a large scale in the USDA/Farm Services Agency(FSA) guaranteed loan programs. According to the FSA State Office, the lender is granted Certified Lender Program (CLP) status. As a CLP lender, abbreviated applications are acceptable. However, in an effort to present all information up front, the lender provides FSA applications as a standard eligible lender. The lender maintains a low loss rate and must maintain less than a seven percent loss rate to remain a CLP lender. According to FSA, the lender performs in a satisfactory manner and is considered a valued partner in the FSA guaranteed loan program. We have previously shared with OIG the FSA report.

Rural Development has, as indicated above, thoroughly evaluated the lender's past and current participation in loan programs, including those associated with FSA. We have determined the lender's participation shows no pattern of negligence. We request management decision and final action.

Recommendation No. 3

Provide documentation evidencing that the action plan has been implemented and has been sufficient to prevent similar problems identified in this report.

Response:

Item A of Finding No. 2 implies Louisiana contributed to the amount of the overall loss due allowing an over-valued appraisal to determine collateral values at loan closing. Neither the lender nor Louisiana had a reason to question this appraisal, as it clearly met all requirements of RD Instruction 4279-B, paragraph 4279.144, specifically where it states, "Chattels will be evaluated in accordance with normal banking practices and generally accepted methods of determining value." Louisiana recognizes that the regulation was subsequently clarified by an administrative notice. However, this notice was not in effect at the time of this Loan Note Guarantee request.

Even though OIG did not request a "reasonable explanation" for the withdrawal of a $ 3 million loan conditional commitment by another business, Corporation A, the audit inexplicably states that no explanation was provided. Further, at the time of the subject audit Louisiana no longer had records regarding that commitment, nor was the State Office obligated to have those records as the files had been destroyed 25 months after the application was withdrawn in accordance wit RD Instruction 2033-A, paragraph 2033-A, paragraph 2033 10(b)(4)(iii).

The audit states that the loan for Corporation A was approved in the amount of $3,000,000. We believe that after the loan was approved and obligated, Corporation A decided to sell the business to the borrower. Corporation A and their lender decided to hold the conditional commitment, within allowed time frames, until after the sale of the business seemed certain. Apparently, when Corporation A determined that the sale would be consummated, Corporation A and the lender requested to withdraw the application. This would appear to be a reasonable business decision and nothing more.

Items B, C, and D of Finding No. 2, indicate the need to closely evaluate collection efforts and servicing actions related to accounts receivable serving as primary collateral. The lender advanced working capital funds according to the conditional commitment. RBS acknowledges the need to strengthen controls to maintain an adequate level of accounts receivable serving as collateral. RBS acknowledges the risk of this type of collateral and has increased underwriting awareness among loan specialists concerning receivables serving as collateral as stated in our discussion above. Further, we have previously agreed to strengthened appraisal standards and application standards as outlined in our response to Audit Report No. 34601-15-TE, September 4, 2003.

Item A of Finding No. 2 implies that Louisiana should not have released a borrower shareholder from a personal guarantee. As mentioned before, the lender provided the necessary documentation and requests to render a decision. The request by the borrower and recommendation by the lender was reviewed and concurred upon by the then RBS Acting Administrator, Washington, DC, and the Office of General Counsel (OGC).

However, because of this finding and increased efforts to reduce such concerns, Louisiana has implemented a policy of "no consideration" for corporate or personal releases until all collateral is liquidated and the lender adequately documents the inability to collect in the form of a compromise settlement or through a deficiency judgment.

The need for increased servicing was acknowledged and documented in the Business Programs Assessment Review (BPAR) in 2003. In response to these findings, the Louisiana State Director increased the staff to a Program Director and four Loan Specialists. The increased awareness of underwriting and servicing is evident in the movement of delinquent loan resolutions and the reduction of obligations.

Also, at the national level, RBS now requires all Loan Specialists in every state to complete the CD-ROM-based "Analyzing Financial Statements," developed by the American Bankers Association and Rural Development, along with analyzing an applicant's financial statements using Moody's Financial Analyst software. In addition, Rural Development Louisiana periodically enrolls employees in commercial lender training courses offered by outside professional training sources. Louisiana continues to provide training to lenders and recently provided state-wide training to interested lenders and the Office of Financial Institution (OFI).

Louisiana has recognized and implemented a policy of a more detailed and stringent analysis and underwriting process. As currently instituted, this policy has decreased the actual loan production in both numbers and dollars of guaranteed loans. Rural Development Louisiana is carrying out an aggressive outreach and training program with lenders and packagers to better educate them on the quality of loan packages and of the loans expected. This will result in long term improvement in the future portfolio, resulting in fewer delinquencies and smaller losses when problems do occur. It is also anticipated that when our customers do become more familiar with our requirements that loan volume will increase, with corresponding decreases in processing time and in servicing issues that must be dealt with.

In summary, both RBS and Louisiana believe that the current plan of increased staffing, education and awareness of loan making/servicing issues are sufficient to prevent similar problems identified in this report and request management decision and final action.

If you have any questions or concerns, please contact Dwight Carmon, Director, Special Projects/Programs/Oversight Division, 690-4100.

John Rosso

JOHN ROSSO
Administrator
Rural Business-Cooperative Service

Attachment: Counsel letter dated April 9, 2002

Pages 31 - 36 [redacted]