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Southwest Region

Audit Report

Rural Business-Cooperative Service Request Audit of Business and Industry Loan in Arkansas

Report No. 34099-6-Te
JULY 2003

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

DATE: July 29, 2003

REPLY TO
ATTN OF: 34099-6-Te

SUBJECT: Rural Business-Cooperative Service, Request Audit of
Business and Industry Loan in Arkansas

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 Business and Industry guaranteed loan in Arkansas. Rural Business-Cooperative Service's response to the official draft, dated July 11, 2003, is included in its entirety as exhibit D with excerpts and the Office of Inspector General's position incorporated into the relevant sections of the report.

Management decision has been reached for the recommendation in this report. In accordance with Departmental Regulation 1720-1, final action should be taken within 1 year of the management decision. Please follow your agency's internal procedures in forwarding documentation concerning final action to the Office of the Chief Financial Officer, Director, Planning and Accountability Division (OCFO/PAD).

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

Rural Business-Cooperative Service Request Audit of Business and Industry Loan in Arkansas (Audit Report No. 34099-6-Te)

Results in Brief

At the request of the Rural Business-Cooperative Service (RBS), we initiated an audit of nine Business and Industry (B&I) guaranteed loans made to a tomato cooperative in the State of Arkansas. The borrower's nine loans totaled $9,604,860 and had a 90-percent B&I guarantee. The RBS Administrator requested our assistance due to irregularities in the lender's loan making and servicing of the B&I guaranteed loans.

The B&I guarantee consisted of three phases with three loans in each phase. The Arkansas Rural Development State Office (SO) approved the first two phases. The RBS National Office (NO) approved the third phase because the borrower's entire loan package had exceeded $5 million. RBS' total 90-percent guarantee for all nine loans was $8,644,374 ($9,604,860 x 90 percent). The nine loans were classified as delinquent as of May 12, 2001. The borrower defaulted, resulting in a potential liability to RBS of $7,441,724 ($6,993,578 remaining guarantee plus $448,146 accrued interest). The lender has filed a final loss claim.

We found that the lender misrepresented key financial information and inadequately serviced the loans. The lender's actions contributed to the ultimate failure of the cooperative. Specifically, we found that the lender:

- Processed guaranteed loans to an ineligible borrower,
- allowed the borrower to use guaranteed funds to pay delinquent Federal debt,
- allowed the borrower to use guaranteed loan funds for unauthorized purposes,
- failed to adequately supervise the construction of the borrower's facilities, and
- allowed the borrower to divert working capital away from the cooperative.

Rural Development instructions provide that lenders are responsible for making and servicing the entire loan package and for taking all servicing actions that a prudent lender would perform in 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 violation of usury laws, use of loan funds for unauthorized purposes, misrepresentation, fraud, or failure

to obtain the required security, regardless of the time at which the agency acquires knowledge of the foregoing. The loan note guarantee may be reduced for the lender's negligent servicing.

Recommendation In Brief

After consultation with the Office of the General Counsel (OGC), take action to contest the guarantees, or substantially reduce the remaining balance of the loan note guarantees totaling $6,993,578.

Agency Response

The NO and the SO concur with this recommendation. On or before August 31, 2003, after consultation with the NO and OGC, the SO will advise the lender that the loan note guarantees will be unenforceable or substantially reduced. A management decision is requested for this recommendation. Closure will be requested upon receipt of a copy of the notification to the lender.

OIG Position

We agree with the management decision for the recommendation in this report. For final action, RBS needs to provide OCFO/PAD documentation that the lender has been notified the guarantee will be unenforceable, or the amount by which the guarantee will be reduced.

Abbreviations Used in This Report

BOD	Board of Directors
B&I	Business and Industry
CFR	Code of Federal Regulations
FDIC	Federal Deposit Insurance Corporation
NO	National Office
OGC	Office of the General Counsel
RBS	Rural Business-Cooperative Service
SO	State Office
USDA	United States Department of Agriculture

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Background and Objectives

Background

RBS, an agency within the United States Department of Agriculture's (USDA) Rural Development mission area, operates loan programs that are intended to assist in the business development of the nation's rural areas and the employment of rural residents. 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. This purpose is achieved by bolstering the existing private-credit structure through the guarantee of quality loans, which will provide lasting community benefits. It is not intended that the guarantee authority will be used for marginal or substandard loans or for relief of lenders having such loans.

To achieve the mission, the agency guarantees loans made by private lenders. A lender would provide the loan to the borrower, and Rural Development would guarantee repayment of a percentage of the loan in the event the borrower defaulted. The guarantee would allow the lender to have additional capital available for other loans.

Rural Development guarantees a maximum of 80 percent of loans $5 million or less, 70 percent of loans between $5 million and $10 million, and 60 percent of loans exceeding $10 million. Loan guarantees exceeding maximum percentages require the concurrence of the RBS Administrator.

Once approved for a guaranteed loan, the lender and borrower enter into and sign a conditional commitment with Rural Development. The conditional commitment outlines the terms and conditions of the guaranteed loan and contains those provisions that the lender and borrower agree to perform.

The lender then submits a lender's certification, which certifies that the provisions contained in the conditional commitment have been or will be met. It also certifies that no major changes have been made in the loan's conditions and requirements, and that any construction has been or will be completed in accordance with plans and specifications.

Once the lender's certification is obtained, Rural Development issues the loan agreement, signed by the lender and the borrower, which mirrors the conditional commitment and contains the loan conditions and requirements. When the lender and borrower notify Rural Development that they have completed the requirements of the conditional commitment, Rural Development will issue the loan note guarantee. Only when Rural Development issues the loan note guarantee does the lender actually have the Government-backed guarantee.

The lender issued nine loans to the borrower totaling $9,604,860 with a 90-percent B&I guarantee. The lender obtained a waiver of the maximum 80 percent that RBS can guarantee from the RBS Administrator. The B&I guaranteed loans were committed to by Rural Development over a 2-year period on three separate occasions, called phases. Each phase consisted of three loans with one loan for real estate purchase, one for machinery and equipment, and one for working capital. Rural Development issued the conditional commitments as follows:

- Phase I: March 20, 1998, for $3,000,000
- Phase II: March 22, 1999, for $1,850,000
- Phase III: December 21, 1999, for $4,754,860

In all three phases, the lender certified that all conditions in the conditional commitments had been met resulting in Rural Development's approval of the loan note guarantees.

The purpose of the guaranteed loans was to help establish and assist a tomato cooperative in Arkansas. The formation of a cooperative is intended to benefit local farms by having them band together so that they can buy and sell at better prices. The cooperative also allows the members to compete for markets that individually they would not be able to, and have access to the resources of the cooperative such as industry contacts and financial expertise.

Rural Development instructions[1] provide that lenders are responsible for servicing the entire loan and for taking all servicing actions that a prudent lender would perform in servicing its own portfolio of loans that are not guaranteed. Lenders are responsible for notifying RBS officials of any violations of lenders' loan agreements. The loan note guarantee may be voided for lender misrepresentation or fraud, and may be reduced due to lender negligence.[2]

Objectives

Our objectives were to determine if the lender properly made and serviced the B&I guaranteed loans, the lender timely submitted required documents to RBS, loan proceeds were used as specified in the loan agreements, and the quality of lender's loan servicing contributed to the borrower's delinquency and eventual failure.

To accomplish our objectives, we reviewed loan records at the NO, the SO, and at the lender's office. We interviewed NO and SO staff, the lender, the lender's board of directors (BOD), the borrower, and the borrower's law firm.

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[1] Title 7, Code of Federal Regulations (CFR), sections 4279(2) and 4279.30(a).
[2] Title 7, CFR, section 4279.72(a).

We also reviewed records and interviewed staff at the certified public accounting firm (accounting firm) with which the lender had contracted to review the failed cooperative.

The borrower did not comply with key provisions of the guaranteed loan documents. This occurred because the lender did not adequately monitor the financial activities of the borrower and did not enforce required provisions of the loan guarantee. In addition, we found that the lender misrepresented to the agency that key provisions of the loan agreements had been met. As a result, the agency approved an additional $4.7 million in loan guarantees for the borrower. Subsequent to receiving these additional loan funds, the borrower defaulted on the entire loan package of over $9 million, resulting in a potential liability to the Government of $7,441,724 ($6,993,578 remaining guarantee plus $448,146 accrued interest).

Title 7, CFR, section 4279.30(a)(1), states that lenders have the primary responsibility for the B&I Guaranteed Loan Program. All lenders obtaining or requesting a B&I loan guarantee are responsible for:

- Obtaining valid evidence of debt and collateral in accordance with sound lending practices,
- distributing loan funds,
- supervising construction,
- following Rural Development regulations, and
- obtaining Rural Development approvals or concurrences as required.

The guarantee constitutes an obligation supported by the full faith and credit of the United States and is incontestable except for fraud or misrepresentation. The amount of the loan note guarantee may be reduced up to the amount of damages suffered by the Government for lender negligence.

We found that the lender misrepresented key financial information and inadequately serviced the loan. The lender's actions contributed to the ultimate failure of the cooperative. Specifically, we found that the lender:

- Processed guaranteed loans to an ineligible borrower,
- allowed the borrower to use guaranteed funds to pay delinquent Federal debt,
- allowed the borrower to use guaranteed loan funds for unauthorized purposes,
- failed to adequately supervise the construction of the borrower's facilities, and
- allowed the borrower to divert funds away from the cooperative.

We found that the lender's BOD allowed its president to make and service the guaranteed loans without the BOD's oversight and supervision. We found the BOD's failure to supervise its president significantly contributed to the deficiencies detailed in this report. Federal Deposit Insurance Corporation (FDIC) guidance states that a BOD that routinely approves the decisions of its president without exercising its own informed judgment is not adequately serving its institutions, stockholders, or communities.

Finding 1 Lender Processed Guaranteed Loans to an Ineligible Borrower

The lender did not adhere to its responsibilities as a participant in the RBS B&I Guaranteed Loan Program. This occurred because the lender's BOD failed to supervise its president's[3] processing of the Phase III guaranteed loans. As a result, an ineligible borrower received $4.7 million in guaranteed loans.

The Debt Collection Improvement Act of 1996[4] states that borrowers with delinquent Federal debt may not obtain additional Federal assistance in the form of loans or loan guarantees. Title 31, CFR, section 285.13(d), allows agencies to establish their own timeframes for defining when a loan, or guaranteed loan, is delinquent. RBS' policy is that a loan or guaranteed loan is delinquent when it is 30 days past due. Office of Management and Budget Circular A-129, section III, states that lenders in guaranteed loan programs should determine whether applicants for guaranteed loans comply with statutory, regulatory, and administrative eligibility requirements for loan assistance.

On November 12, 1999, the borrower became delinquent on three guaranteed loans it had received from the lender during Phases I and II. The amount of the delinquent Federal debt was $447,701. The agency advised the lender that the delinquent guaranteed loans had to be paid current before the borrower's Phase III request for an additional $4.7 million in guaranteed loans could be approved.

In a letter to the agency dated December 13, 1999, the lender wrote that the borrower had made arrangements to resolve the delinquent guaranteed loans within the next few days. The letter did not explain to the agency what types of arrangements the borrower had made. Agency officials said that they believed the money would come from the collection of accounts receivable carried on the borrower's books.

[3] The lender's president refused our request for an interview.
[4] Title 31, United States Code, section 3720B.

The agency received a telephone call on December 15, 1999, from the lender's president stating that the delinquency totaling $447,401 had been paid current. The agency made the following notation on the lender's December 13, 1999, letter: "Loan paid current therefore did not enter a [delinquency] report." Based on the lender's certification that the borrower's delinquent guaranteed loans were current, the agency approved the lender's conditional commitment for $4.7 million in guaranteed loans on December 21, 1999.

We found that the delinquent guaranteed loans were not current as of December 21, 1999. On December 22, 1999, the borrower paid $447,701 to the lender to bring the delinquent guaranteed loans current. Therefore, the lender misrepresented in the December 15, 1999, telephone call to the agency that the delinquent guaranteed loans had been brought current. The agency told us that if it had known that the borrower was still delinquent, it would not have approved the guaranteed loans.

The closeness (1 day) between the agency approval of the conditional commitment and the day the borrower paid the delinquent guaranteed loans is not a coincidence. The borrower and lender developed a scheme to use the Phase III guaranteed loans to pay the delinquent Federal debt. (See Finding 2.)

The BOD stated that it relied fully on its president's trustworthiness to ensure that the borrower's delinquent Federal debt had been paid. The BOD stated that its president had not informed it that the borrower was delinquent on Federal debt when the Phase III guaranteed loans were approved. We concluded that the lender's BOD did not adequately supervise the actions of its president. Although FDIC policy requires that the BOD monitor the activities of its president and of the progress of its loans, it failed to do so. For example:

- Unlike the Phase I and Phase II loans, the BOD never approved the Phase III loans.

- Unlike the Phase I and Phase II loans, there were no BOD minutes for the Phase III loans where the BOD voted on and passed a motion to approve the loans.

- Although the BOD required and obtained an assessment of the risk of the Phase I and Phase II guaranteed loans, the lender was unable to provide documentation that the lender had assessed the risk of the Phase III loans.

Under the B&I Guaranteed Loan Program, it is the lender's responsibility to ensure that borrowers comply with all program requirements. Ensuring that borrowers are current on all Federal debt prior to processing additional Federal loans or loan guarantees is one of those requirements.

Finding 2 Method Used To Conceal Delinquent Federal Debt

The lender and borrower devised a methodology that gave a false appearance that the borrower was current on delinquent Federal debt. The method was devised because the agency would not approve the borrower's request for additional guaranteed loans until the borrower's delinquencies were paid current. Since the borrower did not have sufficient funds in its checking account to pay its delinquencies, it created a scheme that gave the appearance that the checking account did have sufficient funds to pay the delinquencies. As a result, the agency approved the request for an additional $4.7 million in guaranteed loans. The borrower used the newly obtained loan proceeds to replenish its cash reserve and to pay off the delinquent Federal debt.

Regulations[5] allow subsequent loan guarantees to be used to pay delinquent guaranteed loans, but only if approved by the agency. The lender never requested nor received approval from the agency to use the newly obtained guaranteed loan funds to pay delinquent Federal debt.

To analyze the methodology, we determined when and how the delinquent Federal debt had been resolved. We reviewed the borrower's bank statements, deposit slips, and checks used to pay off the delinquent guaranteed loans. We found that out of the borrower's total delinquency of $447,701, $252,797 had been paid off using the newly obtained guaranteed loan funds.

On December 20, 1999, the borrower's checking account balance was $9,467. On that same day, the borrower wrote a check for $252,797 that would be used to pay off some of the delinquent guaranteed loans. Therefore, the borrower wrote the $252,797 check to resolve some of its delinquencies knowing that it did not have sufficient funds in its checking account to cover the check. Instead of debiting the check to the borrower's account, the lender credited the account with the $252,797 check. The lender credited the borrower's account rather than debit it based on the method used by the lender and borrower to give the checking account the appearance that it had sufficient funds to pay the delinquent Federal debt. (See exhibit B.)

[5] Title 7, CFR, section 4287.145(b)(1)(vii).

On December 20, 1999, the borrower made out the $252,797 check to a member farm. A relative of the borrower's president owned the member farm, and the check was for the member farm's 1999 tomato crop. The member farm signed over the check to the borrower's law firm. The borrower's law firm wrote a check dated December 22, 1999, sending the $252,797 back to the borrower with the intention that it would be used to pay off the delinquent guaranteed loans. In effect, the member farm was not paid for its 1999 tomato crop. When we asked the attorney at the borrower's law firm why the borrower just did not keep the $252,797 and use it to pay the delinquencies, the attorney had no explanation other than the member farm wanted a "paper trail."

Based on the belief that the borrower was current on Federal debt, the agency approved the conditional commitment for the guaranteed loan funds on December 21, 1999. On December 22, 1999, the borrower received its first installment of guaranteed loan proceeds totaling $700,000. The lender used $252,797 of these funds to pay its delinquent Federal debt.

Paying off delinquent Federal debt was not an approved use of the guaranteed loan proceeds, and it reduced the working capital available to the cooperative. (See Finding 3.) It was the lender's responsibility to ensure that the borrower had adhered to the conditional commitment. If the lender had acted prudently, it would have ensured that the borrower's delinquent Federal debt was made current prior to allowing the borrower to obtain additional guaranteed loans.

Finding 3 Unauthorized Use of Guaranteed Loan Funds

The lender did not adhere to the provisions of the conditional commitment that was signed and agreed to by both the lender and borrower. This occurred because the lender's BOD failed to supervise its president's actions during the processing of the Phase III guaranteed loans. As a result, $450,000 of guaranteed loan proceeds was used for unauthorized purposes.

Title 7, CFR, section 4279.173, requires that the conditional commitment list the authorized guaranteed loan purposes. The conditional commitment for the Phase III loans detailed how loan proceeds were to be used:

Real Estate Improvements	$1,540,620
Machinery & Equipment	778,240
Working Capital	2,436,000
	$4,754,860

The conditional commitment could have included debt refinancing if the lender had made the request and the agency had approved it. However, the lender never made a request to the agency that guaranteed loan proceeds be used to refinance the borrower's debt.

By analyzing the borrower's checking account statement and other pertinent records, we concluded that guaranteed loan proceeds were used for refinancing of borrower debt. On December 21, 1999, the borrower obtained two personal loans totaling $450,480. The personal loans came from two sources: (1) $150,480 from a local company, and (2) $300,000 from the trust account of the borrower's law firm.

We attempted to determine if there were any official records that documented the two personal loans. We found no record of the borrower's personal loans in the agency records. The agency stated that the lender did not notify them that the borrower planned to use the guaranteed proceeds to pay back its personal loans. We asked the law firm and the borrower if there were any loan documents, agreements, or records to support the personal loans. The law firm had no loan records except for its bank statements.[6] The borrower responded that there were no loan documents besides the checks and deposit slips. The borrower added that the two loans were "bridge" loans.[7]

The borrower repaid the two personal loans using guaranteed loan proceeds as shown below:

- $150,000[8] to the local company on December 30, 1999, and
- $300,000 to the trust account of the borrower's law firm on February 10, 2000 (the February 10, 2000, check used to pay back its law firm had "loan repayment" written on it).

The agency based its approval of the guaranteed loans on the loan purposes specified in the conditional commitment. The agency may have changed its decision to approve the conditional commitment had it known that the lender planned to deviate from the conditions in the conditional commitment. The use of the $450,000 for debt refinancing made less funds available for use in paying the borrower's operating expenses. Subsequently, in a January 3, 2001, letter to the agency, the lender certified that guaranteed loan funds were not used to refinance borrower debt.

The BOD told us that it was initially unaware that any guaranteed loan proceeds were used for unauthorized purposes because its president never

[6] The law firm has yet to provide its bank statements to us.
[7] "Bridge" loans basically provide borrowers with interim financing until the borrowers can obtain permanent funding for their needs.
[8] Neither the lender nor the borrower could explain the $480 difference between the $150,480 loan and the $150,000 repayment of the loan.

informed them of the unauthorized use. The BOD became aware of the unauthorized use when the lender hired an accounting firm to review the borrower's use of guaranteed loan proceeds. It is the lender's responsibility to report to the agency any changes in the conditional commitment.

We found that the BOD:

- Did not ensure that guaranteed loan funds were used only for authorized purposes,
- failed to inform the agency of the changes to the use of guaranteed loan funds for the borrower's debt refinancing, and
- falsely represented to the agency that guaranteed loan proceeds were not used to refinance borrower debt.

Had the BOD properly supervised its president and monitored the borrower's expenditures, the lender could have prevented the unauthorized use of guaranteed loan funds.

Finding 4 Lender Inadequately Monitored Construction of the Borrower's Facilities

The construction of the borrower's facilities was not completed as approved by the agency. This occurred because the lender inadequately monitored the construction of the borrower's facilities and failed to notify the agency of the construction changes. As a result, the agency based its approval of the guaranteed loans on inaccurate information and was unable to assess whether the changes to the approved construction diminished the project's chances of success.

Title 7, CFR, sections 4279.30(a), 4279.156(b), and 4279.181(a), require lenders to approve construction plans and specifications, supervise and monitor the progress of construction, conduct inspections, and document and report any changes to the approved construction plans.

Our review found that the construction of the borrower's facilities was not in accordance with the construction sizes approved by the agency. The following table compares the differences between the construction sizes approved by the agency and the actual construction sizes built by the borrower.

Item Built	Approved Size[9]	Actual Size[10]	Difference[11]
Convenience Store	4,000 sq/ft	3,075 sq/ft	- 925 sq/ft
Farm Supply Store	22,000 sq/ft	32,120 sq/ft	10,120 sq/ft
Paved Parking Lot	17,000 sq/ft	4,000 sq/ft	-13,000 sq/ft

Table 1

The lender did not ensure that the borrower's construction plans and specifications were in accordance with the construction approved by the agency. The lender also failed to adequately monitor and supervise the construction and did not notify the agency of the construction differences.

We found that the lender did not adequately monitor the plans and construction of the borrower's facilities. The lender also failed to notify the agency of the differences between the construction sizes approved by the agency and the actual construction sizes.

Construction Plans and Specifications

The construction plans and specifications document the materials, measurements, layout, and sizes of the proposed construction. The borrower's construction plans and specifications must be in agreement with the materials, measurements, layout, and sizes that were approved by the agency.

We met with architects and an engineer from the NO who informed us that the lender should approve construction plans and specifications before the construction begins. We asked the lender if it had reviewed and approved the borrower's construction plans and specifications. The lender stated that its files did not have any records that the plans and specifications were ever received, reviewed, or approved by the lender prior to or during construction.

The lender told us that it did not find out about the construction differences until May 2002. The lender received the liquidation appraisal report in May 2002, and it identified the construction differences. Once the lender learned of the construction differences, it requested the construction plans and specifications from the borrower. The lender told us the borrower only provided the construction plan for the convenience store. The construction plan was dated March 2000.

[9] Approved construction sizes are documented in the lender's December 10, 1999, preconstruction appraisal report.
[10] Actual construction sizes are documented in the lender's March 22, 2002, liquidation appraisal report.
[11] We met with architects and an engineer from the NO who informed us that the construction differences we identified represent material changes to the construction sizes approved by the SO.

The lender never assured that the borrower's plans and specifications were in agreement with the construction approved by the agency. The lender never received or reviewed the plans and specifications until almost 17 months after construction was completed. Clearly, the lender failed in its responsibility to ensure that the borrower's facilities were constructed as approved by the agency.

Lender's Failure to Monitor/Supervise Construction

During our review of the borrower's loan files maintained by the agency, we found little evidence that the lender ever visited the site. The only evidence we found in the borrower's loan files was one picture showing the foundation for the convenience store and construction in progress on the agricultural farm supply store. The picture is dated August 28, 2000.

We asked the lender if it had any other records that would document its inspections and supervision over the project's construction. The lender said the picture was the only documentation it had to support its supervision over the borrower's construction.

Current officers of the lender stated that its former president visited the borrower's facilities at least 3 times per week. The lender stated that it was sure that the former president was constantly looking at the construction of the facilities. However, the lender said that none of these visits was documented. The former president refused our request for an interview to discuss his monitoring and supervision over the construction of the borrower's facilities.

The March 2002 liquidation appraisal report stated that the lender made no inspections during the construction period because, if it had, the construction differences would have been discovered. The liquidation appraisal report also stated that loan funds were disbursed based on assurances from the borrower that construction had been completed as approved by the agency.

Monitoring and supervising construction of facilities is a major component of servicing B&I guaranteed loans. The lender accepted this responsibility before construction began when it signed the conditional commitment, lender's certification, and loan agreement on December 21, 1999. However, the lender was negligent in its servicing of the guaranteed loans by not effectively monitoring the construction of the borrower's facilities.

Lender Did Not Notify the Agency of Construction Changes

The lender hired a certified appraiser to conduct a preconstruction appraisal report (appraisal report) of the borrower's proposed construction. Lenders

planning to use guaranteed loan funds for construction are required[12] to submit appraisal reports to the agency. The appraisal report is essential because the agency uses it to determine the viability of the project and the amount of guaranteed funds that will be required to complete the proposed construction. The appraisal report was completed on December 10, 1999. It identified the planned construction sizes for the borrower's facilities. The agency approved the appraisal report on January 3, 2000.

Construction began in March 2000 and ended December 2000. During that period, the lender did not report any changes in the construction size of the facilities to the agency. After construction was completed, the lender certified to the agency in a January 3, 2001, letter that no changes to the construction of the facilities had occurred. Based on the lender's certification, the agency issued the $4.7 million in guaranteed loans.

After the borrower defaulted on the guaranteed loans, the lender contracted with the same certified appraiser to estimate the liquidation value of the borrower's collateral used to secure the loan. The liquidation appraisal report was completed on March 22, 2002. The appraiser reported that the convenience store, agricultural farm supply store, and the paved parking lot were not constructed according to the preconstruction appraisal report approved by the agency. The changes in construction size reported in the liquidation appraisal are listed in table 1.

By failing to notify the agency of the construction changes, the lender did not provide the agency with the opportunity to determine how those changes could, or did, affect the borrower's chances for success. If the agency had known of the changes in the project's construction, it could have taken corrective actions such as requiring the borrower's adherence to approved construction sizes, obtaining justification from the lender for the construction changes, lowering the dollar amount of the guarantee, or canceling the guarantee.

In January 2001, after the construction was completed, the lender requested that the agency issue the loan note guarantees. The lender certified in its request that the construction sizes of the borrower's facilities had been completed as approved by the agency. The lender did not inform the agency of the changes that were actually made to the construction sizes approved by the agency. Based, in part, on this false certification, the agency issued the loan note guarantees to the lender.

The agency told us that if it had known that the borrower had not adhered to the construction sizes approved by the agency, it would not have issued the loan note guarantees. The agency stated that it would have assessed the

[12] Title 31, CFR, section 4279.161(b)(6).

impact of the construction changes to the project before deciding whether to issue, or change the amount of, the loan note guarantees.

The lender was responsible for ensuring that construction was adequately planned for, was completed as approved by the agency, and that material changes to the approved construction were reported to the agency. The lender is responsible for not adhering to these loan requirements.

Finding 5 Independent Reviews Identify Lender's Negligence In Making and Servicing Its Guaranteed Loans

The borrower diverted over $6 million of working capital away from the cooperative. This occurred, in part, because the lender was negligent in servicing the borrower's guaranteed loans. The failure of the lender to prevent the diversion of funds contributed, in part, to the cooperative's failure.

Title 7, CFR, sections 4279.30(a)(1) and 4279.2, place primary responsibility for making and servicing guaranteed loans on the lender and require that the lender manage the guaranteed loans as it would any other nonguaranteed loans in its portfolio.

The lender's BOD failed to service the guaranteed loans as it had its nonguaranteed loan portfolio. This was done even though these loans represented the largest single loan package the lender was managing. The BOD assigned all loan making and servicing for the guaranteed loans to the lender's former president. The BOD then ceased its oversight and supervision of the guaranteed loans. The BOD continued to rely on the former president even though it had removed his authority over all other loans in the lender's portfolio. Unlike the guaranteed loans, the BOD remained actively involved in the lender's other loans. Thus, the guaranteed loans were not managed in the same fashion as the lender's nonguaranteed loans.

The BOD stated that since it gave the former president full authority to make all decisions related to the guaranteed loans, the lender had no direct responsibility or accountability for those loans. The BOD stated that the former president was not acting within the scope of his authority, and, therefore, the BOD believed that it was no longer responsible or accountable for the actions of its former president. FDIC policy and case law state that a lending institution's BOD is responsible for the actions of its president, officers, directors, and other employees. The BOD had a fiduciary duty of loyalty and care to adequately supervise its former president.

We found that two independent reviews were conducted of the lender's loan making and servicing activities. Both reviews found serious problems with the lender's management of the guaranteed loans. An accounting firm reviewed the guaranteed loans and determined that the borrower had diverted funds from the cooperative's operation. Proper servicing of the loan by the bank would have identified the diversions, and actions could have been taken to prevent the borrower's diversion of the cooperative's funds. A FDIC review notified the lender that it had been unsafe and unsound in management of the guaranteed loans. The FDIC review stated that the lender and its BOD are responsible and accountable for the actions of their former president and the guaranteed loan losses. The lender has filed a lawsuit that charges the former president with fraud and negligence in making and servicing the guaranteed loans. The lawsuit also charged the borrower with conspiring with the former president to defraud the lender regarding the guaranteed loans. The lawsuit concurred with the accounting firm's findings.

Accounting Firm Review Discloses Improprieties of the Borrower

After the borrower's cooperative failed, the lender hired an accounting firm to review the borrower's guaranteed loan funds. The accounting firm's review was a limited engagement review. No opinion was given by the accounting firm on the borrower's financial statements, accounting records, or on any statements made by the borrower or the lender.

The accounting firm's review found that over $6 million of the cooperative's working capital was diverted away from the cooperative. (See exhibit C.) Many of the diverted funds benefited the cooperative's president and BOD. Generally, there were two ways that they used to divert the funds away from the cooperative. The cooperative's president and BOD would either divert revenues that were owed to the cooperative to local farms or undercharge the member farms for operating expenses of the cooperative.

By diverting the funds, the cooperative had less working capital to pay its operating expenses and guaranteed loans. We found no evidence that the lender monitored the borrower to prevent the diversion of funds away from the cooperative.

FDIC

On August 29, 2002, FDIC issued a "Notice of Charges and of Hearing" to the lender alleging numerous improprieties involving the lender's activities. We contacted FDIC and verified that each FDIC finding centered on the RBS guaranteed loans. FDIC concluded that the lender had engaged in unsafe, unsound, and hazardous lending practices.

Specifically, FDIC found that the lender (a) extended too much credit to the borrower without adequately weighing the credit risk associated with the large guaranteed loans, (b) failed to properly monitor guaranteed loan disbursements, and (c) made and serviced the guaranteed loans inconsistent with management's usual expertise and oversight practices.

FDIC concluded that the lender's president and officers operated in a manner that was detrimental to the lender and jeopardized the safety of its deposits. FDIC also concluded that the BOD engaged in unsafe or unsound banking practices and failed to provide adequate supervision over its employees. FDIC told us that the BOD is ultimately responsible and accountable for the actions of its employees.

Lender's Lawsuit

On December 19, 2002, the lender filed a "Complaint At Law" (lawsuit) against its former president. The lawsuit also brought charges against the president of the cooperative and its farm, the cooperative's BOD and their farms, and the borrower's accountant and law firm.

The lawsuit states that the defendants schemed to defraud the lender so that the borrower could obtain the $4.7 million Phase III guaranteed loans. The lawsuit agreed with our conclusions that the defendants devised a scheme to obtain the additional $4.7 million in guaranteed loans. (See Findings 1, 2, and 3.)

The chairman of the lender's BOD told us that its former president had its full trust and confidence. Based on this trust, the BOD assigned the former president complete responsibility for making and servicing the Phase III B&I guaranteed loans. Prior to giving the president full and sole responsibility for the guaranteed loans, the BOD terminated the president's membership in the BOD. The BOD also told the president that it would not renew the president's contract, leaving him with only 1 year (calendar year 2000) left of service to the lender.

The lender has attempted to disassociate itself from the actions of its former president. The lawsuit states that the former president did not act within the scope of his authority, that he breached his obligations to the lender, and that the BOD was unaware of the actions of its former president.

We conclude that the lender's BOD, and therefore the lender, is responsible and accountable for the actions of its former president. The BOD is also responsible and accountable for failing to adequately supervise and monitor the former president. The BOD failed in its fiduciary responsibility of duty and care to its customers.

Recommendation No. 1

After consultation with OGC, take action to contest the guarantees, or substantially reduce the remaining balance of the loan note guarantees totaling $6,993,578.

Agency Response. The NO and the SO concur with this recommendation. On or before August 31, 2003, after consultation with the NO and OGC, the SO will advise the lender that the loan note guarantees will be unenforceable or substantially reduced. A management decision is requested for this recommendation. Closure will be requested upon receipt of a copy of the notification to the lender.

OIG Position. We agree with the management decision for Recommendation No. 1. For final action, RBS needs to provide OCFO/PAD documentation that the lender has been notified the guarantee will be unenforceable, or the amount by which the guarantee will be reduced.

Scope and Methodology

At the request of the RBS, we initiated an audit of B&I guaranteed loans made to a tomato cooperative in the State of Arkansas. The audit concentrated on the nine B&I guaranteed loans the lender made to the borrower between March 1998 and December 1999. Fieldwork was performed at the RBS NO, the Arkansas SO, and the lender's office. We conducted the fieldwork from October 2002 to March 2003.

To accomplish the audit objectives, we reviewed SO records and the lender's records related to the borrower's B&I guaranteed loans to determine if the lender properly closed the loan, serviced the loan, and that loan proceeds were used as specified in the loan agreements. We interviewed and obtained records from the lender, the lender's BOD, the NO and SO, the borrower's relative (whose farm was a member of the cooperative), the borrower's law firm, and the accounting firm.

We conducted this audit in accordance with the Government Auditing Standards issued by the Comptroller General of the United States. Accordingly, the audit included such tests of program and accounting records as considered necessary to meet the audit objectives.

However, the scope of the audit was limited. The former president of the lender, who was given full and sole authority and control over the guaranteed loans, refused to cooperate and would not be interviewed. The borrower's president would not agree to be interviewed but did respond to our questions in writing. The attorney for the cooperative law firm has not yet provided additional information that we have requested.

Exhibit A – Summary of Monetary Results

FINDING NUMBER	RECOMMENDATION NUMBER	DESCRIPTION	AMOUNT	CATEGORY
1,2,3,4,5	1	Lender Negligence and Misrepresentation Lead to the Loan Note Guarantee Being Contested or Substantially Reduced	$6,993,578	Questioned Costs and Loans, Recovery Recommended
TOTAL			**$6,993,578**	

Exhibit B – *Method Used to Conceal Delinquent Guaranteed Loans*

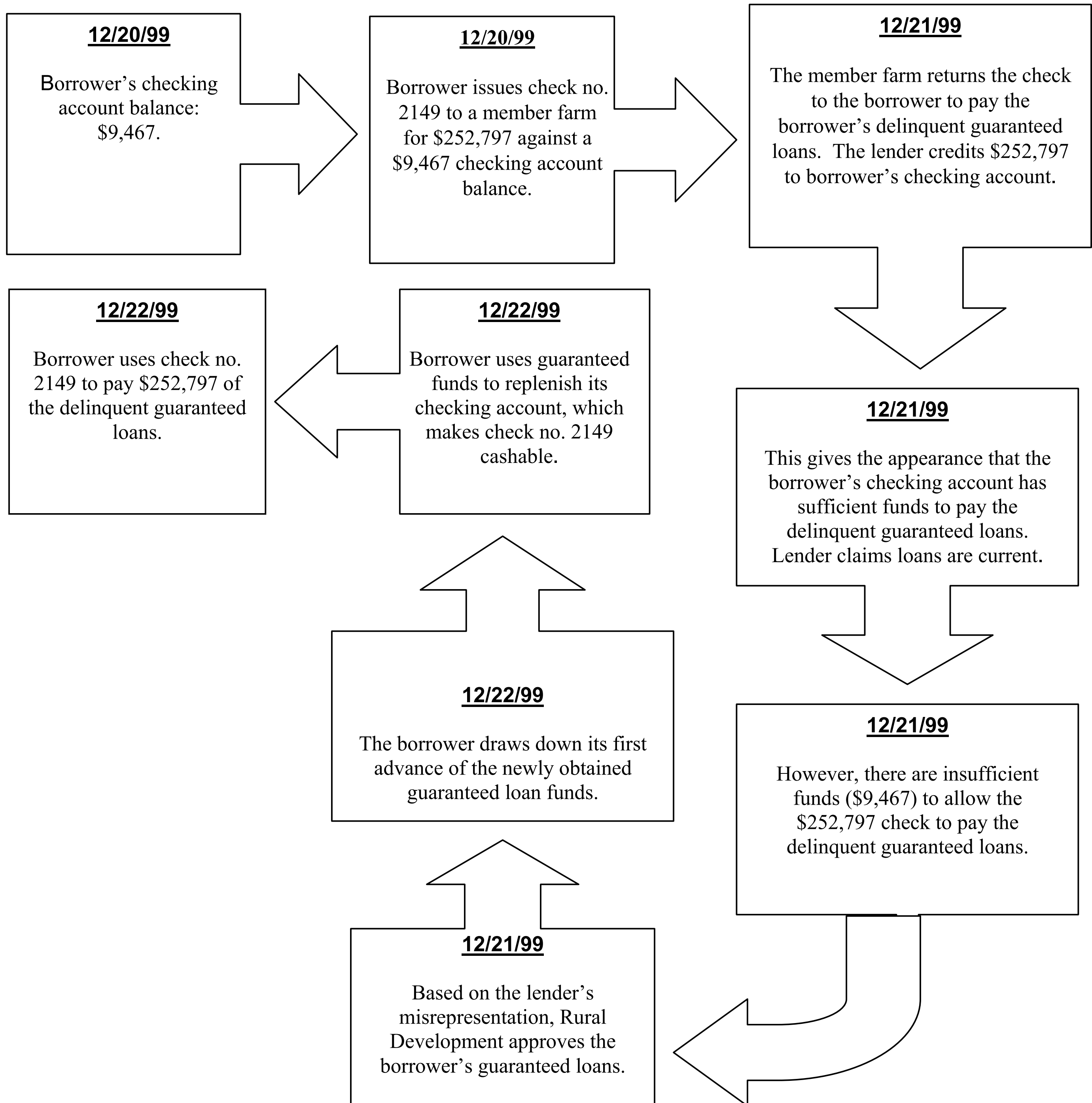


Exhibit C – Funds of the Cooperative Mismanaged and Diverted to Local Farms

Date/Period Diversion Occurred	Description	Effect	Amount of Funds Mismanaged/ Diverted
1998[13]	The borrower[14] did not charge member farms[15] the cooperative's full cost for processing their 1998 tomato crops.	The cooperative absorbed the loss.	$ 79,000
March 1999	The borrower paid crop insurance proceeds to member farms when the proceeds should have been paid to the cooperative.[16]	The cooperative absorbed the loss.	310,000
1999[13]	The borrower did not charge member farms the cooperative's full cost for processing their 1999 tomato crops.	The cooperative absorbed the loss.	842,000
July 1999	The borrower paid member farms the sale proceeds from their 1999 summer tomato crop knowing that it would leave the cooperative unable to pay its guaranteed loan payments.	On December 13, 1999, the cooperative became delinquent on its guaranteed loans. The borrower and lender arranged to resolve the delinquency by obtaining additional guaranteed loans. (Finding 2.)	683,184[17]
August 1999	The borrower paid excessive amounts to two member farms[18] for their assistance in helping the cooperative process and repack tomatoes.	The cooperative absorbed the loss.	19,124
Fall 1999	The borrower used guaranteed loan funds for an experimental fall tomato crop,[19] which was an unauthorized use.[20]	The cooperative absorbed the loss.	239,884
1999	The borrower allowed a member farm to keep proceeds it received totaling $34,003, rather than pay off its debt to the cooperative.	The cooperative absorbed the loss.	34,003
1999	The borrower wrote off accounts receivable of the cooperative with no justification for the writeoff.	The cooperative absorbed the loss as bad-debt expense.	176,000

[13] For 3 straight crop years, 1998, 1999, and 2000, the borrower did not charge member farms full cost for processing their tomato crops resulting in a total loss to the cooperative of over $2.5 million.
[14] In this exhibit, the term "borrower" means the cooperative's president and its BOD, not the cooperative itself.
[15] A member farm is a local farm that is a member of the cooperative.
[16] The crop insurance proceeds of $310,000 should have been used to pay most of the member farms' $322,000 debt to the cooperative.
[17] This amount includes sale proceeds paid to nonmember farms for their crops that the cooperative would not be entitled to retain. The amount of nonmember farm proceeds is unknown. (Source: Lender's letter dated October 1, 2002.)
[18] The cooperative's president owned one farm, and a member of the cooperative's BOD owned the other.
[19] Three member farms participated. The relative of the cooperative's president owned the member farm that incurred the majority of the loss, approximately $200,000 of the $239,884.
[20] The experimental tomato crop was an "agricultural" use; B&I loans can only be used for "marketing" purposes.

2000[13]	The borrower did not charge member farms the cooperative's full cost for processing their 2000 tomato crops.	The cooperative absorbed the loss.	1,648,000
2001	The borrower disposed of assets that served as collateral for the guaranteed loans.	The cooperative absorbed the loss.	75,000
2001	The borrower did not collect member farms' membership fees due to the cooperative for the years 1998 to 2001.	The cooperative absorbed the loss.	1,100,000
2001	The borrower rented the cooperative's facilities and operations to a related company.[21]	During the 2001 crop year, the cooperative realized no revenues but incurred all operating expenses. The borrower diverted all rental fees and revenues away from the cooperative to the related company and to member farms. The cooperative absorbed the loss.	1,119,000
2001 and 2002	Some member farms left the cooperative without paying their debts owed to the cooperative.	The cooperative absorbed the loss.	506,000
Total:			**$6,831,195**

[21] The president of the cooperative was also the president of the related company.

United States Department of Agriculture
Rural Development

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

JUL 11 2003

SUBJECT: Rural Business-Cooperative Service
Hermitage Tomato Cooperative Association
Business and Industry Guaranteed Loan
(Audit Report No. 34099-006-TE)

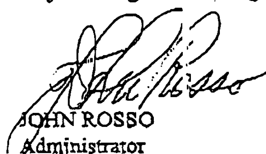
TO: John M. Purcell
Director
Financial Management Division

This is in response to the official draft findings and recommendation of the above-captioned Office of Inspector General audit.

Recommendation No. 1:
After consultation with the Office of the General Counsel (OGC), take action to contest the guarantees, or substantially reduce the remaining balance of the loan note guarantees totaling $6,993,578.

Agency Response:
The Rural Business-Cooperative Service (RBS) National Office and the Arkansas Rural Development State Office concur with this recommendation. On or before August 31, 2003, after consultation with the RBS National Office and OGC, the State Office will advise the lender that the Loan Note Guarantees will be unenforceable or substantially reduced. A management decision is requested for this recommendation. Closure will be requested upon receipt of a copy of the notification to the lender.

If you have any questions or concerns, please contact Dwight Carmon, Director, Special Projects/Programs Oversight Division, (202) 690-4100.



JOHN ROSSO
Administrator

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