

# USDA



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

Lender Servicing of  
Business and Industry  
Guaranteed Loans for  
Paradise of Puerto Rico, Inc.



**Report No.  
04099-5-At  
JUNE 2003**



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



DATE: June 12, 2003

REPLY TO  
ATTN OF: 04099-5-At

SUBJECT: Lender Servicing of Business and Industry  
Guaranteed Loans for Paradise of Puerto Rico, Inc.

TO: John Rosso  
Administrator  
Rural Business-Cooperative Service

THROUGH: John Purcell  
Director  
Financial Management Division

This report presents the results of our audit of two defaulted Business and Industry guaranteed loans totaling \$1.7 million made to Paradise of Puerto Rico, Inc. The audit objectives were to determine if: (1) loan proceeds were used for the intended purposes; (2) the lender properly serviced the loans; and (3) the final loss claim was correct. Our review found that loan funds were used for the intended purposes and the lender adequately serviced the loans and foreclosed and liquidated the collateral when the borrower defaulted on the loans and abandoned the property. The report contains no recommendations and no management decision or response is necessary.

We want to thank your staff for the cooperation provided in the completion of this review. If you have any questions, please call me or have a member of your staff contact Philip T. Cole, Director, Rural Development and Natural Resources Division, at (202) 720-6805.

RICHARD D. LONG  
Assistant Inspector General  
for Audit

Attachments

## **SUMMARY**

Rural Development (RD) requested that the Office of Inspector General review two defaulted Business and Industry guaranteed loans totaling \$1.7 million made to Paradise of Puerto Rico (PR), Inc. Paradise of PR, Inc., was a family-owned business that manufactured bedding and mattress components. The Scotiabank de PR made the loans that RD guaranteed at 90 percent. In April 1998, the borrower abandoned the business and returned to his home in the Dominican Republic after having converted the collateral. On May 8, 2002, the lender submitted a loss claim of \$1,346,912 for principal and interest. We agree with the loss claim amount. Our review found that loan funds were used for intended purposes and the lender adequately serviced the loans and foreclosed and liquidated the collateral when the borrower defaulted on the loans and abandoned the property.

## **OBJECTIVES**

The objectives of our review were to determine if (1) loan proceeds were used for the intended purposes, (2) the lender properly serviced the loans, and (3) the final loss claim was correct.

## **BACKGROUND**

General Background - RD, an agency within the U.S. Department of Agriculture, administers loan programs to assist in the business development of rural areas and the employment of rural residents. RD guarantees loans made by traditional, private lenders, such as commercial banks, and by entities using investment capital for lending.

RD Regulations provide that lenders are responsible for servicing the loan, including the protection of collateral, and for taking all servicing actions that a prudent lender would perform on its own portfolio of loans that are not guaranteed.

Borrower Background - The lender (Scotiabank de PR) made two loans totaling \$1.7 million to Paradise of PR, Inc. The first loan for \$1.2 million was closed on August 6, 1996, and the second loan for \$500,000 was closed on January 21, 1997. RD guaranteed 90 percent of the loans. The purposes of the loans were to refinance existing debts owed other financial institutions, purchase new equipment, and refinance used machinery and equipment.

In December 1997, the borrower informed the lender it was having significant decreases in the sale of mattresses and advised the lender of plans to stop manufacturing mattresses and stay with the production of foam. The borrower requested approval to sell the assets associated with the mattress production. RD and the lender agreed with the borrower's request subject to applying the proceeds to the loan. The mattress division was closed in December 1997.

In February 1998, the lender hired an independent certified public accountant (CPA) to verify the status of the collateral. The CPA reported that some machinery was missing. The borrower told the lender that it had sold the missing machinery for \$450,000 to a company located in Missouri. The lender learned that the Missouri company had in turn sold it to a third party with locations in Mexico and Massachusetts. The lender's attorneys advised that the property mortgage law in PR requires that any legal action to recover collateral be taken against the entity in possession of the collateral rather than the company that originally purchased the machinery. The lender demanded that the borrower return the money obtained from the sale of the machinery. When no payment was received, the lender filed a civil suit against the borrower on April 3, 1998.

Without informing the lender, the borrower closed operations on or about April 6, 1998, and abandoned the business and his residence in PR. The lender found that the borrower had shipped the remaining machinery and equipment to his home country of the Dominican Republic where he relocated. The lender notified RD of the borrower's actions and requested RD's advice regarding legal action. RD advised the lender against further legal action because the agency's prior experience with individuals leaving the PR jurisdiction proved unsuccessful.

The lender promptly foreclosed on the abandoned real estate property. The lender was allowed to enter the property in May 1998 with a court order. After lengthy delays in the judicial system, in December 1999, the lender acquired title to the real estate through a judiciary sale. In October 8, 2001, the lender sold the property for \$350,000 after a long delay caused by an environmental cleanup. Because the cleanup and liquidation costs exceeded the sale proceeds, no residual funds were available to apply to the loan balances.

## **CONCLUSION**

We concluded that loan funds were used for the intended purposes and the lender properly serviced the loans and took timely actions to foreclose on the collateral when the borrower defaulted on the loans and abandoned the property.

## **SCOPE**

We performed work at the RD office and lender offices located in San Juan, PR. We reviewed the propriety of the lender's loanmaking, servicing, and liquidation from loan inception until liquidation.

## **METHODOLOGY**

We held discussions with RD officials at the State and national offices and with lender officials and reviewed the RD and lender records associated with the loans. We evaluated RD's and the lender's actions during the servicing and liquidation phases and the final loss claim.

We evaluated compliance with requirements contained in RD Instructions (1) part 4279, subpart A-"General"; subpart B-"Business and Industry Loans" and (2) part 4287, subpart B-"Servicing Business and Industry Guaranteed Loans", dated December 23, 1996. We also evaluated compliance with RD Instruction 1980-E "Appendix G Liquidation and Property Management Guide", dated December 1996.