



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

**RURAL DEVELOPMENT
RURAL BUSINESS-COOPERATIVE SERVICE
BUSINESS AND INDUSTRY LOAN PROGRAM
OMNIVEST RESOURCES, INC.
FORT GAINES, GEORGIA**



**Audit Report No.
34099-2-AT
September 2001**



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250



DATE: September 14, 2001

REPLY TO
ATTN OF 34099-2-AT

SUBJECT: Rural Business – Cooperative Service – Business and Industry Loan
Program, Omnivest Resources Inc.

TO: William F. Hagy III
Acting Administrator
Rural Business – Cooperative Services

THRU Mark Huntley
Acting Director
Financial Management Division

This report presents the results of the subject audit. Your agency's August 20, 2001, response to the draft report is included in exhibit F with excerpts and the Office of Inspector General's position incorporated into the Findings and Recommendations section of the report.

Based on the information contained in the response, we have reached management decision on Recommendation Nos. 5 and 8. Please follow your agency's internal procedures in forwarding documentation for final action to the Office of the Chief Financial Officer.

Management decision can be made on the remaining recommendations (Nos. 1, 2, 3, 4, 6, and 7) once the agency has provided the additional information outlined in the report sections, OIG Position, for the applicable recommendations.

In accordance with Department Regulation 1720-1, please furnish a reply within 60 days describing corrective actions you plan to take and the timeframes to address these recommendations.

Please note that the regulation requires a management decision to be reached on all recommendations within 6 months of report issuance.

/S/

RICHARD D. LONG
Assistant Inspector General
for Audit

Attachment

cc: Director, Planning and Accountability Division, OCFO
Director, FMD

EXECUTIVE SUMMARY

RURAL DEVELOPMENT RURAL BUSINESS-COOPERATIVE SERVICE BUSINESS AND INDUSTRY LOAN PROGRAM OMNIVEST RESOURCES, INC. FORT GAINES, GEORGIA

AUDIT NO. 34099-2-At

RESULTS IN BRIEF

On December 4, 1996, the Georgia Rural Development State office (RD) approved an 80-percent loan guarantee to First Federal Savings Bank of Southwest Georgia (lender) for a \$5 million loan to Omnivest Resources, Inc. (borrower). The loan was approved subject to Omnivest meeting several conditions, primarily financial positions, and resolution of collateral value issues, before issuance of the guarantee. The loan was closed and the guarantee was issued April 18, 1997. The loan was to refinance private debt of \$2,425,000 and provide \$2,575,000 for operating funds and capital expenditures.

Omnivest produced and marketed a lightweight aggregate (processed clay used in various construction products such as lightweight concrete blocks). The mining and production operation was located in Fort Gaines, Georgia. The business had been in operation since late 1994 with production and sales beginning in February 1995. The company had purchased the real estate, existing facilities, machinery, and equipment through the bankruptcy court.

In March 1998, less than a year after loan closing, the borrower stopped production and on September 1, 1998, the lender foreclosed on the property. On December 14, 1998, RD repurchased the unpaid guaranteed portion of the loan from the secondary market holder for \$4,052,351. Liquidation of loan security is expected to yield about \$588,000.

After the borrower defaulted, the RD State office performed a post review of the loan, which raised several concerns about the lender's processing and servicing actions. The RD State office requested that the Office of

Inspector General for Investigations (OIG-Investigations) review the loan. OIG-Investigations referred the request for an audit. The audit identified the following issues regarding the loanmaking and servicing process and use of loan funds.

- The lender was deficient in its responsibilities for determining borrower eligibility. The lender did not (1) adequately analyze the borrower's financial condition to ensure that cashflow from operations was sufficient for debt servicing, (2) disclose to RD that Omnivest's working capital was insufficient to sustain operations, and (3) ensure that the value of collateral was adequate to secure the loan. Our review of the company's financial records and comparison of them with the lender's debt service ratio calculations identified questionable fiscal transactions and computations without which the loan guarantee could not have been issued. Failure of the lender, borrower, and packager to disclose the company's true financial condition has resulted in a potential loss to RD in excess of \$4 million.
- The lender did not ensure that loan proceeds were used appropriately. The lender disbursed loan funds of \$846,873 to Omnivest for purchases of goods and services that were either not purchased or not paid for. Our review of the Omnivest cash account revealed a direct correlation between the company's receipt of the \$846,873 of questioned loan funds and payments totaling \$558,211 that it made to its officers, investors, and affiliates.
- The lender did not prudently service the Omnivest loan. The lender did not (1) perform servicing reviews and submit quarterly servicing reports to RD timely, and (2) apply funds appropriately from a certificate of deposit (CD) which served as collateral for the guaranteed loan. The lender did not provide the quarterly servicing reports to RD until April 1998, 12-months after loan closing and after the business had closed. The lender relied on its service provider (who was also Omnivest's loan packager) to perform the quarterly servicing reviews and prepare the reports. RD was not aware of serious problems with the Omnivest account until the loan was in default and the business had ceased production operations. In addition, the lender improperly applied \$11,190 of CD principle to pay interest and late charges on a subsequent loan the bank made to the borrower and to pay on the unguaranteed portion of the loan without applying 80 percent to the guaranteed portion.
- A conflict-of-interest situation existed between the lender's service provider and the borrower's packager. The same agent simultaneously acted as the borrower's packager and the lender's

service provider. The packager/lender service provider had a material interest in ensuring approval of the Omnivest loan since it received \$264,000 for its services (\$50,000 from the borrower and \$214,000 from the lender). The packager/lender service provider ushered the loan through the entire approval process. The packager/lender service provider (1) prepared the loan application package for the borrower to include the project summary and assembly of financial reports, (2) performed the financial analysis of the business for the lender including computations of financial ratios, and (3) negotiated terms of the loan guarantee with RD. RD has no regulations to prevent this type of conflict of interest in its guaranteed loan program similar to the Small Business Administration (SBA). The Omnivest packager/lender service provider would have violated SBA regulations designed to prevent this type of conflict of interest. In addition, a former RD State Office management employee responsible for supervising RD staff who worked on processing the Omnivest loan application began employment with the packager/lender service provider after retirement. He was instrumental in placing the Omnivest loan with the lender.

- The RD State office did not perform a sufficient review of the Omnivest loan to ensure that all requirements of the conditional commitment and loan agreement were met prior to issuance of the guarantee. RD issued a conditional commitment to the borrower listing several critical terms and requirements (conditions) that had to be met prior to issuance of the loan guarantee. Before issuance of the guarantee, RD was required to satisfy itself that all conditions were met. However, RD accepted the lender's certifications of compliance with the conditional commitment requirements without performing a substantive review of the lender's certifications and loan eligibility determinations. State office program staff stated that a preguarantee review of the lender's certifications was not required because (1) the lender was responsible for ensuring that all requirements were met prior to loan closing, and (2) the lender's certifications were sufficient to satisfy the agency that the requirements were met. Because of the concerns raised during the initial evaluation, high-risk of loss, and the lender's lack of experience with guaranteed loans and with large loans to complex manufacturing activities such as Omnivest, RD's performance of a substantive review of the loan prior to issuance of the guarantee was even more important to ensure that the borrower had sufficient cashflow, adequate working capital, and sufficient collateral value.

On December 12, 2000, RD's Rural Business-Cooperative Service's National office rescinded the Georgia RD State office's direct and guaranteed loan processing and loan servicing authority. This action was

taken because the State's delinquency rates for both programs were well above the national average and there were specific concerns regarding loan processing and servicing for five loans including the Omnivest loan.

KEY RECOMMENDATIONS

We recommend that RD void the Omnivest loan note guarantee and recover from the lender the \$4,052,351 paid to repurchase the guaranteed portion from the secondary market holder. We also recommend that RD (1) bar the packager/lender service provider and its affiliated companies from further participation in the guaranteed loan program and in the interim conduct preguarantee reviews of all future loans that the packager/lender service provider and its affiliates participate in as either a packager, lender service provider, or lender, and (2) implement regulations that prohibit an agent from acting as both a packager and lender service provider on the same loan.

RD should also establish procedures and review criteria for State Office staff to follow to satisfactorily conclude that all terms and conditions of the conditional commitment and loan agreement have been met prior to issuance of loan note guarantees.

AGENCY RESPONSE

In its August 3, 2001, response to the draft report, RD either agreed with or proposed alternatives to the report's eight recommendations and provided information on actions planned or taken to implement the recommendations. We have incorporated applicable portions of the RD response along with our position within the Findings and Recommendations section of the report. The agency's response is included as exhibit F of the report.

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INTRODUCTION

BACKGROUND

Rural Development's (RD) Rural Business-Cooperative Service administers the Business and Industry Loan Program through its State offices. The purpose of the program is to

improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural communities. RD can guarantee up to 90 percent of private lending institutions' (banks, savings and loans, etc.) loans made to eligible borrowers. RD State offices can approve loans up to \$5 million and generally offer a guarantee of 80 percent. The National office must approve loans over \$5 million and generally offer a 70-percent guarantee for loans between \$5 and \$10 million, and 60 percent for loans exceeding \$10 million.

A loan guarantee is an agreement by the Government to pay the principal and in some cases interest on a loan made by a private financial institution should the borrower default. Guaranteed loans (1) redirect private capital to public purposes (2) provide a subsidy to borrowers in the form of less stringent credit risk thresholds and/or more generous terms, and (3) are a contingent liability of the Government requiring outlays of Federal funds in the event of a default.

The guaranteed loan life cycle consists of: (1) eligibility determination, (2) loan servicing and supervision, and (3) in the event of default, loan termination and payment of lender loss claims after liquidation of acquired property.

The loan guarantee process begins with the lender submitting an application to RD. The application includes information about the borrower's business, and documents such as financial statements, financial projections, and a business plan. The application process also requires the lender to perform a comprehensive financial analysis of the loan proposal and determine that there is reasonable assurance of repayment ability. The lender's determination is based on the borrower's financial history, industry projections, owner's equity, and collateral. If an application is approved, RD issues a conditional commitment to the lender. This commitment contains any stipulations that the borrower must meet before RD will guarantee the loan.

When underwriting a loan for guarantee, lenders are expected to perform prudently regardless of the Government's guarantee. Also, lenders are to

service loans through periodic verification of financial statements and review of business operations.

On December 4, 1996, the RD Georgia State Review Board recommended and the State director approved an 80-percent loan guarantee to First Federal Savings Bank of Southwest Georgia (lender) for a \$5 million loan to Omnivest Resources, Inc. (borrower). The loan was closed and the guarantee was issued April 18, 1997. Omnivest Resources, Inc., was a wholly owned subsidiary of Amereco, Inc. The principal officers of Amereco were also the principal officers of Omnivest. The lender secured a corporate guarantee for the loan from Amereco as protection in the event of default by Omnivest. The guarantee approval was based on the project summary prepared by the staff of the Tifton, Georgia RD area office. The loan was to refinance private debt of \$2,425,000 and provide \$2,575,000 for operating funds and capital expenditures.

Omnivest produced and marketed a lightweight aggregate (processed clay used in various construction products such as lightweight concrete blocks). The business office was located in Castle Rock, Colorado. The mining and production operation was located in Fort Gaines, Georgia. The business had been in operation since late 1994 with production and sales beginning in February 1995. Amereco had purchased the real estate, existing facilities, machinery, and equipment through the bankruptcy court.

The Bank Network Inc. (TBN) was the loan packager for Omnivest. Originally, Harbourton Reassurance, Inc., of Santa Cruz, California, was to be the lender, however, it withdrew from the project. In March 1997, TBN solicited First State Bank of Donalsonville, Georgia, formerly known as First Federal Savings Bank of Southwest Georgia, to be the substitute lender. On April 2, 1997, RD approved First State Bank as a substitute lender. First State Bank accepted all responsibilities of the loan application.

After soliciting First State Bank to be the substitute lender, TBN (the packager) also functioned as a lender service provider for the bank. TBN functioned concurrently as a packager for Omnivest and a lender service provider for the bank during the loan approval process (March and April 1997).

On June 5, 1997, the owners and shareholders of TBN formed B&I Lending, LLC, through the purchase of certain assets and liabilities of TBN and the infusion of cash. The owner and officers of B&I Lending and TBN were the same. B&I Lending assumed TBN's contingent liability related to RD loans previously made including the Omnivest Loan. B&I Lending functions as a lender, in addition to continuing TBN's activities, with regard

to packaging, originating, processing, and servicing of RD Business and Industry guaranteed loans to a network of community banks.

The loan was closed and the guarantee was issued April 18, 1997. For its services in packaging the loan, TBN received \$50,000 in fees from Omnivest. For its services as lender service provider, on April 18, 1997, TBN received (a) \$214,000 (half of the premium¹) from the lender when the guaranteed portion of the loan (\$4 million [80 percent of \$5 million]) was sold on the secondary market, and (b) approximately \$1,000 monthly as a fee for servicing the loan.

After the borrower defaulted, the RD State office performed a review, which raised several concerns about the processing and servicing of the Omnivest loan. The RD State office requested that the Office of Inspector General for Investigations (OIG-Investigations) review the Omnivest loan. OIG-Investigations referred the request for an audit.

On December 12, 2000, the Rural Business-Cooperative Service's National office rescinded the Georgia RD State office's direct and guaranteed loan processing and loan servicing authority. This action was taken because the State's delinquency rates for both programs were well above the national average and there were specific concerns regarding loan processing and servicing for five loans including the Omnivest loan.

OBJECTIVES

The primary audit objective was to determine if the lender complied with program regulations for loanmaking and servicing. Specific objectives were to determine whether (1) the borrower's financial condition was properly analyzed prior to requesting the loan guarantee, (2) the lender and borrower provided all relevant financial information to RD, (3) loan funds were used for authorized purposes, and (4) collateral was sufficient to protect the interest of the agency. We also determined if the borrower's records supported the application information.

SCOPE

The audit reviewed the loanmaking and servicing aspects of the \$5 million loan guarantee to Omnivest Resources, Inc. The audit period was from June 1996 to September 2000. Other periods were reviewed as necessary. We performed audit fieldwork at the RD District office in Macon, Georgia; the

¹ A premium is the excess of the sales price of the loan when sold on the secondary market over the original loan amount. Since the interest rate on the market was lower than the loan contract rate, a premium was realized.

First State Bank of Donalsonville, Donalsonville, Georgia; Omnivest Resources Inc., in Fort Gaines, Georgia and Castle Rock, Colorado.

We performed fieldwork from October 1999 through January 2001. The audit was conducted in accordance with Government Auditing Standards.

METHODOLOGY

To accomplish our objectives, we performed the following procedures.

- Interviewed RD officials and reviewed policies and procedures governing the guaranteed loan program.
- Interviewed lender representatives, representatives of the packager/lender service provider, Omnivest officials and a representative of its public accounting firm.
- Reviewed the lenders' and borrower's business and financial records related to the Omnivest Resources Inc., loan and reviewed related RD records.
- Inspected the Omnivest Resources Inc., business site in Fort Gaines, Georgia.
- Contacted vendors to determine the status of Omnivest's accounts.
- Reviewed bankruptcy court records from the Middle District of Georgia, Columbus Division, for Camp Lightweight, Inc. (later known as Omnivest Resources, Inc.).
- Reviewed prior audits of guaranteed loans.

FINDINGS AND RECOMMENDATIONS

CHAPTER 1	THE LENDER WAS DEFICIENT IN ITS RESPONSIBILITIES FOR DETERMINING BORROWER ELIGIBILITY
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The lender was deficient in its responsibilities for determining borrower eligibility. The lender did not adequately analyze the borrower's financial condition to ensure that cashflow and income from operations were sufficient for debt servicing, working capital was available to sustain operations, and collateral was adequate to secure the loan. The lender relied on its service provider (who was also Omnivest's loan packager) to determine the borrower's financial condition. Our review of the borrower's financial records and comparison of information from them to the lender's debt service ratio calculations identified questionable fiscal transactions and computations without which the loan guarantee would not have been issued. We found that the borrower had material negative cashflow and working capital positions rather than the positive positions that the borrower, lender, and packager reported. Further, the lender accepted an inappropriate appraisal valuation that materially overstated the value of security. Failure of the lender, borrower, and packager to disclose Omnivest's true financial condition has resulted in a potential loss to RD in excess of \$4 million.

Borrower eligibility determination is the process of evaluating a loan application to ensure program eligibility standards are met. Factors to be evaluated include credit history, income, assets, debts, proposed uses of loan funds, and viability of the venture. When the loan is secured by property, an appraisal is required to provide an objective determination of the fair market value of collateral and assess the Government's exposure to loss.

Federal regulations and RD Instructions² specify that the lender is responsible for determining the applicant's credit quality to include adequate cashflow to service debt and provide working capital and sufficient collateral to protect the interest of the lender and the Government. The regulations state that cashflow is the most important consideration in the loanmaking process and that loan guarantee requests

² RD Instruction 4279B, 4279.131(a) and RD Instruction 4279A, 4279.30(b), dated December 23, 1996.

that do not show repayment ability should not be approved. The regulations also require that collateral value be sufficient to reasonably assure repayment of the loan. The lender is responsible for analyzing all credit factors associated with the proposed loan and applying its professional judgment to determine that the credit factors, considered in combination, ensure loan repayment.

Before issuance of the loan note guarantee, the lender must certify that there has been no material adverse change in the borrower's financial condition during the period of time from RD's issuance of the conditional commitment to issuance of the loan note guarantee. On April 18, 1997, the lender certified that there were no material adverse changes in Omnivest's financial condition between December 4, 1996 (conditional commitment date), and April 18, 1997 (loan note guarantee date).

FINDING NO. 1

THE DEBT SERVICE COVERAGE REQUIREMENT WAS NOT MET

The lender did not ensure that Omnivest had sufficient earnings from operations to meet its debt service requirements. A condition for issuance of the guarantee was that Omnivest first achieve a minimum debt service ratio of 1.25. This ratio represents the proportion of a company's net profit (adjusted for noncash

expenses) that will be needed to pay the principal portion of long-term debt in the coming year. The company did not meet the requirement. On March 28, 1997, the lender notified RD that Omnivest had achieved a debt service ratio of 1.29 based on the company's operations for December 1996 and January 1997. The ratio was computed based on the company's unaudited financial statements for those 2 months. The statements showed combined revenue of \$695,569, expenses of \$650,465, and net profit of \$45,104. Our review of the company's financial records showed that revenue was inflated \$285,000 (41 percent). In addition, our review of the debt service ratio computation showed that expenses of \$64,213 (10 percent) were improperly treated in the calculation. As a result, cash flow available for debt service was actually a negative \$191,731 yielding a negative debt service ratio of 1.56 for the 2 months. The debt service ratio was misstated because (1) the information that the borrower/packager submitted to the lender misrepresented Omnivest's financial status and (2) the lender did not confirm or perform independent analysis of the borrower's fiscal status.

The borrower's historical and projected financial status presented with the initial loan application did not show debt repayment ability. Therefore, in October 1996, RD offered a 50-percent loan guarantee. The original lender (Harbourton Reassurance, Inc.) would not accept a 50-percent guarantee. As an alternative, the packager negotiated with RD that if

Omnivest could achieve a minimum debt service ratio of 1.25 then an 80 percent guarantee would be approved. The debt service coverage ratio measures the borrower's ability to repay a loan from the cashflow of the business. The debt service ratio is computed by adding depreciation and other noncash expenses back to net profit and dividing the sum by the current principal amounts of long-term debt.

Omnivest's project summary presented to the State Review Board on December 4, 1996, stated, "The gross sales for the month of November 1996 has reached \$333,000. The net income yield is \$34,110, and debt service coverage of 1.392 for November." In contrast to the project summary, we found that the November 1996 actual sales were \$174,214 and the company had a net loss of \$49,566, as shown on the financial statements (see exhibit B). Our review of Omnivest's financial records and the 1996 year-end audit disclosed that the November sales recorded on the financial statements were correct. We were unable to determine the reason for the difference between the actual sales of \$174,214 for November and the purported sales of \$333,000 as presented to the State Review Board. The packager stated that the borrower prepared the preliminary November sales and income figures and that the packager used them in the project summary it provided to RD.

On March 28, 1997, the lender (First State Bank) certified to RD that Omnivest had met the conditional commitment requirement of a 1.25 ratio. The lender reported that the borrower had an aggregate debt service ratio of 1.29 for the months of December 1996 and January 1997. The 1.29 ratio was supposed to mean that the company's adjusted net earnings for the 2-months equaled \$1.29 for each \$1 of current long-term debt principal. RD accepted the lender's certification that the 1.25 ratio was met.

The packager, who also functioned as the lender's service provider, calculated the 1.29 debt service ratio for the lender from the company's unaudited financial statements. The packager added \$66,818 of existing interest payments and \$45,560 for depreciation for the 2 months back to the \$45,104 net income for the 2 months to arrive at a total of \$157,482 cashflow available for debt service. The \$157,482 was then divided by 2 months of anticipated debt payments (after loan closing) of \$122,358, (\$109,600 principal and interest on the guaranteed loan and \$12,758 principal and interest on other outstanding debt) yielding the aggregate 1.29 debt service ratio (see table 1).

Table 1

Lender's Certification			
	December	January	Total
Net Income	\$47,400	(\$2,296)	\$45,104
Interest	\$31,833	\$34,985	\$66,818
Depreciation	\$21,449	\$24,111	\$45,560
Cashflow available for debt service	\$100,682	\$56,800	\$157,482
Debt to be serviced	\$61,179	\$61,179	\$122,358
Debt Service Ratio	1.65	.93	1.29

Because of losses each month, December 1996 was the only month of the company's operation that could have been used in an attempt to show a 1.25 debt service coverage ratio (see exhibit B). Although the packager computed the aggregate 1.29 ratio for the 2-month period, revenue from Omnivest operations for January 1997 was only enough to generate a debt service ratio of .93, meaning that month's debt service requirements could not be paid from the company's earnings.

A 1-month's profitable operation was not a reasonable basis to conclude that the company would sustain a profit sufficient to support its debt service cost.

We asked the packager why only a 2-month period was used to calculate the debt service coverage ratio. The packager told us that these were the latest financials that Omnivest made available to them. Our review showed that Omnivest had monthly financial statements available for every month of its operation including adjustments made as a result of the 1996 year-end audit.

Although the packager used a non-standard procedure to calculate the debt service ratio, our review of the company's financial records and the debt service calculations identified questionable fiscal transactions and computations without which the loan would not have been guaranteed. Details are presented below.

- A. Inflated Sales – Omnivest's sales for December 1996 and January 1997 were overstated by \$285,000. The \$285,000 (December 1996 [\$190,000] and January 1997 [\$95,000]) was recorded on Omnivest's books for purported by-product shipments of 15,000 cubic yards to an Omnivest subsidiary (Alliance Materials). The purported by-product shipments and corresponding sales amounts were handwritten notations that an Omnivest officer recorded at the bottom of the

computer-generated listings of shipments and corresponding sales entries for the respective months. However, these shipments were never made.

Generally accepted accounting principals require that revenue be earned before it is recognized. Revenue is usually recognized when the earning process is complete and an exchange has taken place. The earning process is not complete until collection of the sales price is reasonably assured. Revenues from manufacturing activities are commonly recognized at the time of sale, usually meaning delivery.

In February 1997, Omnivest's in-house accountant made material adjustments to the company's financial statements based on its 1996 year-end independent audit. The accountant made an adjustment to transfer the \$190,000 of questioned sales from December 1996 to February 1997. A hand-written notation on the February shipment list stated, "Alliance Materials per audit and shipment not starting until January 1997, more appropriate to show as 1997 sales not 1996." The 1996 audited financial statements showed that December sales were adjusted from \$348,345 to \$158,345 (-\$190,000). In addition, a similar purported by-product shipment of \$95,000 was recorded for January 1997. We found that none of the by-product for the purported \$285,000 of sales for the 2 months was ever shipped to Alliance Materials. Further details are presented in exhibit C.

The packager told us that it was not aware of the overstated sales. Even though the packager and the borrower first met with First State Bank on March 18, 1997, to discuss it becoming the lender for the Omnivest loan, the bank did not require the packager/borrower to provide the audited financial statements or adjustments made as a result of the audit. The unadjusted financial statements for December 1996 and January 1997 were used as the basis for certifications to RD regarding the borrower's financial status.

We asked the packager why the audited and/or adjusted financial statements were not used in the debt service calculation and included in the loan package presented to the lender and RD. The packager told us that at the time of loan submission, the 10q quarterly statements (required quarterly report filed with the Securities and Exchange Commission (SEC) pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934) were only available through September 30, 1996, and that the 10K report with accompanying audited annual statements (required annual report filed with the SEC pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934) was not available until July 15, 1997. The quarterly

10q report is due 45 days after the end of each of the company's first three fiscal quarters. The annual 10K report is required to be filed within 90 days of a company's fiscal year-end. Omnivest was in violation of the SEC 90-day 10K filing requirement at loan closing. However, Omnivest had monthly financial statements available and the year-end audit of the 1996 financial statements was conducted in January 1997 and the resulting adjustments to the accounting records were made in February 1997, before the packager met with the lender.

Adjusting for the overstated sales, Omnivest had a net loss of \$239,896 for the 2 months instead of a net income of \$45,104 (see table 2).

Table 2

Month	Net Sales Per Lender Certification	Overstated Sales	Corrected Sales	Net Income (Loss) per Lender Certification	Net Loss After Sales Adjustment
December	\$348,345	\$190,000	\$158,345	\$47,400	(\$142,600)
January	\$347,224	\$95,000	\$252,224	(\$2,296)	(\$97,296)
Total	\$695,569	\$285,000	\$410,569	\$45,104	(\$239,896)

B. Incorrect Expense Amounts – The debt service calculation (1) overstated depreciation expense by \$19,555, (2) overstated interest expense by \$24,406, and (3) understated management fees expense by \$20,252. These mistreatments of expenses in the calculation each had the effect of increasing the debt service ratio.

1. Depreciation expense totaling \$45,560 for December 1996 and January 1997 was shown on "Schedule A to Monthly Financial Statements" that the packager/lender service provider prepared as a supplement to Omnivest's monthly financial statements (\$21,449 for December and \$24,111 for January). The schedule was attached to the two monthly financial statements that accompanied the debt service calculation. However, the financial statements showed aggregate depreciation of only \$26,005 for the 2 months. The \$45,560 depreciation was a calculation based on the amount of aggregate sold. However, Omnivest's accounting procedures called for and its financial records showed that depreciation expense was based on the amount of aggregate produced. Since the \$45,560 for depreciation used in the debt service ratio calculation (see table 1) was never removed from net income, it should not have been added back. Depreciation added back to net income should have been \$26,005 (\$22,588 for December and \$3,417 for January) as actually shown on the financial statements.

An Omnivest representative stated the depreciation expense of \$45,560 was a special calculation that the packager prepared for purposes of the loan debt service ratio. He explained that since production for January was low, the calculation was based on the amount of aggregate sold from inventory (39,880 cubic yards) in order to match depreciation costs associated with prior months when the inventory was produced against the January sales. Using this reasoning, all other variable production costs of prior months (e.g., coal, salaries and wages, mining, etc.) should have been considered as well in order to accurately match the cost of producing the aggregate with the January sales from inventory. Consideration of the other variable costs would have substantially lowered net income and the debt service ratio. Further, the \$45,560 included depreciation for the inflated \$285,000 sale of 15,000 cubic yards of by-product for December 1996 and January 1997 that never occurred. In addition to the sale not occurring, no depreciation should have been associated with the 15,000 cubic yards of by-product because Omnivest's depreciation rates and monthly depreciation expenses were based on primary aggregate product produced. There was no depreciation associated with "by-product."

We asked the packager why the calculation did not include all other variable production costs of prior months in order to accurately match the cost of producing the aggregate with the January sales from inventory. The packager told us that it did not prepare the depreciation calculation and that Omnivest accounted for and submitted the figures for the calculation.

2. The prescribed debt service ratio formula calls for adding back to net income depreciation expense and other noncash charges and dividing the sum by the current principal amounts of long-term debt. The packager's calculation also added interest back to net income. The reasoning for adding interest expense back to net income was to forecast future cash availability for debt service since some of Omnivest's debt would be refinanced with the RD guaranteed loan. However, the lender added back to net income the total interest of \$66,818 that Omnivest paid for the 2-month period rather than only the \$42,412 of interest that pertained to the debt that would be refinanced (see tables 1 and 3).

We asked the packager why interest was added back to net income. The packager stated that in order to calculate debt service coverage, interest is added back to cash flow as well as depreciation, amortization and other noncash charges. The RD debt service coverage formula only calls for adding depreciation

and other noncash charges to net income and does not provide for interest and amortization. The principal portion of amortization cost is included in the debt service coverage formula as debt to be serviced and is not added back to net income. We also asked the packager why the calculation included total interest paid by Omnivest rather than only the interest that pertained to the debt that would be refinanced. The packager did not address the question and only stated that all of a borrower's debt, which would remain after the loan, would be used in calculating debt service coverage.

3. The December 1996 financial statements presented to the lender and RD did not include a management fee expense of \$20,000. An Omnivest representative stated the packager/lender service provider asked that the management fee expense be deleted from the financial statements. Although the fees were paid, the expense was removed from December's Profit and Loss statement and the statement was reprinted and sent to the packager. The reprinted statement showed net income of \$47,400. The December 1996 financial statements and general ledger obtained from the borrower's records show that the management fees were expensed and the net income for December was \$27,148. The packager told us that it made no such request of the borrower.

In summary, the borrower had a negative cashflow of \$191,731 to meet its debt service cost of \$122,358 after correcting for sales and depreciation, interest, and management fee expense.

Table 3

	Per Packager	OIG Adjustments		Adjusted Ratio
		December	January	
Net Income				\$45,104 ¹
OIG Adjustments				
Sales		(\$190,000)	(\$95,000)	(\$285,000)
Depreciation		\$22,588	\$3,417	\$26,005
Interest		\$21,321	\$21,091	\$42,412
Management fees		(\$20,252)	0	(\$20,252)
Cashflow available for debt service	\$157,482	(\$219,625)	(\$129,588)	(\$191,731)
Debt to be serviced	\$122,358			\$122,358
Debt service ratio	1.29			(1.56)
¹ Net income per unaudited financial statements (see table 1).				

If the questionable methods used for the debt service calculation had not been applied, the required ratio of 1.25 would not have been achieved and the loan would not have been closed.

The lender did not verify the application information. The lender basically relied on its service provider to assemble all of the application information and to usher it through the loan approval process. The incorrect cashflow projection should have been apparent to the lender had it used due diligence and obtained and analyzed Omnivest's most current and audited financial statements and the debt service calculation.

FINDING NO. 2
THE BORROWER'S WORKING CAPITAL WAS INSUFFICIENT

The lender did not disclose to RD Omnivest's negative working capital position and its need for \$2 million of working capital in addition to the \$5 million guaranteed loan. A condition of the guarantee was that the borrower maintain a minimum current ratio³ (working capital) of 1 to 1. As of December 31, 1996, Omnivest

had a current ratio of .49 to 1, which represented a negative working capital of \$3,190,475. Even after loan closing, its current ratio was .86 to 1, a negative working capital of \$436,271. Our interviews with representatives of the borrower, packager, and lender disclosed the need for the additional \$2 million of working capital was known to them prior to loan closing. The lender's analysis of Omnivest's financial status and resulting balance sheet ratios presented to RD was based on stale dated financial information 9 months old. An updated cashflow analysis would have revealed that (1) Omnivest's cashflow was not sufficient to meet operating cost and (2) working capital in addition to the guaranteed loan would be needed.

RD Instructions⁴ require the lender to provide RD a written credit analysis that addresses the borrower's repayment ability that includes a cashflow analysis. The lender did not perform a sufficient credit analysis of the borrower's financial status. The fact that Omnivest would have a working capital shortfall, even after obtaining the RD guaranteed loan, was not included in the cashflow analysis presented to RD.

On August 5, 1996, the original lender (Harbourton Reassurance, Inc.) submitted an analysis with the loan application. The analysis summary stated, in part, the following:

Although the lender has no credit experience with the borrower, the lender believes that the business and its owners are of excellent character, the growth potential of the business is enormous, and that their credit history is sufficient

³ The current ratio is calculated by dividing the company's total current assets by its total current liabilities. The current ratio is an indication of a company's ability to meet its financial obligations as they come due.

⁴ RD Instruction 4279A, 4279.161(b) dated December 23, 1996.

evidence to support the repayment of the proposed RD loan...Balance sheet ratios are acceptable and cashflow adequately supports the proposed debt.

The original lender's analysis was based on historical data for 1994, 1995, and January through June 30, 1996, and optimistic projections for year-end 1996, 1997, and 1998. The analysis accompanied the loan application the packager submitted to RD on August 5, 1996. First State Bank was approved as substitute lender on April 2, 1997.

First State Bank did not validate and update the original credit analysis although it was based on stale dated information 9 months old. In February 1997, material adjustments were made to Omnivest's financial statements based on a 1996 year-end independent audit. The borrower did not provide the lender with the 1996 audit report or audited financial statements. The lender based its certifications to RD regarding the borrower's financial status based on unaudited 1996 financial statements and the stale dated lender credit analysis.

The current ratio, also called the working capital ratio, is calculated by dividing the total current assets by the total current liabilities. The current ratio is used in evaluating a company's ability to meet currently maturing obligations. The composition and quality of current assets are critical factors in the determination of working capital and the current ratio. For example, if a current asset is restricted for a specific use, it would not be considered available to meet current obligations. A current ratio higher than 1.0 is considered essential while a current ratio of 2.0 is the rule of thumb. The conditional commitment stated that Omnivest was to "maintain a minimum current ratio of 1.0 to 1.0 during the life of the loan."

On April 18, 1997, the lender certified that all requirements of the conditional commitment had been met. However, Omnivest did not have a current ratio 1 to 1. As of December 31, 1996, Omnivest's unaudited financial statements showed a positive working capital position of \$1.5 million -- current assets of \$4.4 million minus current liabilities of \$2.9 million. The 1996 year-end audit made significant adjustments to balance sheet accounts by decreasing current assets, \$1,384,858 (31 percent) and increasing current liabilities \$3,338,839 (115 percent) yielding a negative \$3,190,475 working capital (current ratio of .49 to 1.0) as of December 31, 1996. Table 4 shows the principal adjustments.

Table 4

	Per		Difference	Percent	Reason for Adjustment
	Omnivest	Audit			
Current Assets					
Receivables	\$713,761	\$308,258	\$405,503	57	- Write off of note receivable for loan costs - Inflated sales receivable - Bad debt allowance
Inventories	\$2,535,440	\$1,648,387	\$887,053	35	Year end physical count of inventories
Other	\$1,178,391	\$1,086,089	\$92,302	8	Cash reconciliation and Prepaid expenses
Total Assets	\$4,427,592	\$3,042,734	\$1,384,858	31	
Current Liabilities	\$2,894,370	\$6,233,209	\$3,338,839	115	Long-term debt reclassified as short-term debt
Working Capital	\$1,533,222	(\$3,190,475)			

Details of the more significant audit adjustments follow.

- Accounts receivables decreased \$190,000 for purported product shipments to an Omnivest subsidiary that were not made (see Finding No. 1).
- Notes receivable decreased \$165,000 to write off an inter-company receivable for loan costs.
- Inventory decreased \$887,053 based on physical count of inventories at year-end.
- Current liabilities increased \$3,338,839 due to reclassifying long-term debt to short-term debt effective July 1996, for a loan that matured June 1997.

Even after receipt of the guaranteed loan in April 1997, Omnivest did not have sufficient working capital to sustain business operations and meet current obligations. The guaranteed loan was to be used primarily for debt restructuring, capital expenditures, and reimbursement of prior expenditures. Approximately \$4.1 million was disbursed to Omnivest to restructure debt, reimburse for prior purchases, and reduce payables that in effect increased working capital. Table 5 shows Omnivest's working capital and current ratio status from June 1996 through April 1997.

Table 5

	Current		Working Capital	Current Ratio
	Assets	Liabilities		
6/96	\$3,525,108	\$1,254,329	\$2,270,779	2.81
7/96	\$3,624,955	\$4,853,846 ¹	(\$1,228,891) ¹	.75
8/96	\$3,627,060	\$5,055,543	(\$1,428,483)	.72
9/96	\$3,752,336	\$5,254,237	(\$1,501,900)	.71
10/96	\$3,908,959	\$5,572,762	(\$1,663,803)	.70
11/96	\$4,129,997	\$5,871,442	(\$1,706,605)	.70
12/96 ²	\$3,042,734	\$6,233,209	(\$3,190,475)	.49
1/97 ³				
2/97	\$2,455,175 ⁴	\$6,364,692	(\$3,624,517)	.39
3/97	\$2,673,591 ⁴	\$6,904,814	(\$4,231,223)	.39
4/97	\$2,666,727 ⁵	\$3,102,998 ⁶	(\$436,271)	.86

¹ Current liabilities increased due to reclassifying long-term debt to short-term debt for a loan that matured June 1997.

² Totals from 1996 audited financial statements.

³ Adjusted financial statements not available.

⁴ Balance sheet total adjusted for inflated receivables for purported product shipments to an Omnivest subsidiary that were not shipped.

⁵ Balance sheet total adjusted for:

- Inflated receivables for purported product shipments to an Omnivest subsidiary that were not shipped.
- Escrowed loan funds held by the lender restricted for capital expenditures that would not be a current asset.

⁶ Balance sheet total adjusted for current portion of long-term debt.

Omnivest's representative told us that both the packager and the lender were aware before the guaranteed loan closed of the company's need for an additional \$2 million for working capital. He also stated that the packager told him not to mention to RD the need for the additional working capital because the packager would be able to get a \$2 million working capital loan once the guaranteed loan closed. We asked the packager the reason for its request to the borrower not to mention the need for the additional funds. The packager did not address the question but stated that it was not aware of the lender withholding information from RD.

Examples of correspondence discussing the need for the additional \$2 million follow.

June 6, 1997 – Amereco's Form 10-KSB [required annual report filed with the SEC pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934] for fiscal year ended December 31, 1996 states, "On April 18, 1997, the Company (Amereco) completed the long-awaited debt refinancing with First Federal Savings Bank of Southwest Georgia (FFSB). The Company's Board of Directors and officers continue to search for an unrelated party source for the approximately \$2 million which it required in

working capital financing and repayment of the Company's note payable to Congress."

June 26, 1997 – Lender Loan Committee minutes – Omnivest requested another \$2 million loan secured by inventory, accounts receivable and irrevocable stand-by letter from the guaranteed loan lender. The lender denied the request based on Omnivest's lack of history with the bank.

December 11, 1997 – Correspondence from the borrower to the lender states, "As we were aware and discussed with First State Bank (lender) prior to proceeding with the RD loan last spring, the business was in need of a \$2 million line of credit to meet its equipment and working capital needs."

September 1, 1998 - Amereco's Form 8-K (report required by the SEC to describe any significant events that may affect the company) states "Amereco, Inc., and its operating subsidiary, Omnivest Resources, Inc., a Georgia corporation have experienced difficulty in meeting its obligations as they become due. This was primarily due to the inability of Omnivest to obtain a \$2 million working capital loan...which the Registrant expected to be funded by FFBSB, or another lender, immediately subsequent to the funding of a \$5 million long-term financing from the lender."

Exhibit D shows additional details of the documented need for the \$2 million.

An RD official stated that the company's need for additional working capital was not discussed during the loan processing and should have been disclosed before the loan closed.

FINDING NO. 3

THE LOAN SECURITY WAS INADEQUATE

The value of the collateral securing the guaranteed loan was insufficient to cover loan losses. As of January 31, 1999, the balance owed on the defaulted loan, including interest accrued by the lender, was \$5,140,977. RD's liability was \$4,052,351 -- the amount it paid to the secondary market holder on

December 14, 1998, when it repurchased the 80-percent guaranteed portion of the loan. The loan was under-secured because the lender accepted a collateral appraisal based on an inappropriate valuation approach. The approach valued the business as a going concern rather than appraising the collateral based on its liquidation or auction value for repayment of the loan in the event of default.

RD Instructions⁵ provide that the lender is responsible for ensuring that appraisal values reflect the actual value of the collateral. Instructions specify that chattels will be evaluated in accordance with normal banking practices and generally accepted methods of determining value. This regulatory requirement is important because sufficient collateral minimizes the risk of loss to the Government in the event a loan cannot be repaid. Regulations⁶ require sufficient collateral value to reasonably assure repayment of the loan.

A significant disparity existed between the February 1995 appraised value of the loan security, primarily machinery and equipment that the borrower submitted with the loan application and the September 1998 foreclosure appraisal obtained by the lender. The February 1995 appraisal, obtained by Omnivest for a short-term \$4 million loan financed by another lender, valued the machinery and equipment at \$15,132,000. The September 1998 liquidation appraisal that the lender obtained valued its replacement value as \$1,647,500.

The February 1995 appraisal submitted with the loan application valued the machinery and equipment at the “fair market value in place”. Fair market value in place is defined as “the most probable price estimated in terms of money the items appraised could realize if exposed for sale in the open market allowing a reasonable time to find a purchaser who buys with knowledge of all the uses to which they are adapted and for which they are capable of being used, including the benefit of their present location.”

Prior to loan approval, RD notified the lender several times that the appraisal was not acceptable because it did not utilize the Sales Comparison, Income, or Cost approaches to value, nor did it comply with the requirements of the Uniform Standards of Professional Appraisal Practice (USPAP). The lender responded that machinery and equipment was classified as chattel and did not have to comply with USPAP guidelines as would apply to real estate. RD did not accept the appraisal until the lender certified to RD that the appraisal met the bank’s standards.

The lender’s certification stated,

The appraisal performed is the fair market value of the machinery and equipment. It is our assessment, because the cost of the machinery and equipment is in excess of \$13.9M, and since the machinery and equipment is the bulk of the collateral securing the loan, that this appraisal is

⁵ RD Instruction 4279B, 4279.144 dated December 23, 1996.

⁶ RD Instruction 4279B, 4279.131(b) dated December 23, 1996.

appropriate...As bank policy, we do not require appraisals of chattels to comply with all of the USPAP guidelines as would apply to real estate...As a matter of record, our normal banking practices require that personal property be evaluated by an appraisal firm that has the necessary qualifications and experience to perform this type of valuation. We have determined that the Daley-Hodkin Appraisal Corporation is qualified and that their appraisal is acceptable for this loan.

The appraisal was based on the “fair market value in place” and not the actual cost to Omnivest to acquire the machinery and equipment. On March 25, 1996, Omnivest reported on its County Business Personal Property Report a value of \$3,445,431 for furniture, fixtures, machinery, and equipment at cost. Omnivest’s 1996 County Ad Valorem Tax Notice for Real and Personal Property showed a fair market value of \$4,360,969 for both real estate and business personal property. These valuations were accessible to the lender; however, they were not obtained.

The appraisal process includes several approaches for establishing value and weighing those approaches to develop a final opinion of value. To make an informed decision on the value of the collateral, the lender should have required appraisal reports that included more than one valuation approach. Use of the “fair market value in place” approach may be acceptable for appraising the value of a viable business offered for sale as a going concern. However, it is not appropriate for assessing future value of collateral in the event of loan default when the business is no longer a viable going concern. Omnivest had never been a viable going concern (see exhibit B). Further, it had acquired the facility, machinery and equipment through the bankruptcy court after failure of the original business under other ownership.

Our review of the borrower’s files disclosed two other valuation reports that were performed as a part of the February 1995 appraisal. One valued the machinery and equipment at \$2,273,700 based on an orderly liquidation process, and the other valued the machinery and equipment at \$1,258,400 based on an auction. These two other valuation reports were not provided to RD. Table 6 shows a comparison of the appraisals performed in February 1995 and September 1998.

Table 6

Appraisal Type	February 1995	September 1998
Fair Market Value in Place	\$15,132,000	
Replacement Value		\$1,647,500
Orderly Liquidation Value	\$2,273,700	\$1,108,200
Auction Value	\$1,258,400	\$728,150

The four valuation approaches are generally accepted and standard appraisal practices for appraising businesses.

In October 1998, the Georgia RD State office requested the RD National office to review the February 1995 appraisal. The National office review stated,

The appraisal does not provide appropriate, comparable sales data, auction results, offers from reputable firms or other statistics to support the \$15 million estimated value. An explanation should have been provided concerning the exclusion of any of the usual valuation approaches...It is difficult to understand how the value in 1995, with installation, was \$15 million, when the replacement cost of the property in 1998 is \$1.7 million.

Another review of the February 1995 performed in January 1999 by a second RD appraiser stated,

An appraisal that reports the 'value in place' or 'value in use' is not much good without some assurance that the business will continue to be operated. The income approach to value should be considered when the value in use is reported. The business must have a net operating income that, when capitalized with a reasonable rate, supports the value in place. When this is not true, the value as if offered for sale, on the open market or liquidation value would be more appropriate.

The appraisal valuation was more important in this case since no personal guarantees were obtained from the Omnivest shareholders. RD Instructions⁷ state, "personal and corporate guarantees for those owning greater than 20 percent of the borrower will be required where legally permissible." The lender did not obtain personal guarantees because no one individual owned more than 20 percent of Omnivest. The lender

⁷ RD Instruction 4279B, 4279.149(b), dated December 23, 1996

obtained a corporate guarantee from Amereco, Inc., Omnivest's parent company. However, the corporate guarantee was worthless since Omnivest comprised all of Amereco's assets.

Omnivest's Certified Public Accountant stated that the SEC ruled in 1996 that Omnivest Resources, Inc., and Amereco, Inc., were one corporation--Omnivest Resources, Inc. Since Amereco, Inc., was a public corporation, both names could be used, however, consolidated financial statements were required.

Since Omnivest comprised all of Amereco's assets, Omnivest, in effect, guaranteed itself.

As of January 31, 1999, the balance owed on the defaulted loan, including interest accrued by the lender, was \$5,140,977. RD's liability was \$4,052,351 – the amount it paid to the secondary market holder on December 14, 1998, when it repurchased the 80-percent guaranteed portion of the loan. Because of the lender's deficient borrower eligibility determination, RD should recover the \$4,052,351 from the lender.

RECOMMENDATION NO. 1

Take action to void the loan note guarantee and recover from the lender the \$4,052,351 RD paid to repurchase the guaranteed portion from the secondary

market holder.

RD Response

In consultation with the Office of the General Counsel (OGC), to the extent the lender's negligence caused the loss to the Department of Agriculture (USDA) and the Agency can prove fraud or misrepresentation on the part of the lender, the Agency will take action to recover \$4,052,351, plus any associated costs, which may have accrued. The findings in this audit will be helpful in proceeding with voidance of the loan note guarantee.

Within 90 days of acceptance of the Agency response and OIG's permission to utilize the findings in this audit as part of the basis for voidance of the loan note guarantee, the agency will notify the lender of the agency's decision on voidance of the loan note guarantee.

The Agency is requesting a management decision on the response to this recommendation.

OIG Position

We agree with the planned actions and grant the agency permission to use the audit findings as necessary to carry out the planned actions. However, to achieve a management decision, we will need documentation that the loan note guarantee has been voided and details of the resulting actions to recover the \$4,052,351 from the lender.

CHAPTER 2**THE LENDER DID NOT ENSURE PROPER USE OF
LOAN FUNDS****FINDING NO. 4**

The lender did not ensure that loan proceeds were used appropriately. The lender disbursed loan funds of \$846,873 to Omnivest for purchases of goods and services that were either not purchased and/or not paid for. Our review of the Omnivest cash account revealed a direct correlation between the company's receipt of the \$846,873 of questioned loan funds and payments totaling \$558,211 that it made to its officers, investors, and affiliates.

RD Instructions⁸ state that distribution of loan funds is a responsibility of the lender and requires the lender to certify that loan proceeds have been disbursed for purposes and in amounts consistent with the conditional commitment. The lender's agreement⁹ states, "any losses will be unenforceable by the lender to the extent that loan funds are used for purposes other than those specifically approved by the U.S. Department of Agriculture (USDA) in its Conditional Commitment for Guarantee¹⁰."

The approved use of loan proceeds as cited in the loan application, conditional commitment, and loan agreement was to pay appropriate fees and expenses associated with the loan, refinance existing indebtedness, purchase new machinery and equipment (which would then become part of the collateral), and for working capital. RD required the lender to furnish a certified disbursement statement (disclosure/settlement statement) at loan closing showing the disbursement and use of the loan proceeds (see exhibit E).

At loan closing on April 18, 1997, checks totaling \$3,054,391 were made payable to creditors to (1) pay fees and expenses totaling \$202,096 associated with the loan, (2) restructure debt of \$2,425,000, (3) pay down accounts payable of \$314,795, and (4) purchase machinery, equipment, and spare parts totaling \$112,500. The closing attorney's disclosure statement included schedules specifying the creditors paid and the corresponding amounts. On the same date, a check totaling \$1,113,434 was made payable to Omnivest. The check was to provide the company with \$278,953 for working capital and \$834,481 as reimbursement for its prior purchases of machinery,

⁸ RD Instructions 4279A, 4279.30(a) and 4279B, 4279.181(1), dated December 23, 1996.

⁹ USDA Form 4279.4, paragraph II (A), dated October 1996.

¹⁰USDA Form FMHA 449-14 (Rev. 7-93)

equipment, spare parts, and payments of accounts payable. The disclosure statement stated that the lender had documentation on file to support the \$834,481 of prior purchases and payments. The lender placed the remaining \$832,175 in escrow for future purchases. The loan closing documents from the lender's attorney included an April 18, 1997, escrow agreement executed between Omnivest and the lender which stated that all escrow disbursements would be in the joint names of the borrower and the vendor. Table 7 shows details for loan closing disbursements.

Table 7

Disbursed to		Amount
Creditors		\$3,054,391
Omnivest		\$1,113,434
- Working Capital	\$278,953	
- Prior Purchases	\$834,481	
Escrowed		
- Future Purchases		\$832,175
Total		\$5,000,000

Of the \$1,666,656 disbursed to Omnivest for prior (\$834,481) and future (\$823,175) purchases, we question \$846,873 that the company used for unapproved and unauthorized purposes. Of the questioned \$846,873, we found that \$635,239 earmarked to be used for machinery and equipment, as shown on the disclosure statement, was never used for that purpose. Instead, the funds were used for general operating expenses and to make payments to company officers, investors, and affiliates. Further details follow.

- A. At loan closing, a balance of \$832,175 was placed in escrow to be disbursed to Omnivest for future facility improvements and purchases of machinery, equipment, and spare parts (see table 8).

Table 8

Balance to be disbursed to borrower for funds expended on	Amount
Facility Improvements	\$ 40,000
Machinery and equipment	\$510,175
Purchase of spare parts	\$282,000
Total	\$832,175

To obtain the \$832,175 from escrow, between May 9 and October 13, 1997, Omnivest submitted to the lender 10 reimbursement requests that included 258 invoices and/or purchase orders along with copies of uncanceled checks written on Omnivest's account. The Omnivest checks were payable to vendors. The lender did not issue bank checks made out jointly to the borrower and vendor as required

by the escrow agreement. Instead, the lender wired the total amount of each of the 10 reimbursement requests to the borrower. Our interviews with vendors and review of Omnivest's records determined that items totaling \$410,251 were never paid for and/or purchased. Included in the questioned \$410,251 was \$198,617 for facility modifications and construction, and installation of machinery to be completed in the future that was never purchased as reported in the disclosure statement.

Omnivest submitted to the lender 42 invoices and 5 purchase orders along with uncanceled checks totaling \$410,251 as support for its need for the questioned funds. The 5 purchase orders totaled \$223,550 (54 percent) of the questioned funds and were for facility modifications and construction, and installation of machinery to be completed in the future. The lender had no documentation to show whether the purchase orders were ever executed, the work was in process or completed, Omnivest had been billed for the work, or the contractors were paid. Our review found that 3 of 5 purchase orders totaling \$198,617 were never executed and the contractors were not paid in the other 2 cases totaling \$24,933. The lender should not have released the \$223,550 to Omnivest until the purchase orders had been executed and the contractors had billed the company. The remaining \$186,701 (46 percent) of the questioned \$410,251 was for purchases that were made, however, Omnivest did not pay the vendors.

Our review showed that Omnivest generally voided the company checks, reversed the accounting entries, and used the \$410,251 to make \$101,000 in payments to officers and an investor and used the remainder for general operating expenses such as payroll and supplies. If the lender had issued joint bank checks as required by the escrow agreement, the items would have been paid for and/or purchased. For example, of the questioned \$410,251, the majority (\$310,224 [76 percent]) was drawn on 3 dates (September 10, and October 14 and 15, 1997). Our review showed that 14 invoices and/or purchase orders totaling \$310,224, were never paid and/or executed (see table 9).

Table 9

Draw			Questioned	
Date	Amount	Items	Amount	Items
9/10	\$113,612	8	\$89,136	4
10/14	\$77,727	32	\$30,403	7
10/15	\$190,685	3	\$190,685	3
Total	\$382,024	43	\$310,224	14

Further details follow.

- Of the \$113,612 drawn on September 10, 1997, \$89,136 was not used for the approved purposes. For example:
 - Omnivest submitted to the lender an invoice and uncanceled check totaling \$58,450 for a double deck screen for sizing aggregate. Our review showed that the invoice was not paid, the check was voided, and the accounting entry was reversed.

We found most of the questioned \$89,136 was used to make unauthorized payments to company officials. On September 10, 1997, the same day that Omnivest received the \$113,612, the company paid unauthorized management fees totaling \$111,102 to Omnivest officers. Our review of Omnivest's cash account determined that at least \$76,000 of the \$113,612 of loan funds drawn from escrow was used for payment of the unallowable management fees to officers of Amereco who were also officers of Omnivest.

A term of the conditional commitment was that management fees were not to be paid to the officers until the company achieved a debt service coverage ratio of 1.25 exclusive of management fees. Management fees were paid to the officers even though the debt service requirement was never met. Management fees of \$20,000 were expensed monthly for the period April 1997 through September 1997 with a reciprocal credit to an account payable. In April 1997, after the guaranteed loan closed, \$20,252 was credited to the account payable for payments made to Omnivest directors with another \$111,102 paid to them on September 10, 1997. One of the officers told us that he would not have signed the conditional commitment if he thought he couldn't get paid. He said that a representative of the packager told him not to worry about signing the conditional commitment because the packager would be servicing the loan and would waive the restriction on management fees after the loan closed. The packager stated that it would not have made such a representation.

- On October 13, 1997, Omnivest requested a draw of \$197,483 that was accompanied by copies of three uncanceled checks and associated purchase orders. On October 15, 1997, the lender wired \$190,685 (the remaining escrow funds) to Omnivest. One of

the three purchase orders was never executed and Omnivest never paid the vendor for the other two procurements.

- Attached to one of the purchase orders was a \$172,550 quotation from a vendor for construction and installation of conveyors and machinery. Our review of Omnivest's records and discussion with the vendor revealed that the work was never contracted for.
- The other two purchase orders totaling \$24,933 were to the same vendor for additions to an existing building. Our review of Omnivest records showed that the checks were voided and the payable was still outstanding as of August 31, 1998.

Our review of Omnivest's cash account showed that Omnivest used the \$190,685 to pay off a \$25,000 note payable to an investor and for general operating expenses such as payroll and supplies.

- B. At loan closing, Omnivest received \$834,481 as reimbursement for amounts previously paid for machinery, equipment, spare parts, and accounts payable (see table 10).

Table 10

Reimbursement for funds expended on	Amount
Accounts payable	\$314,028
Machinery/ equipment	\$436,622
Purchase of spare parts	\$83,831
Total	\$834,481

The closing attorney's disclosure statement reported that documents supporting these prior purchases and payments were on file with the lender. The lender had no documentation to support the prior purchases and payments.

The \$834,481 was deposited in Omnivest's operating account; however, there was no audit trail to show what prior purchases and payments Omnivest was being reimbursed for. RD officials stated that reimbursement for purchases made prior to loan closing were allowed, but that generally the purchases should be within 6 months and there should be documents supporting the purchases and payments.

Immediately after receiving the \$834,481, Omnivest used \$382,000 to repay a loan it obtained in September 1996 from an unaffiliated corporation. We questioned the use of the remaining \$452,481 because Omnivest used these loan funds to (1) repay \$378,000 of a loan that the company also obtained in

September 1996 from an affiliated corporation controlled by a stockholder who held approximately 65 percent of the common stock of Amereco Inc., (Omnivest's parent company) and (2) pay \$79,211 to Omnivest officers for payables "Due to Amereco."

The conditional commitment states, "the lender is prohibited from disbursing any of the loan funds under this guarantee to the owners, stockholders or beneficiaries of the applicants or members of their families when such person(s) will retain any portion of their equity in the business."

Even though the lender did not directly disburse loan funds to company investors or officers, the investors and officers received the loan funds indirectly. Our review of the cash account showed that although the loan funds were commingled with other income, Omnivest could not have made these payments to its officers and the affiliated corporation without the infusion of the guaranteed loan funds.

The disclosure statement showed that \$436,622 of the \$834,481 was for reimbursement to Omnivest for its prior purchases of machinery and equipment (see table 10). However, our review of Omnivest's records from September 1996 through April 1997 showed that no machinery and equipment was purchased with the original loan funds obtained in September 1996 from the affiliated and unaffiliated companies. Our review of Omnivest's records disclosed that the prior loans were used for day-to-day operating expenses (such as payroll, utilities, and coal), rather than purchases of machinery and equipment, as the disclosure statement showed.

RECOMMENDATION NO. 2

Recover from the lender the questioned \$846,873. This amount is included in the \$4,052,351 questioned in Recommendation No. 1.

RD Response

In consultation with the Office of the General Counsel (OGC), to the extent the lender's negligence caused the loss to the Department of Agriculture (USDA) and the Agency can prove fraud or misrepresentation on the part of the lender, the Agency will take action to recover \$4,052,351, plus any associated costs, which may have accrued. The findings in this audit will be helpful in proceeding with voidance of the loan note guarantee.

Within 90 days of acceptance of the Agency response and OIG's permission to utilize the findings in this audit as part of the basis for voidance of the loan note guarantee, the agency will notify the lender of the agency's decision on voidance of the loan note guarantee.

The Agency is requesting a management decision on the response to this recommendation.

OIG Position

We agree with the planned actions and grant the agency permission to use the audit findings as necessary to carry out the planned actions. However, to achieve a management decision, we will need documentation that the loan note guarantee has been voided and details of the resulting actions to recover the \$4,052,351 from the lender.

CHAPTER 3**THE LENDER DID NOT PRUDENTLY SERVICE THE GUARANTEED LOAN****FINDING NO. 5**

The lender did not prudently service the Omnivest loan. The lender did not (1) perform servicing reviews of the borrower's financial status, (2) submit quarterly servicing reports to RD timely, and (3) appropriately apply funds from a certificate of deposit (CD) which served as collateral for the RD guaranteed loan. The lender had an agreement with a service provider to perform the required reviews and analysis to ensure the borrower's compliance with requirements of the conditional commitment and loan agreement and to prepare the quarterly servicing reports. The lender did not provide the servicing reports to RD until April 1998, 12 months after loan closing and after the business had ceased operations. RD was not aware of serious problems with the Omnivest account until the loan was in default and the business had ceased operations. In addition, the lender improperly applied \$11,190 of the CD principal to pay interest and late charges on a subsequent loan the bank made to the borrower and to pay on the unguaranteed portion of the guaranteed loan without applying 80 percent to the guaranteed portion. As a result of inadequate servicing, the lender (1) did not notify RD of problems with the Omnivest loan until the business operations had shut down and (2) misused \$11,190 of the guaranteed loan collateral.

The loan agreement¹¹ required the lender to submit quarterly servicing reports to RD. The purpose of the servicing reports is to require the lender to review and analyze the borrower's financial status to help identify and possibly correct potential problems.

RD Instructions¹² state, "The lender is 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," and "that loan servicing is intended to be preventive rather than curative. Prompt follow-up on delinquent accounts and early recognition of and pursuing a solution to potential problems are keys to resolving many problem accounts." The lender's agreement¹³ states, "the Loan Note Guarantee will be unenforceable by the lender to the extent any loss is occasioned by violation of usury laws, negligent servicing, or failure to

¹¹ Term Loan Agreement Section 10.8(b), dated April 18, 1997.

¹² RD Instructions 4287B, 4287.107 dated December 23, 1996.

¹³ USDA Form 4279-4, paragraph II (A), dated October 1996.

obtain the required security regardless of the time at which USDA acquires knowledge of the foregoing.”

Our review disclosed that the lender did not (1) perform quarterly servicing reviews of the borrower’s financial status, (2) submit quarterly servicing reports timely, and (3) appropriately apply funds from a CD which was served as collateral for the RD loan.

A. Servicing Reports – The lender did not perform quarterly servicing reviews of Omnivest’s financial status. The lender had an agreement with a service provider to service the loan. On April 8, 1998, the lender submitted servicing reports to RD for the quarters ended June, September, and December 1997. No other quarterly reports were submitted because as of March 1998 the business was closed. The lender’s service provider furnished the quarterly servicing reports all at one time to the lender who put them on the bank’s letterhead and passed them on to RD. The individual quarterly reports presented Omnivest operations as if the company was a going concern and the analyses on the individual reports were presented as though they were submitted at the end of each quarter when due rather than all at once on April 8, 1998. At the time the reports were sent to RD, the business had shut down.

The lender’s servicing plan required the lender to review and analyze the borrower’s quarterly financial statements to ensure that the company was in compliance with all financial requirements of the conditional commitment. Upon completion of the review, the lender was to prepare a report with comments to the specific loan covenants and any action needed to be taken, and submit a copy of the report to RD within 30 days of receipt of the borrower’s quarterly statements. RD was also to be notified immediately of any adverse action.

Omnivest’s monthly financial statements showed that the business never had sufficient working capital after the receipt of the guaranteed loan. Omnivest had a cumulative net loss of \$2,456,264 for the 13-month period between loan closing and when the business shut down (see table 11).

Table 11

Month	Net Loss	Month	Net Loss	Total	
4/97	(\$103,418)	11/97	(\$267,104)		
5/97	(\$122,496)	12/97	(\$282,764)		
6/97	(\$158,846)	1/98	(\$182,211)		
7/97	(\$210,939)	2/98	(\$257,377)		
8/97	(\$163,209)	3/98	(\$178,793)		
9/97	(\$136,730)	4/98	(\$243,770)		
10/97	(\$148,607)				
Total	(\$1,044,245)	Total	(\$1,412,019)		(\$2,456,264)

The lender made several visits to Omnivest's operation site. However, the lender did not perform quarterly servicing reviews of the borrower's financial status. Had the servicing reviews been performed, the lender could have detected that the borrower (1) used loan proceeds to pay officers/stockholders, (2) was paying management fees contrary to the requirement stipulated in the conditional commitment, and (3) did not use the loan funds as required for facility improvements and equipment purchases.

The lender did not notify RD of adverse conditions timely. The lender was aware of financial problems with the Omnivest loan shortly after loan closing. The lender (1) denied a \$2 million working capital loan to the borrower in June 1997, 2 months after loan closing, (2) provided a temporary \$250,000 line of credit (LOC) to the borrower in September 1997, and (3) used the \$500,000 CD held as collateral to make loan payments starting November 1997. However, RD was not notified of the adverse conditions until April 8, 1998. The lender's April 8, 1998, cover letter to RD transmitting the quarterly reports prepared by its service provider stated, "Please find attached the quarterly servicing reports for Omnivest Resources. Omnivest is experiencing severe working capital shortfalls, which have hurt both production and sales. As of December 31, 1997, Omnivest was in violation of the following covenants as outlined in the Term Loan Agreement: (1) current ratio requirement of 1.1 and (2) working capital requirement of \$500,000...Because Omnivest has had to use its existing working capital to fund the day-to-day operations, the company has been unable to service the USDA RD debt...Omnivest is currently in negotiations to bring in new investors to provide the company with the operating capital needed to run the plant at full capacity and be able to service its debt. If Omnivest does not meet the loan covenants by the June 30, 1998, quarterly report, the lender will take corrective action."

We asked the lender's service provider why the quarterly reviews and servicing reports were not conducted timely. The service provider stated that Omnivest would not return its telephone calls or requests for financial information on a timely basis. The lender and the lender service provider each received approximately \$1,000 monthly for servicing the loan.

- B. Questionable Application of Collateral Funds – Omnivest had a \$500,000 CD on deposit with the lender that was assigned to be used if the borrower was unable to make monthly payments on the guaranteed loan. The CD was used to make payments on the guaranteed loan totaling \$426,465 for the period November 1, 1997, through June 1, 1998, and the 1997 delinquent taxes of \$49,602. CD principal of \$13,987 was also used to pay interest and late charges on a subsequent loan the lender made to the borrower, and applied to the unguaranteed portion on the guaranteed loan held by lender. Eighty percent (\$11,190) of the \$13,987 should have been paid to the holder or RD.

On September 12, 1997, the lender provided the borrower a \$250,000 LOC without RD's knowledge or prior written approval. RD Instruction 4287.107(e) required the lender to obtain prior written approval of additional loans to the borrower, even though such loans will not be guaranteed. The LOC was to be an interim loan to be paid back with proceeds from a Small Business Administration (SBA) loan that never materialized. The terms of the LOC were that interest was to be paid monthly and the principal was to be paid October 12, 1998. As of November 1999, the LOC had an outstanding balance of \$240,050. Between May 13, 1998, and July 15, 1998, the lender used \$8,542 of the CD principal to pay the interest on the LOC and \$2,194 for late charges on the LOC.

The lender applied the residual CD principal of \$3,251 to the unguaranteed portion of the Omnivest loan held by the bank without remitting 80 percent (\$2,601) to RD for the guaranteed portion of the loan.

The lender should have credited \$11,190 (80 percent), of the total \$13,987 misapplied funds to the guaranteed portion of the loan.

RECOMMENDATION NO. 3

Recover \$11,190 from the lender for the 80 percent of principal collateral funds that should have been applied to the guaranteed portion of the loan. This amount is included in the \$4,052,351 questioned in Recommendation No. 1.

RD Response

In consultation with the Office of the General Counsel (OGC), to the extent the lender's negligence caused the loss to the Department of Agriculture (USDA) and the Agency can prove fraud or misrepresentation on the part of the lender, the Agency will take action to recover \$4,052,351, plus any associated costs, which may have accrued. The findings in this audit will be helpful in proceeding with voidance of the loan note guarantee.

Within 90 days of acceptance of the Agency response and OIG's permission to utilize the findings in this audit as part of the basis for voidance of the loan note guarantee, the agency will notify the lender of the agency's decision on voidance of the loan note guarantee.

The Agency is requesting a management decision on the response to this recommendation.

OIG Position

We agree with the planned actions and grant the agency permission to use the audit findings as necessary to carry out the planned actions. However, to achieve a management decision, we will need documentation that the loan note guarantee has been voided and details of the resulting actions to recover the \$4,052,351 from the lender.

CHAPTER 4	THE BORROWER'S PACKAGER AND LENDER'S SERVICE PROVIDER HAD A CONFLICT OF INTEREST
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A conflict of interest existed between the borrower's packager and the lender's service provider. The same agent simultaneously acted as both the borrower's packager and lender's service provider. The packager/lender service provider had a material interest in ensuring approval of the Omnivest loan since it received \$264,000 for its services. The packager/lender service provider (1) prepared the loan application package for the RD loan to include the project summary and assembly of financial reports, (2) performed the financial analysis of the business for the lender including determinations of financial ratios, and (3) negotiated terms of the loan guarantee with RD. RD had no regulatory provisions to prevent an agent from representing both the borrower and lender on the same loan. The dual functions that the agent performed on the Omnivest loan would have violated SBA regulations designed to prevent conflicts of interest. In addition, a former RD State office management employee responsible for supervising State RD staff who worked on processing the initial Omnivest application began employment with the packager/lender service provider after retirement in November 1996. He was instrumental in placing the Omnivest loan with the lender.

FINDING NO. 6

THE PACKAGER/LENDER SERVICE PROVIDER REPRESENTED BOTH BORROWER AND LENDER

The loan packager/lender service provider simultaneously represented both Omnivest and the lender during the loan application and closing process and serviced the loan after closing. The packager/lender service provider ushered the loan through the entire loan process including soliciting the lender, influencing the lender's acceptance of the

loan, and preparing financial analysis and documentation necessary to satisfy RD that the conditional commitment terms and other loan requirements were met. The packager/lender service provider received \$50,000 from the borrower for packaging services and \$214,000 from the lender when the guaranteed portion of the loan was sold in the secondary market.

The packager/lender service provider prepared the loan application including the project summary and negotiated the terms with RD before soliciting the lender to make the loan. In October 1996, RD offered a 50-percent loan guarantee, since the borrower's historical and projected financial status presented with the loan application did not show debt

repayment ability. The packager/lender service provider negotiated the terms of the guarantee with RD, and as an alternative, RD required that Omnivest achieve a minimum debt service ratio of 1.25 in order to obtain an 80 percent guarantee. The packager/lender service provider solicited First State Bank as substitute lender after the original lender (Harbourton Reassurance, Inc.) withdrew. In March 1997, the packager/lender service provider prepared and presented documents including financial analysis and certifications to the lender regarding compliance with the conditional commitment and other RD loan requirements. The lender, in turn, put them on the bank's letterhead and passed them on to RD without verification.

Prior to loan closing, the bank and lender service provider had an agreement for the provider to (1) perform loan origination duties to include arranging for the sale of the guaranteed portion of the loan on the secondary market and (2) service the loan. For its services, the packager/lender service provider received \$50,000 from Omnivest for packaging services and \$214,000 (50 percent of the \$428,000 premium) from the lender when the guaranteed portion of the loan was sold on the secondary market on April 18, 1997 -- the same day the loan closed. In addition, the lender service provider shared equally the monthly servicing fees of approximately \$2,000 with the lender.

On April 17, 1998, the lender service provider entered into a more formal broad based participation and servicing agreement with the lender. The agreement provided that the lender service provider would solicit new potential borrowers in Georgia with a view towards the lender functioning as the lead lender or participant for loans originated by the lender service provider. The lender would perform the role as lead lender and the lender service provider would perform loan origination, processing, underwriting, servicing, and liquidation functions on the loans. The agreement provided that the lender service provider and the lender share equally in all loan income and losses to include sharing the risk on the unguaranteed portions of the loans. The Omnivest loan was also covered under this agreement.

Examples of the packager/lender service provider's questionable actions during the Omnivest loan process follow.

- Performed the debt service ratio analysis to show that the borrower had sufficient cashflow (see Finding No. 1).
- Was aware of the needed \$2 million for working capital before the guaranteed loan closed and told an Omnivest officer not to mention the loan need to RD (see Finding No. 2).

- Provided the three quarterly servicing reports all at one time to the lender who put them on the bank's letterhead and passed them on to RD. At the time the reports were sent to RD, the business had stopped operations. In addition, the reports did not question the payment of management fees which was in violation of the conditional commitment (see Findings No. 4 and 5).

An agent's independence is compromised when it represents both the borrower and the lender on the same loan.

RECOMMENDATION NO. 4

Bar the packager/lender service provider and its affiliated companies from further participation in the guaranteed loan program.

RD RESPONSE

We have interpreted the intent of the recommendation to also include the individuals who are owners of the businesses referenced in the recommendation and will proceed accordingly in any process of debarment. We agree this recommendation is appropriate, however, as agreed during the exit conference, we will consult OGC and the USDA Debarment and Suspension Instructions to determine appropriate action.

The findings in this audit will be helpful in proceeding with debarment of the packager and the lender service provider. Within 90 days of acceptance of the Agency response and with OIG permission to utilize the findings in this audit, the Agency will notify the packager/lender service provider and debar them from further participation in the B&I Guaranteed Loan program.

The Agency is requesting management decision on the response to this recommendation.

OIG Position

We agree with the planned actions and grant the agency permission to use the audit finding as necessary to carry out the planned actions. However, to achieve a management decision, we will need documentation that the agency has debarred the packager/lender service provider.

RECOMMENDATION NO. 5

Pending debarment, conduct pre-guarantee reviews to verify compliance with conditional commitment terms and the loan agreement requirements on future loans that the

packager/lender service provider and affiliates participate in as either, a packager, lender service provider, or lender.

RD Response

We agree this recommendation is appropriate; however, as agreed during the exit conference, we will consult OGC and the USDA Debarment and Suspension Instructions to determine appropriate action. Upon acceptance of the agency's response and OIG's permission to utilize the findings in this audit, the agency will, on an on-going basis, conduct pre-guarantee reviews to verify compliance with conditional commitment terms and the loan agreement requirements that the packager and the lender service provider and their affiliates participate in as either a packager, lender, service provider, or lender.

The Agency is requesting a management decision on the response to this recommendation.

OIG Position

We agree with the management decision and grant permission to use the audit findings as necessary carry out the planned actions.

FINDING NO. 7
**RD HAS NO RESTRICTIONS
AGAINST AGENTS
REPRESENTING BOTH THE
BORROWER AND LENDER**

RD had no regulatory provisions to prevent an agent from representing both a borrower and lender on the same loan. The packager/lender service provider's activities with the Omnivest loan were similar to unauthorized activities one of its predecessor companies performed in the past with loans guaranteed under a SBA program similar to the RD loan program. SBA regulations¹⁴

specifically prohibit an agent from acting as both a lender service provider and packager for the same business loan. The regulatory intent is to keep the packager's interest separate from monetary gain if the loan is accepted, therefore, allowing the packager to be unbiased as to the approval or disapproval of the loan based on the packager's assertions in

¹⁴ 13 CFR 103.4(a) and 13 CFR 120.222(d), dated January 1, 2000.

the loan package. An entity's independence is compromised when it represents both a borrower and a lender on the same loan.

In October 1993, the SBA's OIG issued two audit reports involving regulatory violations by a lender service provider that was a predecessor company with the same officers as that of the packager/lender service provider for the Omnivest loan. The audit found that the lender service provider violated SBA regulations by (1) acting as both a packager and a lender service provider on the same business loans, (2) receiving compensation from both the lender and the borrower for the same loan, and (3) sharing the risk on the unguaranteed portion of the loans. The SBA OIG recommended that SBA seek recovery of losses on loans if SBA had purchased the guaranty from the lender and to consider other penalties or sanctions against both the packager/lender service provider and the lender. In its response to the recommendations, SBA stated its intentions to (1) cease doing business with the lender with respect to new loans, (2) seek recovery of incurred losses where legally possible, and (3) obtain assurances that the lender service provider ceases violations of SBA rules and regulations.

SBA's Office of General Counsel (OGC) also found that under SBA rules a proposed contract similar to the one the Omnivest lender entered into on April 17, 1998, with the lender service provider was illegal. In response to a 1994 request for approval of a written lender service provider contract between a provider and a lender, SBA's OGC found the proposed arrangement illegal and subsequently published a Procedural Notice, "Requirements for Lenders Using Bank Service Providers," effective August 10, 1994. The procedural notice specifies that lenders must not (1) compensate lender service providers on any basis that is not commensurate with the work actually performed, (2) split fees from the sale of loans on the secondary market, (3) allow lender service providers to assume a portion of the risk on the unguaranteed portion of the loan. The notice also prohibits lender service providers from directly or indirectly receiving compensation for packaging services including the preparation of an application. The lender service provider that was the subject of the SBA's OGC review was the predecessor company with the same officers as that of the packager/lender service provider of the Omnivest loan. The subject contract was similar to the April 17, 1998, participation and servicing agreement between the Omnivest lender and the lender service provider and the earlier 1997 arrangements between the two parties specific to the Omnivest loan.

RD has no regulations to prevent conflict of interest in its guaranteed loan program similar to the SBA regulations. The Omnivest packager/lender

service provider would have violated SBA regulations designed to prevent this type of conflict of interest (see table 12).

Table 12

SBA Requirements	We found that:
13 CFR 103.4(g) – An agent may not act as both a lender service provider and a packager on the same loan and receive compensation from both the lender and applicant. A lender service provider may not receive compensation for the provision of packaging services.	The packager/lender service provider had concurrent agreements with both the borrower and the lender, and received compensation from both. The packager/lender service provider had a material interest in ensuring the approval of the Omnivest loan. RD was unaware of this dual role.
13 CFR 120.222(d) - Lender may not share any premium received from the sale of the guaranteed loan in the secondary market with a packager, lender service provider, or other loan referral source.	The lender and the packager/lender service provider shared equally the \$428,000 premium received when the Omnivest guaranteed loan was sold on the secondary market. The April 17, 1998, agreement between the lender and lender service provider provided that all income from future RD guaranteed loans be shared equally.
13 CFR 120.140 - Lender service providers are prohibited from assuming a portion of the risk of the unguaranteed portion of the loan.	The lender and packager/lender service provider agreed that any losses on the unguaranteed portion of the Omnivest loan were to be shared equally. The April 17, 1998, agreement between the lender and lender service provider provided that losses on future loans would be shared equally.
13 CFR 103.5 - The lender may not delegate its authority with respect to the origination, processing, servicing, collection, and liquidation of guaranteed loans.	On the Omnivest loan, the packager/lender service provider performed the loan origination, processing and servicing functions. The April 17, 1998, agreement between the lender and the packager/lender service provider provided that the packager/lender service provider would be responsible for loan origination, processing, servicing, collection, and liquidation of future RD guaranteed loans.

The SBA regulations were implemented to prevent a lack of objectivity by parties who bear no responsibility for subsequent losses to the government.

RECOMMENDATION NO. 6

Implement regulations that prohibit (1) agents from acting as both a packager and lender service provider on the same loan, (2) a lender from sharing any premium received from the sale of a guaranteed loan in the secondary market with a service

provider or a packager, (3) a lender from sharing any portion of the risk on the unguaranteed portion of the loan, and (4) a lender from delegating its authority with respect to the origination, processing, servicing, collection, and liquidation of a guaranteed loan.

RD Response

During the exit conference, it was agreed that the Small Business Administration and the Business and Industry Guaranteed Loan programs are similar but different. We propose to rewrite appropriate sections of the Business and Industry regulations that would provide for inclusion of a prohibition of (1) an entity acting as both packager and lender service provider on the same loan, (2) a lender from sharing any premium received from the sale of a guaranteed loan in the secondary market with a service provider or a packager, and (3) a lender from delegating its authority with respect to the origination, processing, servicing, collection, and liquidation of a guaranteed loan. We will not prohibit the lender from sharing any portion of the risk on the unguaranteed portion of the loan. The reason for this is that there is an existing provision in the Business and Industry Guaranteed Loan program instructions that requires the lender to retain five percent of the loan, which must be of the unguaranteed part of the loan. Furthermore, Business and Industry Guaranteed Loans are much larger than Small Business Administration Loans which makes it much more difficult for the lender to make these larger loans within its capitalization limitations. Since implementation of this action is not an emergency effecting the public well being, an interim final rule change cannot be justified. Consequently, the change will entail both proposed and final rule making actions, which are anticipated to take until June 30, 2003.

The Agency is requesting a management decision on the response to this recommendation.

OIG Position

We agree with the proposed prohibitions that will be included in the rewrite of the regulations, however interim actions should be implemented to prohibit the conflict of interest practices detailed in the audit finding.

To achieve a management decision, we need details of interim actions the agency will take, pending issuance of the revised regulations, to implement the recommendation.

FINDING NO. 8

AN EMPLOYEE OF THE PACKAGER/LENDER SERVICE PROVIDER HAD A POST FEDERAL EMPLOYMENT CONFLICT OF INTEREST

During the period February 1997 through April 1997, an employee of the packager/lender service provider (Individual A), who had retired from RD in November 1996, was instrumental in placing the loan with the lender. When employed with RD, Individual A served in a management position in the RD State office and was involved with the Omnivest loan application. Shortly before retirement, Individual A was detailed to the Tifton,

Georgia RD district office where he again had knowledge and influence regarding the Omnivest application, because it was processed through that office. After retiring from RD, Individual A was hired by the packager/lender service provider for the Omnivest loan. In February 1997, Individual A contacted another former USDA employee (Individual B) who was affiliated with First State Bank of Donalsonville, Georgia, (the lender) to solicit the bank to make the loan to Omnivest.

Federal regulations¹⁵ provide for certain post employment restrictions. A former employee may never personally represent any party before the agency on a matter in which he or she participated as a Federal employee. There is a 2-year restriction prohibiting “employees from representing an outside organization with the Federal Government if, during the year prior to the employee’s departure, a subordinate was personally and substantially involved in a particular matter.”

Individual B was a former USDA employee for 20 years (approximately 1971-1991), who was employed in an agricultural housing program under direct supervision of Individual A. Individual B told us that Individual A contacted her sometime in February 1997 with a request that the bank be a substitute lender for the Omnivest loan. Individual A told Individual B that RD had already approved the loan and that the RD State Director wanted the loan to go through. Individual B stated that at the time of the telephone call she assumed Individual A still worked with RD.

On March 18, 1997, Individual A and an officer of the packager met with Individual B to discuss the Omnivest loan and to provide materials relating to the loan (i.e., feasibility study, loan application, conditional commitment,

¹⁵ 7 CFR 2637.201 and 2637.202 dated January 1, 2000.

etc.). Individual B told us that she put a great deal of reliance upon her prior professional association with Individual A and his association with USDA when deciding to approve the Omnivest loan.

Individual B also stated that in April 1997, Individual A requested she not mention his name in any discussions with RD. She stated that she did not question this request.

We asked the packager why Individual A made the request to Individual B. The packager did not address whether Individual A made the request of Individual B. The packager responded that the company never made such a request and that Individual A was not an officer of the packaging company. The packager also stated that Individual A introduced the packager to the bank and recused himself from further discussions regarding this loan proposal. However, Individual B stated that Individual A discussed the merits and viability of the Omnivest loan proposal with her. Our review of correspondence showed that Individual A was an employee of the packager and continued to be involved with the Omnivest loan after the initial introduction meeting. On March 28, 1997, the packager sent the lender copies of the lender's certifications to be sent to RD. The cover letter stated that Individual A said the certifications were acceptable.

On August 11, 1997, in reply to correspondence from the packager concerning its approval as an eligible lender for the Business and Industry loan program, the RD State director advised the packager that Individual A should not be involved in any activities in Georgia because "the statute restricts former employees from representing an outside organization in connection with any particular matter which he/she worked on as a Federal employee."

Investigators from the USDA OIG interviewed the former RD State director and another State management employee. The interview with the former State director stated, in part,

- "She never heard [Individual A] discuss the Omnivest loan guarantee with anyone but she said [Individual A] could have been substantially involved."
- "She said that she and [Individual A] discussed the Omnivest loan guarantee and both wanted the project to go forward for a very poor county. She said they were both aware of the pitfalls. She said the loan packager, ... called the RD National office and her office on a variety of issues."

The interview with the other management employee stated, in part,

- “[Name] said he discussed the loan guarantee to Omnivest Resources, Inc., with [Individual A] as [Individual A] asked him to troubleshoot inquiries or complaints.”
- “...said [Individual A] did call him and asked about the Omnivest loan guarantee after [Individual A] left the Government service.

The investigators also interviewed a State office program specialist who stated, in part, that Individual A “had knowledge of the Omnivest loan but just prior to his retirement, no involvement.” The program specialist told us that she was sent to the RD Tifton office for a week in October 1996 to help a district office program specialist with the processing of the Omnivest loan application. The district program specialist who was processing the application was under the supervision of Individual A during his detail to the Tifton office. The State office program specialist also told us that she worked with Individual A while in the Tifton office and he had review authority and was involved with the review of the Omnivest loan.

Although Individual A did not sign off on or approve the loan, he advised the employees in the district office. The new district director presented the project summary to the State Review board on December 4, 1996.

RECOMMENDATION NO. 7

Use Individual A’s violations of post-employment restrictions as further support for barring the packager from further participation in the program.

RD Response

We agree this recommendation is appropriate, however, as agreed during the exit conference, we will consult OGC and the USDA Debarment and Suspension Regulations to determine appropriate action. Within 90 days of acceptance of the agency’s response and OIG’s permission to utilize the findings in this audit, the agency will notify the packager/lender service provider and debar them from further participation in the B&I Guaranteed Loan program.

The Agency is requesting a management decision on the response to this recommendation.

OIG Position

We agree with the planned actions and grant the agency permission to use the audit finding as necessary to carry out the planned actions. However, to achieve a management decision, we will need documentation that the agency has debarred the packager/lender service provider.

CHAPTER 5**RD INADEQUATELY PROCESSED AND MONITORED THE LENDER'S SERVICING OF THE OMNIVEST LOAN****FINDING NO. 9**

The RD State office did not adequately evaluate the Omnivest loan to ensure that requirements of the conditional commitment and loan agreement were met prior to issuance of the guarantee. RD evaluated the initial loan application to determine whether the proposed loan was for an eligible purpose and complied with applicable statutes and regulations. Based on this review, RD issued a conditional commitment to the borrower listing several critical terms and requirements (conditions) that had to be met prior to issuance of the loan guarantee. Before issuance of the guarantee, RD was required to satisfy itself that all conditions were met. However, RD accepted the lender's certifications of compliance with the conditional commitment requirements without performing a substantive analysis of the lender's certifications and eligibility determination. In addition, the RD State office did not adequately monitor the lender's servicing of the Omnivest loan. As a result, RD faces a loss of over \$4 million.

Prior to December 23, 1996, Federal regulations¹⁶ required RD to conduct a preguarantee review of all loans before issuance of the Loan Note Guarantee. The purpose of the preguarantee review was to assure that all requirements of the application and the conditional commitment had been met. Effective December 23, 1996, new RD regulations, 7 CFR Parts 4279 and 4287, were issued to streamline and update the Business and Industry Loan Program. The intended effect was for the loan program to be more flexible and to place more reliance on lenders. If a loan was not closed but a conditional commitment had been issued before December 23, 1996, the lender had the option of closing the loan under the old or the new regulations. Lenders with existing outstanding loans were also given the option to service the loans under the new regulations. All loan applications processed after December 23, 1996, were to be closed under the new regulations. The Omnivest loan was closed under the new regulations. The new regulations¹⁷ state that the loan note guarantee will be issued when RD is satisfied that all conditions for the guarantee have been met.

¹⁶ 7 CFR 1980.454, paragraph B, dated January 1, 1997.

¹⁷ 7 CFR 4279.186 dated December 23, 1996.

- A. RD Review of Lender's Certifications – RD did not adequately evaluate the Omnivest loan prior to issuance of the loan note guarantee. In October 1996, RD evaluated the borrower's historical and projected financial status presented with the initial loan application. At that time, Omnivest was not a viable operation as structured. RD's review determined that the company did not have debt repayment ability and projections of future revenues and profits were optimistic. The evaluation also raised concerns about the appraised value of the collateral offered as security for the loan. Because of the high risk of loss, in October 1996, RD offered a 50-percent loan guarantee. As an alternative, the packager negotiated with RD that if Omnivest could achieve a minimum debt service ratio of 1.25, then an 80-percent guarantee would be approved.

Based on the initial evaluation and the project summary, on December 4, 1996, RD issued a conditional commitment listing terms and conditions to be met prior to issuance of the loan guarantee. Several of the more critical conditions were that Omnivest (1) achieve a minimum debt service coverage of 1.25 before the loan closed (2) maintain a current ratio of 1 to 1 during the life of the loan, (3) achieve a minimum working capital of \$500,000 during 1997, and (4) resolve all appraisal issues/deficiencies.

On March 28, 1997, the lender notified RD that Omnivest had met all requirements of the conditional commitment including the financial ratios. RD accepted the lender's certification of compliance without performing a substantive analysis of the lender's certification. State office program staff stated that a preguarantee review of the lender's certifications was not required because (1) the loan was closed under the new regulation, (2) the lender was responsible for ensuring that requirements are met prior to loan closing, and (3) the lender's certifications were sufficient to satisfy the agency that the requirements were met.

The lender had no prior experience with RD loans, large loans and complex manufacturing operations such as Omnivest. Because of the RD concerns raised during the initial evaluation, the high-risk of loss, and the lender's lack of experience with large loans and manufacturing operations, RD's performance of a substantive analysis or a preguarantee review of the Omnivest loan and lender's certifications was even more important to satisfy itself that the borrower had sufficient cashflow to support loan repayment, adequate working capital to sustain operations and collateral value sufficient to secure the loan. After loan default, the RD State office performed a post review of the loan. From information that was available to RD prior to loan closing, the post review identified similar deficiencies that should have been detected if RD had

evaluated the lender's certifications and eligibility determination prior to issuance of the loan note guarantee. The deficiencies RD identified during the post review were the basis for the referral to OIG for investigation.

The following deficiencies with the Omnivest loan should have been detected from a pre-loan closing review (see table 13).

Table 13

<p>RD should not have accepted the lender's certification that the required 1.25 debt service coverage was met. The lender based its determination and calculations on a 2-month period (December 1996 and January 1997), of which only 1 month showed a profit. One month's profitable operations was not a reasonable basis to conclude that the company would sustain a profit sufficient to support its debt service cost particularly in light of the October 1996 application review findings. The post review also questioned the lender's certification that the required debt service requirement was met based on suspicious sales for November 1996 through January 1997, shown on the unaudited financial statements submitted with the loan application and lender certification (see Finding No. 1).</p>
<p>RD did not require the lender to provide an updated credit analysis of the borrower's financial condition. The credit analysis provided with the loan application was based on outdated financial statements 9 months old at the time of the loan closing and the substitute lender did not do the analysis. As a result, the borrower's cashflow, debt repayment ability, and working capital balance positions were not adequately assessed prior to loan closing (see Finding No. 2).</p>
<p>RD did not ensure that the lender obtained the 1996 year-end audited financial statements. Amereco, Omnivest's parent company, is registered with the SEC. SEC requires an annual report that includes audited financial statements to be filed with the Commission within 90 days of a company's fiscal year end. The audit was performed in January and February 1997, and material adjustments to the 1996 fiscal results were made on the books in February 1997. If RD had requested the 1996 year-end audit results, it would have been apparent that as of December 31, 1996, Omnivest had a negative working capital in excess of \$3 million and that the unaudited financial statements for December 1996 and January 1996 contained materially inflated assets and revenues. Even after infusion of the guaranteed loan funds, Omnivest still had a negative working capital in excess of \$436,000 (see Finding No. 2).</p>
<p>RD should not have accepted an appraisal based on an inappropriate valuation approach. RD notified the lender several times that the appraisal was not acceptable. However, once the lender certified to RD that the appraisal met the bank's standards, RD accepted the appraisal even though it was not based on an appropriate methodology. During the post review the State office sent the appraisal of security property submitted with the loan application to the National office to obtain the opinion of two staff specialists on the property of the appraisal. Both National office reviews stated that the appraisal valuation method was not appropriate for a collateral appraisal (see Finding No. 3).</p>
<p>RD should not have accepted a corporate guarantee from Amereco, Inc. (Omnivest's parent company) since Omnivest comprised all of Amereco's assets and would be worthless in the event of loan default. RD requires a personal guarantee from parties owning greater than 20 percent of the borrower. However, due to Omnivest constituting all of Amereco's assets and the high-risk nature of the loan, personal guarantees should have been required of the owners regardless of their ownership percent as a condition for the guarantee (see Finding No. 3).</p>

- B. Servicing – RD did not ensure that the lender submitted the required quarterly servicing reports. RD did not receive any servicing reports until 12 months after loan closing. We found no documentation in RD’s files requesting the servicing reports. As a result, RD was not aware of serious problems with the Omnivest account until the loan was in default and the business had ceased operations (see Finding No. 5).

In addition, a requirement of the conditional commitment was that no management fees would be paid until Omnivest achieved debt service coverage of 1.25 exclusive of management fees. If RD had received the quarterly servicing reports, it could have detected that management fees continued to be expensed after loan closing without Omnivest ever achieving a 1.25 debt service ratio.

On December 12, 2000, the RD National office rescinded the Georgia RD State office’s Business and Industry direct and guaranteed loan processing and loan servicing authority because (1) the State’s delinquency rates for both programs were well above the national averages and (2) there were specific concerns regarding loan processing and servicing for five loans totaling \$18 million including the Omnivest loan.

Concerns the National office noted regarding the processing and servicing of the five loans are shown on table 14.

Table 14

Concerns	No. of Loans
Closed with inadequate working capital ¹	1
Lacked a reasonable assurance of repayment ability	2
Insufficient collateral	2
Insufficient equity	3
Working capital proceeds were used to pay owners/stockholders	1
Financial statements were not prepared in accordance with generally accepted accounting principals	1
Projections were optimistic ¹	2
Unqualified management ¹	2
Appraisal concerns ¹	2
¹ Deficiency includes Omnivest	

RECOMMENDATION NO. 8

Establish procedures and review criteria for State Office staff to follow to satisfactorily conclude that all terms and conditions of the conditional commitment and loan agreement

have been met prior to issuance of loan note guarantees.

RD Response

...Considering the latitude provided by the Business and Industry (B&I) Guaranteed Loan program instructions and the policy guidance given by the then Agency Administrator, we do not fully agree that the Georgia Rural Development State Office did not perform sufficient due diligence. Program instructions place almost total reliance upon the lender in regard to certifications concerning performance and the execution of certain duties and functions of the lender.

The B&I Guaranteed Loan Program is designed to be lender-driven, with the realization that there are provisions to reduce or deny the Loan Note Guarantee for just cause. The audit recommendations and our response are evidence of how this process was designed and is intended to function. We are planning to provide nationwide training and technical assistance, as well as continued monitoring of State Office performance, in a cooperative effort to strengthen B&I Guaranteed Loan Program delivery and servicing. Furthermore, we are going to inform Rural Development staff nationwide, who are responsible for B&I Guaranteed Loan processing and servicing, as to what constitutes a reasonable review and analysis of information and certifications provided by the lender/borrower. This will be accomplished by amending appropriate parts of the administrative sections of RD Instructions 4279-A and B. The amendment to the instructions will be completed within 180 days of the acceptance of the response to Recommendation 8.

As was indicated in the exit conference, we are developing a plan to work with the State in providing the training and technical assistance we deem necessary in order for delegated loan processing and servicing authorities to be returned to the State. The findings in the audit will be helpful in preparation of this plan.

OIG Position

We agree with the management decision.

EXHIBIT A – SUMMARY OF MONETARY RESULTS

Description	Amount	Category
Lender was deficient in processing and servicing of the Omnivest loan.	\$4,052,351	Questioned costs/loans, recovery recommended

EXHIBIT B – OMNIVEST’S PROFIT AND LOSS STATEMENTS

Month	Net Sales	Cost of Sales		Operating Expenses	Income (Loss) from Operations	Other Expenses	Net Income (Loss)
		Amount	Percent (Sales)				
6/96	\$236,964	\$171,638	72	\$79,557	(\$14,231)	\$29,258	(\$43,489)
7/96	\$297,036	\$216,836	73	\$74,733	\$5,467	\$30,116	(\$24,649)
8/96	\$220,773	\$166,302	75	\$72,278	(\$17,807)	\$31,698	(\$49,505)
9/96	\$303,460	\$198,064	65	\$68,382	\$37,014	\$36,710	\$304
10/96	\$187,563	\$172,992	92	\$84,917	(\$70,346)	\$29,400	(\$99,746)
11/96	\$174,214	\$125,744	72	\$69,089	(\$20,619)	\$28,947	(\$49,566)
12/96 ¹⁸	\$348,345	\$228,556	66	\$64,171	\$55,618	\$28,472	\$27,148
12/96 ¹⁹	\$348,345	\$223,004	64	\$49,471	\$75,870	\$28,470	\$47,400
1/97 ¹⁹	\$347,224	\$244,454	70	\$72,969	\$29,801	\$32,097	(\$2,296)
1/97 ¹⁸	\$347,224	\$377,010	109	\$73,110	(\$102,896)	\$30,791	(\$133,687)
2/97	\$329,844	\$378,515	115	\$73,326	(\$121,996)	\$25,808	(\$147,804)
3/97	\$157,755	\$165,578	105	\$64,966	(\$72,790)	\$83,046	(\$155,836)
4/97	\$282,620	\$269,623	95	\$70,818	(\$57,821)	\$45,597	(\$103,418)
5/97	\$165,228	\$175,559	106	\$63,337	(\$73,669)	\$48,827	(\$122,496)
6/97	\$170,473	\$206,293	121	\$63,628	(\$99,448)	\$59,398	(\$158,846)
Total²⁰	\$3,221,499	\$2,852,710		\$922,312	(\$553,524)	(\$508,068)	(\$1,061,590)
<i>April – December 1997 (9 months)</i>							
	\$1,743,189	\$2,160,896	124	\$593,472	(\$1,011,179)	\$582,932	(\$1,594,112)
1997 (12 months) Totals							
	\$2,578,012	\$3,081,999	120	\$804,874	(\$1,308,862)	\$722,577	(\$2,031,440)

¹⁸ Financial statements prepared by Omnivest’s accountant and per general ledger.

¹⁹ Financial Statements presented to lender.

²⁰ 13-Month Total (6/96 – 6/97). Does not include 12/96 and 1/97 shaded columns.

EXHIBIT C – CALCULATION OF THE DEBT SERVICE COVERAGE RATIO

Our review of Omnivest's and Alliance Materials' customer and shipping/receiving records and interviews with Omnivest's vice president and accountant determined that purported shipments of by-product to Alliance Materials never took place and payment of \$380,000 was never received. The purported shipments and corresponding sales amounts were handwritten notations made on the accounting records for December 1996, and January, February, and April 1997. The notations were made by Omnivest's vice president. The notations were added to the bottom of the computer-generated listings of shipments and corresponding sales for the respective months. Omnivest's accountant made individual journal entries to record the purported shipments, which increased sales and accounts receivable from Alliance Materials. Omnivest's vice president stated that Omnivest Resources and Florida Mining and Materials (a Florida aggregate company) entered into a joint venture to form Alliance Materials, Inc. By-products resulting from Omnivest and Florida Mining production was to be shipped to Alliance Materials and combined to produce a marketable product. Omnivest's vice president stated that the joint venture required (a verbal agreement) each company to allocate a certain amount of their by-product inventory to be reserved for Alliance Materials and that since this inventory could not be sold to anyone else, he considered it a sale. Omnivest's vice president also stated that he was responsible for Alliance Material's books and that it was his decision not to record the reciprocal accounts payable on Alliance's records. In September 1998, the last month books were maintained for Omnivest, a reversing entry was made deducting \$380,000 from sales and crediting accounts receivable from Alliance Materials.

The December 1996 and January 1997 financial statements used to calculate the debt service coverage ratio include these inflated sales. The following summarizes the corrected sales and resulting net income for December 1996 through April 1997.

Month	Net Sales per Lender Certification	Overstated Sales	Corrected Sales	Net Income (Loss) per Lender Certification	Net Loss After Sales Adjustment
December	\$348,345	\$190,000 ¹	\$158,345	\$47,400	(\$142,600)
January	\$347,224	\$95,000	\$252,224	(\$2,296)	(\$97,296)
February	\$329,844	\$190,000	\$139,844	(\$147,804)	(\$337,805)
March	\$157,755	\$0	\$157,755	(\$155,835)	(\$155,835)
April	\$282,620	\$95,000	\$187,620	(\$103,418)	(\$198,418)
¹ As a result of the year-end audit, the December 1996 sales of \$190,000 was canceled and recorded in February 1997. Therefore, purported by-product sales totaled \$380,000 for January, February, and April.					

EXHIBIT D – INFORMATION SUPPORTING THE NEED OF \$2 MILLION FOR WORKING CAPITAL

Our review of the lender, borrower, and RD files disclosed the following information supporting the need for the additional \$2 million.

- May 9, 1997 – An Omnivest representative notified the lender that they would be in south Georgia May 14 through 16 and would like to meet and discuss the establishment of a revolving loan.
- June 6, 1997 - Amereco's Form 10-K [required annual report filed with the SEC pursuant to section 13 or 15 (d) of the Securities Exchange Act of 1934] for fiscal year ended December 31, 1996 states, "On April 18, 1997, the Company (Amereco) completed the long awaited debt refinancing with First Federal Savings Bank of Southwest Georgia (FFSB)...The Company's Board of Directors and officers continue to search for an unrelated party source for the approximately \$2 million which it requires in working capital financing and repayment of the Company's note payable to Congress."
- June 26, 1997 – Lender Loan Committee minutes – Omnivest requested a \$2 million loan secured by inventory, accounts receivable and irrevocable stand-by letter. Denied based on lack of history with bank.
- July 10, 1997 – Lender Loan Committee minutes – Omnivest requested an \$800,000 loan secured by 45-percent inventory, 75-percent accounts receivable. Denied based on lack of established history with bank.
- July 31, 1997 – Lender Loan Committee Narrative – Omnivest has requested a \$250,000 line of credit to be collateralized by 75 percent of the accounts receivable. This loan would serve as a bridge loan for working capital until a SBA loan can be completed. The SBA loan is to be 75 percent guaranteed. A letter has been received from Cathay Global Investments stating the willingness to release liens and security interest against the accounts receivable of Omnivest.
- August 11, 1997 – In correspondence with the lender, Omnivest states that the \$250,000 loan secured by accounts receivable should only be necessary until the SBA loan is completed as a proposed by the packager. The bridge loan term should be for a 90-day period based on the 45 to 60-day timing represented by the packager for completion of the SBA loan.
- September 11, 1997 – In correspondence with the lender, the packager states that it is diligently preparing the SBA loan application.
- September 12, 1997 – The \$250,000 bridge loan is closed, and the additional terms of the loan specify that this loan will be paid in full from anticipated SBA loan proceeds.

EXHIBIT D – INFORMATION SUPPORTING THE NEED OF \$2 MILLION FOR WORKING CAPITAL

- December 11, 1997 - Correspondence from the borrower to the lender states, “As we were aware and discussed with First State Bank (lender) prior to proceeding on the RD loan last spring, the business was in need of a \$2 million line of credit to meet its equipment and working capital needs.”
- May 27, 1998 - RD first became aware of the needed \$2 million during a meeting between RD, the borrower, packager, and lender. The borrower informed RD during the meeting that Omnivest was in need of a \$2 million working capital loan when the \$5 million guaranteed loan was closed in April 1997.
- September 1, 1998 - Amereco’s Form 8-K (report required by the SEC to describe any significant events that may affect the company) states “Amereco, Inc., and its operating subsidiary, Omnivest Resources, Inc., a Georgia corporation have experienced difficulty in meeting its obligations as they become due. This was primarily due to the inability of Omnivest to obtain a \$2 million working capital loan...which the Registrant expected to be funded by FFSB, or another lender, immediately subsequent to the funding of a \$5 million long-term financing from the lender.”

EXHIBIT E – LOAN DISBURSEMENT STATEMENT

Item(s) Description	Loan Agreement	Disclosure/Settlement Statement
Facility improvements	\$40,000	\$40,000.00 ³
Payment of fees and expenses	130,000	202,096.46 ¹
Refinancing debt (Payoff Congress Financial)	2,425,000	2,425,000.00 ¹
Pay down accounts payable and working capital	980,000	
Funds disbursed as working capital		278,953.68 ²
Funds disbursed to pay down accounts payable		314,794.54 ¹
Reimbursement to borrower for funds expended on accounts payable		314,028.09 ²
Purchase machinery/equipment	1,025,000	
Funds disbursed for the purchase of machinery/ equipment		78,885.04 ¹
Reimbursement to borrower for funds expended on machinery/ equipment		436,622.18 ²
Balance of funds to be disbursed for purchase of machinery/ equipment		510,174.82 ³
Spare parts inventory	400,000	
Funds disbursed for purchase of spare parts inventory		33,614.58 ¹
Reimbursement to borrower for funds expended on purchase of spare parts inventory		83,830.61 ²
Balance of funds to be disbursed for purchase of spare parts inventory		282,000.00 ³
	\$5,000,000	\$5,000,000.00
¹ Funds disbursed at closing, checks made to creditors totaling \$3,054,390.62. ² Disbursed to Omnivest at loan closing totaling \$1,113,434.56. ³ Balance of loan proceeds placed in escrow for future disbursements to Omnivest totaling \$832,174.82.		

EXHIBIT F- RURAL DEVELOPMENT'S RESPONSE TO THE DRAFT REPORT

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United States Department of Agriculture
Rural Development

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

AUG 20 2001

SUBJECT: Office of Inspector General Audit Report No. 34099-2-At
Omnivest Resource Services, Inc. - Fort Gaines, Georgia

TO: Rebecca Anne Batts
Director
Rural Development and Natural Resources
Office of Inspector General

THROUGH: Barbara Scott *Barbara Scott*
Acting Director
Financial Management Division AUG 20 2001
Rural Development

for Sherie Hinton Henry *Barbara Scott*
Acting Deputy Administrator
Operations and Management AUG 20 2001
Rural Development

This replaces our August 3, 2001, response to the discussion draft on the subject audit, since that response had several omissions. It is our understanding, based on conversation during the exit conference, that the discussion draft has been elevated to an official draft.

We appreciate your meeting with us and discussing our concerns during the exit conference, and, as promised, our concerns and observations as well as official Agency responses are presented accordingly.

We agree that the lender was deficient in its responsibilities for determining borrower eligibility. We agree that the lender did not ensure that loan proceeds were used appropriately and that the lender did not prudently service the Omnivest loan properly, as identified in the report. We understand the potential conflict of interest when the same entity is both the packager and the service provider. Considering the latitude provided by the Business and Industry (B&I) Guaranteed Loan Program instructions and the policy guidance given by the then Agency Administrator, we do not fully agree that the Georgia

Rural Development is an Equal Opportunity Lender
Complaints of discrimination should be sent to:
Secretary of Agriculture, Washington, DC 20250

Office of Inspector General Audit Report No. 34099-2-At
Omnivest Resource Services, Inc. - Fort Gaines, Georgia

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Rural Development State Office did not perform sufficient due diligence. Program instructions place almost total reliance upon the lender in regard to certifications concerning performance and the execution of certain duties and functions of the lender.

The B&I Guaranteed Loan Program is designed to be lender-driven, with the realization that there are provisions to reduce or deny the Loan Note Guarantee for just cause. The audit recommendations and our responses are evidence of how this process was designed and is intended to function. We are planning to provide nationwide training and technical assistance, as well as continued monitoring of State Office performance, in a cooperative effort to strengthen B&I Guaranteed Loan Program delivery and servicing. Furthermore, we are going to inform Rural Development staff nationwide, who are responsible for B&I Guaranteed Loan processing and servicing, as to what constitutes a reasonable review and analysis of information and certifications provided by the lender/borrower. This will be accomplished by amending appropriate parts of the administrative sections of RD Instructions 4279-A and B. The amendment to the instructions will be completed within 180 days of acceptance of the response to Recommendation 8.

As was indicated in the exit conference, we are developing a plan to work with the State in providing the training and technical assistance we deem necessary in order for delegated loan processing and servicing authorities to be returned to the State. The findings in the audit will be helpful in preparation of this plan.

The audit contained recommendations, which we will address separately, as outlined below:

- **Recommendation No.1:**

"Take action to void the loan note guarantee and recover from the lender the \$4,052,351 RD paid to repurchase the guaranteed loan from the secondary market holder."

Response:

In consultation with the Office of the General Counsel (OGC), to the extent the lender's negligence caused the loss to the Department of Agriculture (USDA) and the Agency can prove fraud or misrepresentation on the part of the lender, the Agency will take action to recover \$4,052,351, plus any associated costs which may have accrued. The findings in this audit will be helpful in proceeding with voidance of the loan note guarantee.

Within 90 days of acceptance of the Agency response and with OIG permission to utilize the findings in this audit as part of the basis for voidance of the loan note guarantee, the

Office of Inspector General Audit Report No. 34099-2-At
Omnivest Resource Services, Inc. - Fort Gaines, Georgia

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Agency will notify the lender of the Agency decision on voidance of the loan note guarantee.

The Agency is requesting management decision on the response to this recommendation.

- **Recommendation No. 2:**

"Recover from the lender the questioned \$846,873. This amount is included in the \$4,052,351 questioned in Recommendation No. 1."

Response:

In consultation with OGC, to the extent the lender's negligence caused the loss to USDA and the Agency can prove fraud or misrepresentation on the part of the lender, the Agency will take action to recover \$4,052,351, plus any associated costs which may have accrued."

Within 90 days of acceptance of the Agency response and with OGC permission to utilize the findings in this audit, the Agency will make demand for recovery of these funds.

The Agency is requesting management decision on the response to this recommendation.

- **Recommendation No. 3:**

"Recover \$11,190 from the lender for the 80 percent of principal collateral funds that should have been applied to the guaranteed portion of the loan. This amount is included in the \$4,052,351 questioned in Recommendation No. 1."

Response:

In consultation with OGC, to the extent the lender's negligence caused the loss to USDA and the Agency can prove fraud or misrepresentation on the part of the lender, the Agency will take action to recover \$4,052,351, plus any associated costs which may have accrued.

Within 90 days of acceptance of the Agency response and with OGC permission to utilize the findings in this audit, the Agency will make demand for recovery of these funds.

The Agency is requesting management decision on the response to this recommendation.

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Omnivest Resource Services, Inc. - Fort Gaines, Georgia

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• **Recommendation No. 4:**

"Bar the packager/lender service provider and its affiliated companies from further participation in the guaranteed loan program."

Response:

We have interpreted the intent of the recommendation to also include the individuals who are owners of the businesses referenced in the recommendation and will proceed accordingly in any process of debarment. Furthermore, we interpret "affiliated companies" to include B&I Lending, Inc., which is a non-traditional lender. We agree this recommendation is appropriate; however, as agreed during the exit conference, we will consult OGC and the USDA Debarment and Suspension Instructions to determine appropriate action.

The findings in this audit will be helpful in proceeding with debarment of the packager/lender service provider. Within 90 days of acceptance of the Agency response and with OIG permission to utilize the findings in this audit, the Agency will notify the packager/lender service provider and debar them from further participation in the B&I Guaranteed Loan Program.

• **Recommendation No. 5:**

"Pending debarment, conduct pre-guarantee reviews to verify compliance with conditional commitment terms and the loan agreement requirements on future loans that the packager/lender service provider and affiliates participate in as either a packager, lender service provider, or lender."

Response:

We agree this recommendation is appropriate; however, as agreed during the exit conference, we will consult OGC and the USDA Debarment and Suspension Instructions to determine appropriate action. Upon acceptance of the Agency response and with OIG permission to utilize the findings in this audit, the Agency will, on an on-going basis, conduct pre-guarantee reviews to verify compliance with conditional commitment terms and the loan agreement requirements that the packager/lender service provider and affiliates participate in as either a packager, lender, service provider, or lender.

The Agency is requesting management decision on the response to this recommendation.

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• **Recommendation No. 6:**

"Implement regulations similar to SBA's that prohibit (1) acting as both a packager and lender service provider on the same loan, (2) a lender from sharing any premium received from the sale of a guaranteed loan in the secondary market with a service provider or a packager, (3) a lender from sharing any portion of the risk on the unguaranteed portion of the loan, and (4) a lender from delegating its authority with respect to the origination, processing, servicing, collection, and liquidation of a guaranteed loan."

Response:

During the exit conference, it was agreed that the Small Business Administration (SBA) and the B&I Guaranteed Loan Programs are similar but different. We propose to rewrite appropriate sections of the B&I regulations that would provide for inclusion of a prohibition of (1) an entity acting as both packager and lender service provider on the same loan, (2) a lender from sharing any premium received from the sale of a guaranteed loan in the secondary market with a service provider or a packager, and (3) a lender from delegating its authority with respect to the origination, processing, servicing, collection, and liquidation of a guaranteed loan.

We will not prohibit the lender from sharing any portion of the risk on the unguaranteed portion of the loan. The reason for this is that there is an existing provision in the B&I Guaranteed Loan Program instructions that requires the lender to retain 5 percent of the loan, which must be of the unguaranteed part of the loan. Furthermore, B&I Guaranteed Loans are much larger than SBA loans, which makes it much more difficult for the lender to make these larger loans within its capitalization limitations. Since implementation of this action is not an emergency affecting the public well-being, an interim final rule change cannot be justified. Consequently, the change will entail both proposed and final rulemaking actions, which are anticipated to take until June 30, 2003.

The Agency is requesting management decision on the response to this recommendation.

• **Recommendation No. 7:**

"Use the former employee's violations of post-employment restrictions as further support for barring the packager from further participation in the program."

Response:

We agree this recommendation is appropriate; however, as agreed during the exit conference, we will consult OGC and the USDA Debarment and Suspension Regulations to determine appropriate action. Within 90 days of acceptance of the

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Agency response and with OIG permission to utilize the findings in this audit, the Agency will notify the packager/lender service provider and debar them from further participation in the B&I Guaranteed Loan Program.

The Agency is requesting management decision on the response to this recommendation.

• **Recommendation No. 8:**

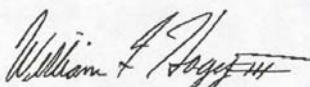
"Establish procedures and review criteria for State Office staff to follow to satisfactorily conclude that all terms and conditions of the conditional commitment and loan agreement have been met prior to issuance of loan note guarantees."

Response:

We are currently working with the Georgia State Office to develop a plan to respond to findings noted through the audit as well as through internal reviews. The Agency will amend appropriate administrative parts of sections of the B&I Guaranteed Loan Program instructions to identify what criteria are to be used to verify and document that the terms and conditions of the conditional commitment have been met prior to issuance of the loan note guarantee. The instruction changes will be finalized within 180 days of acceptance of this response.

The Agency is requesting management decision on the response to this recommendation.

If additional information is needed, please contact Dwight Carmon, Director, Special Projects/Programs Oversight Division, (202) 690-4100.



WILLIAM F. HAGY III
Deputy Administrator
Business Programs

ABBREVIATIONS

RD	
Rural Development.....	1
TBN	
The Bank Network Inc.	2
OIG	
Office of Inspector General	3
SEC	
Securities and Exchange Commission	9
FFSB	
First Federal Savings Bank	17
USPAP	
Uniformed Standards of Professional Appraisal Practice.....	18
USDA	
Department of Agriculture	23
CD	
Certificate of Deposit	30
LOC	
Line of Credit	30
OGC	
Office of General Counsel.....	36