



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

RURAL BUSINESS-COOPERATIVE SERVICE
BUSINESS AND INDUSTRY
GUARANTEED LOANS
RURAL DEVELOPMENT STATE OFFICE
TEMPLE, TEXAS



Report No.
34601-11-Te
DECEMBER 2001



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Southwest Region
101 South Main
Temple, Texas 76501



DATE: December 27, 2001

REPLY TO

ATTN OF: 34601-11-Te

SUBJECT: RBS B&I Guaranteed Loans – Rural Development State Office,
Temple, Texas

TO: R. Bryan Daniel
State Director
Rural Development
101 South Main Street, Suite 102
Temple, TX 76501

This report presents the results of our audit of lender servicing in the Rural Development Business and Industry (B&I) guaranteed loan program in Texas. The Texas Rural Development State Office's response to the draft report, dated December 11, 2001, is included in exhibit B with excerpts and the Office of Inspector General's (OIG) position incorporated into the relevant sections of the report.

Management decision has been reached for Recommendations Nos. 1, 2, and 4. Follow your internal agency procedures in forwarding final action correspondence to the Office of the Chief Financial Officer/Planning and Accountability Division. We will address your concern regarding insurance companies obtaining guarantees as eligible lenders in our national report.

To reach management decision for Recommendation No. 3, we need additional information as set forth in the Recommendation section of Finding No. 2 in the report. Please furnish the information needed to reach agreement on the management decision for this recommendation within 60 days. Please note that Departmental Regulation 1720-1 requires a management decision for all recommendations within a maximum of 6 months from the date of report issuance, and final action to be taken within 1 year of each management decision.

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

/s/ R. E. Gray
ROBERT E. GRAY
Regional Inspector General
for Audit

EXECUTIVE SUMMARY

RURAL BUSINESS-COOPERATIVE SERVICE BUSINESS AND INDUSTRY GUARANTEED LOANS RURAL DEVELOPMENT STATE OFFICE TEMPLE, TEXAS

AUDIT REPORT NO. 34601-11-Te

RESULTS IN BRIEF

This audit was conducted as part of a nationwide audit of lender servicing of Business and Industry (B&I) guaranteed loans, and the results of this audit may be included in a report to the Rural Business-Cooperative Service (RBS) National Office. We performed this audit to determine if Texas lenders were properly servicing their B&I guaranteed loans.

The purpose of the B&I guaranteed loan program is to improve, develop, or finance business, industry, and employment and to improve the economic climate in rural communities. B&I loans achieve this purpose by bolstering the existing private credit structure through the guarantee of quality loans. Loans are guaranteed through private lenders that are responsible for taking servicing actions that a prudent lender would perform in servicing its own portfolio of loans that are not guaranteed.

We found that all three lenders reviewed did not service their guaranteed B&I loans in accordance with program requirements. Lenders A and C did not monitor the collateral for borrowers A1, A2, and C; lender A did not verify that loan proceeds for borrowers A1 and A2 were used as specified in the loan agreements; lender B did not make sure that borrower B had the required operating license; and lenders A and C did not obtain and submit required financial statements and other required documents for borrowers A1, A2, and C.

Inadequate servicing by lenders increases the likelihood of a loss if the businesses of the borrowers are liquidated. Two of these loans are being liquidated, one is current in its loan payments, and one is delinquent.

KEY RECOMMENDATIONS

We recommend that the Texas Rural Development State Office (SO) take action, in consultation with the Office of the General Counsel (OGC), if a loss occurs, to render the loan note guarantees unenforceable to lenders A and B by the amount attributed to inadequate servicing. Additionally, we recommend that the SO notify lender C that not maintaining collateral properly and not submitting documents timely could result in the loan note guarantee being deemed unenforceable.

AGENCY RESPONSE

In a letter dated December 11, 2001, the SO informed us that the agency has consulted with OGC and that OGC has filed a proof of claim with the receiver for the government's portion of the loans for lender A. Additionally, the SO informed us that the agency would submit the facts surrounding the loan by lender B to OGC, for an opinion, if the final loss claim may be reduced by any negligent servicing. Based upon OGC's opinion, the agency will reduce or void any final loss claim of the lender. In addition, the SO advised us that they have already notified lender C that failure to maintain collateral and failure to timely submit annual financial statements could result in the loan note guarantee being deemed unenforceable in the event of a loss. The agency will notify the lender again of its responsibilities in the next 60 days. See exhibit B.

OIG POSITION

We agree with the management decisions for Recommendations Nos. 1, 2, and 4. To reach management decision on Recommendation 3, we need documentation showing that the agency has submitted the facts for lender B to OGC to obtain their opinion as to whether the final loss claim may be reduced by any negligent servicing.

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INTRODUCTION

BACKGROUND

The mission of RBS is to enhance the quality of life for all rural residents by assisting new and existing businesses and cooperatives through partnerships with rural communities. RBS accomplishes this, in part, through the B&I guaranteed loan program.

The purpose of the B&I guaranteed loan program is to improve, develop, or finance business, industry, and employment and improve the economic and environmental climate in rural communities with a population of less than 50,000. B&I guaranteed loans achieve this purpose by bolstering the existing private structure through the guarantee of quality loans, which provide lasting community benefits. It is not intended to use the guarantee authority for marginal or substandard loans or for the relief of lenders having such loans.

Generally, the total amount of agency loans to one borrower cannot exceed \$10 million.¹ This limit includes the guaranteed and non-guaranteed portions, the outstanding principal, and the interest balance for any new loan requests. The Administrator, with the concurrence of the Under Secretary for Rural Development, may grant an exception to the \$10 million limit under certain circumstances. Total guaranteed loans to one borrower may not exceed \$25 million under any circumstances. Generally, the maximum guaranteed percentages are 80 percent for loans of \$5 million or less, 70 percent for loans between \$5 million and \$10 million, and 60 percent for loans exceeding \$10 million.

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. The loan note guarantee is unenforceable by the lender to the extent any loss is occasioned by violation of usury laws, use of loan funds for unauthorized purposes, negligent servicing, or failure to obtain the required security regardless of the time at which the agency acquires knowledge of the foregoing. This responsibility includes but is not limited to the collection of payments, obtaining compliance with the covenants and provisions in the loan agreement, obtaining and analyzing financial statements, checking on payments of taxes and insurance premiums, and maintaining liens on collateral.²

¹ Rural Development Instruction 4279-B, section 4279.119, dated December 23, 1996.

² 7 Code of Federal Regulations (CFR) 4287, subpart B, paragraph 4287.107, revised January 1, 1998.

The SO has loan authority and provides oversight to lenders. The SO B&I guaranteed loan portfolio consists of 142 borrowers with 154 loans totaling \$205 million, including 10 borrowers with 11 loans totaling \$12.9 million classified as delinquent.

OBJECTIVE

We performed this audit to determine whether lenders were properly servicing B&I guaranteed loans.

SCOPE

We performed this audit as part of a nationwide review of the B&I guaranteed loan program. Texas was selected based on the number of loans outstanding and the total dollar value of

those loans, the total delinquent amount, and total loss payments made by the agency to honor its guarantees. We conducted the fieldwork from January through March 2001 at the SO in Temple, Texas. Coverage included B&I guaranteed loan activity during fiscal years 1998, 1999, and 2000.

Since January 1, 1990, the SO has issued 85 loan note guarantees with lending institutions totaling over \$134 million, a segment of the 3,150 loans totaling over \$4.1 billion made nationally by the agency. As of October 17, 2000, the Texas B&I guaranteed loan portfolio had 67 unpaid loans totaling \$111.6 million on loans made since January 1, 1990, a segment of the 2,420 loans totaling over \$3.2 billion made nationally by the agency. Of the 67 unpaid loans, 47 were \$1 million or greater. From this universe, we judgmentally selected six loans totaling \$13,179,000 for review. We based our selection on loans \$1 million or greater that were classified as either a delinquent or problem loan. From these six loans, we identified four with potential problem areas for an in-depth evaluation. Of the selected loans, two were delinquent, one was in liquidation, and one was current. These four loans were selected because of the loan status, the lender type, and the location of the collateral. One lender that was an insurance company made two of the loans that were delinquent. Another insurance company made the one current loan. We selected the fourth loan because the borrower's collateral was located in another State.

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

METHODOLOGY

To accomplish the audit objective, we conducted fieldwork at the SO in Temple, Texas. We examined: (1) Rural Development instructions, policies, and procedures relating to the B&I guaranteed loan program, (2) SO records related to the borrowers' loans, (3) the lenders' records related to the borrowers' loans, and (4) the borrowers' records. We interviewed borrowers or their representatives, representatives of the lenders, and SO personnel. We were unable to interview one of the lenders because the lender had failed and was in receivership. We also conducted interviews, reviewed loan files, and conducted collateral inspections in Alachua, Florida, and Dimmitt, Premont, and Plano, Texas.

FINDINGS AND RECOMMENDATIONS

CHAPTER 1	INADEQUATE SERVICING BY LENDERS
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All three lenders that we reviewed did not service their four B&I guaranteed loans in accordance with program requirements. This occurred because the lenders did not properly monitor collateral, did not ensure loan proceeds were used properly, did not make sure that the borrower had the required operating license, and did not submit required documents. As a result, inadequate servicing by lenders increases the likelihood of a loss if the businesses of the borrowers are liquidated. Two of these loans are being liquidated, one is current in its loan payments, and one is delinquent. Findings Nos. 1 through 3 discuss inadequate loan servicing by the lenders.

Rural Development instructions state that 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.³ Additionally, the instructions state that it is the responsibility of the lender to ascertain that all requirements for making, securing, servicing, and collecting the loan are complied with.⁴

FINDING NO. 1 – INADEQUATE SERVICING BY LENDER A

Servicing of two B&I guaranteed loans by lender A was inadequate. This occurred because the lender did not document collateral inspections, did not obtain records to verify use of loan proceeds, did not obtain an

appraisal on all collateral for one of the loans, and did not obtain required financial statements and other required documents. As a result, the agency's risk of loss on the guarantees for both loans is increased.

Lender A made two separate B&I guaranteed loans to borrowers A1 and A2. Lender A was an insurance company that failed and is in receivership. Borrower A1 is a start-up corporation that is a vegetable processing/freezing facility for institutional, wholesale, and retail markets in Texas. Borrower A1 received a \$2.5 million B&I guaranteed loan from lender A on June 13, 1996. A loan note guarantee for \$2 million (an

³ Rural Development Instruction 4287-B, section 4287.107, dated December 23, 1996.

⁴ Rural Development Instruction 4279-A, section 4279.1(b), dated December 23, 1996.

80 percent guarantee) was executed on June 13, 1996. The borrower projected that the business would create 41 jobs. The business now has only two employees. The borrower is delinquent on the loan and has not made a payment since May 1998.

Borrower A2 was a start-up company that developed and distributed biological research products. The products were packaged individually or as specially designed kits for timesaving applications. Borrower A2 received a \$1,315,000 million B&I guaranteed loan from lender A on June 24, 1997. A loan note guarantee for \$1,052,000 (an 80 percent guarantee) was executed on June 24, 1997. The borrower projected that the business would save or create 43 jobs. The last payment made for this borrower was in March 1999. Borrower A2 is no longer in operation, all collateral has been liquidated, and a final report of loss estimated at \$1.1 million may be submitted for this loan.

During our review, we found a number of inadequate servicing actions by the lender.

Collateral Inspections

We reviewed lender A's records for both borrower A1 and borrower A2. We found no documentation to support that collateral inspections had been done.

The lender's agreements for both borrowers state in the servicing sections that the lender's responsibilities include, but are not limited to, inspecting the collateral as often as necessary to properly service the loan.

During a review of the SO records for borrower A1, we found a memorandum dated December 2, 1997, from the lender to the loan file that documented an annual visit to the plant on October 15, 1997. However, lender A did not mention collateral in the memorandum. We could not find documentation that the lender visited this borrower and inspected the collateral for the B&I loan after October 15, 1997. We also reviewed the SO records for borrower A2, and we found no documentation relating to collateral inspections by the lender.

We determined that borrower A2 moved the business from Texas to Florida between June and September 1999 without obtaining lender approval. This was in violation of the loan agreement and, because the lender was in receivership, we were unable to interview lender officials to determine exactly when the move occurred or why the lender was unaware of the move.

On April 11, 2001, an official of the SO informed us that collateral for borrower A2's B&I guaranteed loan had been sold for \$30,000 and that the receivership received the proceeds from the sale. The value of the collateral deteriorated because all of the equipment items were contaminated with hazardous chemical waste that would have required decontamination and refurbishment to be useful. It appears that the security interest in the collateral was not handled properly in Florida by the lender. We could not determine: (1) if all of the collateral had been accounted for, and (2) why the lender did not attempt to protect the collateral or why the lender was unaware of the borrower's move from Texas to Florida.

On October 10, 2001, OGC sent a letter to the receiver asking for the status of the proofs of claim for RBS that had been submitted to the receiver on May 25, 2001. A SO official informed us on October 16, 2001, that the receiver will submit a final report of loss; however, no payment will be made since the agency has repurchased the guaranteed portion of the loan. It is anticipated that the final report of loss could total \$1.1 million for borrower A2.

Since lender A did not document collateral inspections in either case, and since borrower A2 moved collateral without obtaining approval of lender A, we believe the lender did not adhere to its servicing responsibilities.

Use of Loan Funds

We determined that lender A violated provisions of the lender's agreement and the conditional commitment for both loans. This occurred because lender A did not obtain sufficient records to verify the use of loan proceeds. As a result, we were unable to verify over \$2 million in loan proceeds for both loans and, therefore, lender servicing was improper.

Section II of the lender's agreement states that any losses will be unenforceable by the lender to the extent that loan funds are used for purposes other than those specifically approved by FmHA (Rural Development) in its conditional commitment for guarantee. According to the conditional commitment for guarantee, the lender must verify use of loan proceeds.

A comparison of the use of loan funds according to the conditional commitment for guarantee, dated January 4, 1996, and the use of loan funds from the lender's settlement statement with the borrower, dated December 20, 1996, showed the following for borrower A1:

Use of Proceeds Per Conditional Commitment		Use of Proceeds Per Settlement Statement
Item	Amount	Amount
Land and building	\$650,000	\$249,686
Machinery and equipment	\$1,550,000	\$305,000
Working capital	\$300,000	\$0
Total	\$2,500,000	\$554,686
Difference		\$1,945,314

Therefore, we were unable to verify \$1,945,314 in loan proceeds from our review of the lender's records. On March 20 and 21, 2001, we performed a physical inspection of borrower A2's business in Alachua, Florida. Although we observed that there was machinery and equipment at the business location, we could not determine if this was the machinery and equipment purchased with B&I loan funds.

Section II A of the lender's agreement stated that the loan funds will be used for the purposes authorized in 7 CFR, part 4279, per the Form 4279-3. Section IV C 1 provided that the lender's servicing responsibilities include, but are not limited to, obtaining compliance with the covenants and provisions in the note, loan agreement, security instruments, and any supplemental agreements and notifying the United States Department of Agriculture (USDA) and the borrower of any violations. It also states that the lender must service the loan in a reasonable and prudent manner.

We reviewed the conditional commitment to determine how the loan proceeds should have been used for borrower A2. We also reviewed the lender's loan files for this borrower on January 18, 2001. We obtained a copy of a disbursement schedule during this review. We found no other documentation in the lender's files to support how the loan proceeds were used:

Use of Loan Proceeds Per Conditional Commitment		Use of Loan Proceeds Per Lender's Files	
Item	Amount	Disbursements	Funds Remaining
Land and buildings	\$90,000	\$5,613	\$84,387
Machinery & equipment	\$349,000	\$289,445	\$59,555
Debt refinance – SBA	\$806,000	\$806,000	\$0
Working capital	\$70,000	\$65,577	\$4,423
Total	\$1,315,000	\$166,635	\$148,365

Therefore, we were unable to verify \$148,365 in loan proceeds from our review of the lender's records. Since both the lender and borrower A2 are no longer in existence, we were unable to substantiate the disbursements.

Collateral Appraisal

We found that lender A did not obtain an appraisal for all of borrower A1's collateral before loan closing. This occurred because one piece of equipment was not included on the equipment list provided to the appraiser. As a result, the loan was under collateralized at loan closing.

FmHA Instruction 1980-E, section 1980-444(a), dated February 25, 1987, provides that appraisal reports prepared by independent qualified fee appraisers will be required on all property that will serve as collateral.

We located an appraisal dated September 28, 1995, in the lender's files. This appraisal provided the estimate of value in use for the borrower's collateral that consisted of land, building, and equipment. The value for the land and building was \$800,000 and the value for the equipment was \$2,600,000, for a total value of \$3,400,000 per the appraisal.

During our review of the SO loan files for borrower A1, we noted that documentation signed on December 8, 1995, by the B&I State loan committee, showed the appraised value of machinery and equipment to be \$2,660,000 and \$800,000 for land and buildings. Since the lender's appraisal showed the equipment value as \$2,600,000, the amount shown on the State loan committee documentation was \$60,000 greater than the value shown on the appraisal.

We then noted that the loan review summary in the SO files dated October 31, 1995, showed a harvester offered as additional collateral with a value of \$60,000. We reviewed the equipment list from the September 28, 1995, appraisal to determine whether this harvester was included on the appraisal in the lender's file. We found that the harvester was not included on the equipment list in the appraisal.

We interviewed borrower A1 to determine whether the harvester had been appraised. The borrower stated that the harvester was not included in the appraisal by mistake. Since lender A was in receivership, we were unable to interview its officials.

Because the lender did not obtain an appraisal of the piece of equipment, we question whether the \$60,000 value given to the equipment was reflective of the value had it been appraised. Applying the discount values that the Texas RBS State loan committee used, we determined that the total collateral value after discounts was \$2,460,000. The loan note guarantee

showed the principal loan amount was \$2,500,000. Therefore, the loan to borrower A1 was under collateralized \$40,000 (\$2,500,000 - \$2,460,000) at loan closing. See tables below.

OIG Computation Using Appraised Values in Lender's File			
Item	Appraised Value	Discount	Discount Value
Land & Building	\$800,000	.80	\$640,000
Machinery & Equipment	\$2,600,000	.70	\$1,820,000
Totals	\$3,400,000		\$2,460,000

SO Computation Using Lender's Appraised Values Plus Value Given for Harvester			
Item	Appraised Value	Discount	Discount Value
Land & Building	\$800,000	.80	\$640,000
Machinery & Equipment	\$2,660,000	.70	\$1,862,000
Totals	\$3,460,000		\$2,502,000

The SO files showed the loan properly collateralized because they included the extra \$60,000 value given to the harvester in their calculation of the discounted collateral value.

Financial Statements and Forms RD 1980-41 and 1980-44

We determined through review of lender records and the SO records that lender A had not obtained and submitted annual financial statements for the years 1998-2000 for both borrowers A1 and A2. We reviewed the lender's records to determine what action, if any, the lender took to obtain the annual financial statements. We determined that the 1996 and 1997 financial statements were waived for borrower A1 and that the 1997 financial statement for borrower A2 had been submitted. We found no evidence that lender A took any action to obtain the financial statements of borrower A2 for 1998-2000.

We reviewed the loan agreements for both borrowers to determine when the financial statements were due. We found that each loan agreement showed that the annual financial statements were due 120 days after the end of the fiscal year. Since the loan to borrower A1 was made in 1996, annual financial statements were due for years 1996 through 2000. Since the loan to borrower A2 was made in 1997, annual financial statements

were due for years 1997 through 2000. We were unable to interview representatives of lender A because the company failed and was in receivership. The lender's records were made available to us through the receiver.

We also reviewed Form FmHA 449-35, Lender's Agreement, for borrower A1 and the lender's agreement for borrower A2. Both forms stated that the lender's servicing responsibilities include, but are not limited to, obtaining compliance with the covenants and provisions in the note, loan agreement, security instruments, and any supplemental agreements. It also stated that the lender must service the loan in a reasonable and prudent manner.

An FmHA instruction states that all borrowers with a principal and interest loan balance for loans under this subpart, at the end of the borrower's fiscal year, of more than \$1 million, must submit annual audited financial statements.⁵ Rural Development instructions provide that the lender will determine the type and frequency of submission of financial statements by the borrower. At a minimum, annual financial statements prepared by an accountant in accordance with Generally Accepted Accounting Principles (GAAP) will be required.⁶

We also determined from our review of lender and SO records that neither Forms RD 1980-44, Guaranteed Loan Borrower Default Status, nor Forms RD 1980-41, Guaranteed Loan Status Report, were submitted as required for either of these borrowers. The table below summarizes documents not submitted or not submitted timely by lender A.

Borrower	Financial Statements Submitted for 1998-2000	Form RD 1980-41 Submitted	Form RD 1980-44 Submitted
Borrower A1	None	Late	None
Borrower A2	None	None	None

Rural Development instructions require that the lender must notify the agency when a borrower is 30 days past due on a payment or is otherwise in default of the loan agreement.⁷ In addition, Rural Development instructions require that the lender must report the outstanding principal and interest balance on each guaranteed loan semiannually using Form RD 1980-41.⁸

⁵ FmHA Instruction 1980-E, paragraph 1980.445(a), dated February 25, 1987.

⁶ Rural Development Instruction 4279-B, paragraph 4279.137(a), dated December 23, 1996.

⁷ Rural Development Instruction 4287-B, paragraph 4287.145(a), dated December 23, 1996.

⁸ Rural Development Instruction 4287-B, paragraph 4287.107(a), dated December 23, 1996.

Lender A has failed and is currently in receivership. The loans to borrowers A1 and A2 have been repurchased by the agency. The last payment made on the loan to borrower A1 was May 1998, and the last payment made on the loan to borrower A2 was March 1999. As of September 28, 2001, principal and interest for borrower A1 totaled \$3,094,494, and \$1,163,592 for borrower A2. Because of the inadequate servicing of lender A, the agency will need to obtain legal advice from OGC for borrowers A1 and A2.

In summary, we believe that loan servicing by lender A was inadequate for borrowers A1 and A2 because of the inadequate servicing actions discussed above.

RECOMMENDATION NO. 1

Take action, in consultation with OGC, to render the loan note guarantee unenforceable due to inadequate servicing for borrower A1.

Rural Development Response

In a letter dated December 11, 2001, the SO informed us that the agency has consulted with OGC and that OGC has filed a proof of claim with the receiver for the government's portion of the loans.

OIG Position

We agree with the management decision.

RECOMMENDATION NO. 2

Take action, in consultation with OGC, to render the loan note guarantee unenforceable due to inadequate servicing for borrower A2.

Rural Development Response

In a letter dated December 11, 2001, the SO informed us that the agency has consulted with OGC and that OGC has filed a proof of claim with the receiver for the government's portion of the loans.

OIG Position

We agree with the management decision.

**FINDING NO. 2 – INADEQUATE
SERVICING BY LENDER B**

Servicing by lender B of the B&I guaranteed loan to borrower B was inadequate. This occurred because the lender did not ensure that the facility was licensed for operation before loan closing. As a result, the agency's

risk of loss on the guarantee is increased.

Lender B made a \$1,665,000 B&I guaranteed loan to borrower B on December 30, 1997. Borrower B was a Texas limited partnership that used the loan proceeds to pay the principal of a construction loan made by another lending institution. The B&I guaranteed loan was for construction of a congregate care facility for patients with Alzheimer's or other age-related diseases involving decreased mental capacity. A loan note guarantee for \$1,332,000 (an 80 percent guarantee) was executed on December 30, 1997. The borrower projected that the business would create 25 jobs. The borrower is in liquidation and there are no employees. All collateral was sold for \$1.3 million. It is anticipated that the lender will submit a final report of loss estimated at \$1.05 million for this borrower. However, no loss payment will be made since the agency has repurchased the guaranteed portion of the loan.

The loan proceeds were used to purchase land and buildings as specified in the conditional commitment. However, lender servicing was inadequate because the lender did not verify whether the facility met applicable codes for licensing as specified in the loan agreement and the loan note guarantee. As a result, the agency's risk of loss was increased.

According to the loan agreement dated December 30, 1977 (it should have been dated 1997):

Article 2 – Conditions Precedent for Making Loan, of the loan agreement included covenant 2.2, Borrower's Affidavit. Loan covenant 2.2 F stated that all necessary consents, approvals, or authorizations of any governmental agency or regulatory authority or of stockholders which are necessary have been obtained. It also stated that the improvements and use of the property comply in all respects with all federal, State, and local laws applicable thereto.

Article 3 – Affirmative Covenants, 3.1 Use of Loan Proceeds, stated that the proceeds of the note shall be used by the borrower to pay off the principal balance of the existing construction loan. Loan covenant 3.10 stated that the borrower must comply with all regulations, orders, or requirements of city, State, and federal regulatory agencies.

We obtained and reviewed a copy of the affidavit required in loan covenant 2.2. The borrower stated, in the affidavit signed on December 30, 1997, that “all certificates, permits, and licenses that are necessary or required to operate the real property and improvements as an assisted care living facility have been obtained from the governmental authorities.”

We determined that the lender provided a letter to the agency dated December 30, 1997. In this letter, the lender certified that all planned property acquisition has been or will be completed, all development has been or will be substantially completed in accordance with plans and specifications, and conforms with applicable Federal, State, and local codes, and costs have not exceeded the amount approved by the lender and RBS.

In addition, we determined that lender B has filed suit against the interim lender since the attorney for the interim lender certified on December 30, 1997, that the facility had been built in accordance with all State regulations.

It was noted during our audit survey that the facility did not meet State specifications for this type of facility. In addition, we obtained a copy of a letter, dated January 20, 1998, from the Texas Department of Human Services, that showed that an inspection was conducted on January 12, 1998, and that the facility did not comply with code.

The borrower made three payments in February, March, and April 1998. The note was accelerated on August 3, 1998, by the lender. The note was first posted for foreclosure in September 1998 for a sale to occur on October 6, 1998. The foreclosure sale was postponed twice because the borrower was in negotiation to sell the facility. However, on or about November 6, 1998, the prospective purchaser of the facility terminated the sale contract. The lender submitted a liquidation plan to the agency on November 10, 1998. The lender stated in the liquidation plan that the borrower failed to make required principal and interest payments and struggled to meet the current operational requirements on a weekly basis.

In addition, the borrower attempted to obtain a provisional license for operation. However, in a letter dated August 18, 1999, the Texas Department of Human Services notified the borrower that it had determined that the facility did not meet the criteria for a provisional license. Therefore, we conclude that the business failed because the facility did not have the appropriate State license for operation.

Section IV B of the lender's agreement stated that it is the lender's responsibility to see that all construction is properly planned before any work proceeds; that any required permits, licenses, or authorizations are obtained from the appropriate regulatory agencies; that the borrower has obtained contracts through acceptable procurement procedures; and that periodic inspections during construction are made.

Section IV C 1 of the lender's agreement provided that the lender's servicing responsibilities include, but are not limited to: obtaining compliance with the covenants and provisions in the note, loan agreement, security instruments, and any supplemental agreements and notifying USDA and the borrower of any violations. It also stated that the lender must service the loan in a reasonable and prudent manner.

Rural Development instructions state that the loan note guarantee is unenforceable by the lender to the extent any loss is occasioned by violation of usury laws, use of loan funds for unauthorized purposes, negligent servicing, or failure to obtain the required security interest regardless of the time at which the agency acquires knowledge of the foregoing. This responsibility includes but is not limited to obtaining compliance with the covenants and provisions in the loan agreement.⁹

RECOMMENDATION NO. 3

Take action, in consultation with OGC, to render the loan note guarantee unenforceable due to inadequate servicing for borrower B.

Rural Development Response

In a letter dated December 11, 2001, the SO informed us that the agency would submit the facts surrounding this loan to OGC, for an opinion, if the final loss claim may be reduced by any negligent servicing. Based upon OGC's opinion, the agency will reduce or void any final loss claim of the lender.

OIG Position

To accept the management decision, we need documentation showing that the agency has submitted the facts for lender B to OGC to obtain their opinion as to whether the final loss claim may be reduced by negligent servicing.

⁹ Rural Development Instruction 4287-B, paragraph 4287.107, dated December 23, 1996.

**FINDING NO. 3 – INADEQUATE
SERVICING BY LENDER C**

Servicing by lender C of the B&I guaranteed loan to borrower C was inadequate. This occurred because the lender did not properly maintain collateral and did not timely submit annual financial statements to the agency. As

a result, the agency's risk of loss on the guarantee is increased.

Lender C made a \$3.5 million B&I guaranteed loan to borrower C on June 10, 1999. Borrower C is a corporation that purchased a company with operations in the waste management industry. The company collects, handles, treats, and disposes certain nonhazardous oil and gas wastes for its customers throughout southern Texas. A loan note guarantee for \$2.8 million (an 80 percent guarantee) was executed on June 10, 1999. The borrower is current on the loan.

During our review, we found two inadequate servicing actions by the lender:

Maintenance of Collateral

We determined that the lender did not properly maintain collateral. This occurred because the lender did not document collateral inspections and because the lender did not know that the borrower had sold collateral for the loan.

Regulations state that lenders may release collateral with a cumulative value of up to 20 percent of the original loan amount without agency concurrence if the proceeds generated are used to reduce the guaranteed loan or to buy replacement collateral.¹⁰

We reviewed the lender's agreement and found that the agreement stated that the lender is required to inspect the collateral as often as necessary to properly service the loan. An official of lender C stated that a collateral inspection was made during the summer of 2000. He also stated that a letter to the file documented the inspection. We reviewed the loan files and found no evidence of any collateral inspections. On February 1, 2001, we asked the lender for a subsequent collateral list. The lender informed us that the collateral list at loan closing was the latest list and that there had been no changes in the collateral.

On February 7, 2001, we made a collateral inspection at the borrower's place of business. While verifying the collateral, we determined that a farm tractor was sold for \$7,000 and a 1997 Dodge truck had been traded in on a

¹⁰ 7 CFR , Chapter XLII, part B, subpart B, section 4287.113, paragraph (b), revised January 1, 1998.

newer model. We then obtained evidence from borrower C relating to the tractor sale. The check borrower C received for the sale of the tractor was dated June 27, 2000.

We contacted officials of lender C to inform them of the sold collateral. An official of lender C informed us that provisions in the loan agreement allow the borrower to buy and sell collateral up to \$200,000 without approval from the lender. To support this, the lender sent us excerpts of the loan agreement that included covenants 5.8 and 5.13 relating to disposition of assets and collateral, respectively.

We reviewed the loan agreement and determined that these two covenants were part of Article 5 – Negative Covenants. However, we determined that, when covenant 5.13 of the loan agreement is read in its entirety, it provided that the borrower should not dispose of any of the collateral without written consent of the lender. In addition, we determined that covenant 5.8 of the loan agreement stated that the borrower should not sell or dispose of any real property, equipment, furniture, or fixtures not constituting collateral, without written consent of the lender. This covenant also provided that the borrower should not sell or dispose any collateral except in accordance with covenant 5.13.

Covenant 5.13 also stated that the borrower further agreed that all payments of any kind from any sale of any of the collateral will be made jointly payable to the lender and borrower C and that all proceeds must be applied to the obligations. Covenant 7.1(d) stated that one event of default is when the borrower violates any covenant contained in the loan agreement.

We requested a copy of the payment ledger from the lender. We obtained and reviewed the payment ledger to determine whether borrower C had applied the collateral proceeds to the loan. We found that borrower C did not apply the proceeds to the loan. We asked an official of borrower C how the proceeds from the sold collateral were disbursed. The official stated that the proceeds were used in the purchase of a 1999 Dodge truck. We requested and obtained a copy of the sales contract. We reviewed the sales contract dated January 6, 2000. We determined that the 1999 Dodge truck was purchased for a total of \$16,550. The sales contract showed that a 1997 Dodge truck was traded in for \$6,550 and that a cash payment of \$10,000 was made.

However, we determined that the \$7,000 in collateral proceeds could not have been used to purchase a truck on January 6, 2000, since the tractor was not sold until June 27, 2000. Thus, we determined that the truck was purchased 5 months before the tractor was sold.

We discussed this finding with an official of the borrower on April 23, 2001. The official stated that they would take corrective action by paying the \$7,000 in collateral proceeds on the loan balance. We obtained a copy of the check dated April 30, 2001, in the amount of \$7,000, payable to lender C for payment on the principal. We also verified with the lender that the payment had been made. Thus, borrower C took corrective action on the finding.

Since lender C was not aware that borrower C had sold collateral, and no evidence existed to support that collateral inspections had been conducted, we believe lender C did not service the loan properly.

Financial Statements

During the survey phase of our review, we reviewed the SO loan files and noted that as of May 23, 2000, the financial statements had not been submitted. On February 1, 2001, we examined the financial records and correspondence files of borrower C. We found that the annual financial statement for 1999 had been submitted to the lender. Thus, we concluded that the 1999 annual financial statement was submitted late. This occurred because the financial statement had not been submitted until after May 23, 2000.

We reviewed the loan agreement to determine the date the annual financial statement was due. Article 4, covenant 4.1(a) of the loan agreement requires that the annual audited financial statements be submitted within 90 days of the end of the fiscal year. Since the borrower's fiscal year ended December 31, 1999, the annual financial statement was due no later than March 31, 2000.

Rural Development instructions provide that the lender will determine the type and frequency of submission of financial statements by the borrower. At a minimum, annual financial statements prepared by an accountant in accordance with GAAP will be required.¹¹

In summary, we conclude that servicing by lender C was inadequate for the B&I guaranteed loan to borrower C because of the inadequate servicing actions discussed above. As a result, the loan to borrower C is at an increased risk of loss in the event of default.

RECOMMENDATION NO. 4

Notify lender C that failure to maintain collateral and failure to timely submit annual financial statements could result in the loan note guarantee being deemed unenforceable

in the event of a loss by borrower C.

¹¹ Rural Development Instruction 4279-B, paragraph 4279.137(a), dated December 23, 1996.

Rural Development Response

In a letter dated December 11, 2001, the SO informed us that they have already notified the lender that failure to maintain collateral and failure to timely submit annual financial statements could result in the loan note guarantee being deemed unenforceable in the event of a loss. The agency will notify the lender again of its responsibilities in the next 60 days.

OIG Position

We agree with the management decision.

EXHIBIT A – SUMMARY OF MONETARY RESULTS

FINDING NUMBER	RECOMMENDATION NUMBER	DESCRIPTION	AMOUNT	CATEGORY
1	1	Inadequate servicing by lender A for B&I guaranteed loan to borrower A1	\$3,094,494	Questioned Loan-Recovery Recommended
1	2	Inadequate servicing by lender A for B&I guaranteed loan to borrower A2	\$1,163,592	Questioned Loan-Recovery Recommended
2	3	Inadequate servicing by lender B for B&I guaranteed loan to borrower B	\$1,058,098	Questioned Loan-Recovery Recommended
TOTAL			\$5,316,184	

EXHIBIT B – AUDITEE’S RESPONSE TO THE DRAFT REPORT



UNITED STATES
DEPARTMENT OF
AGRICULTURE

RURAL
DEVELOPMENT

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DEC 11 2001

SUBJECT: Rural Business-Cooperative Service Business & Industry Guaranteed Loans
Audit 34601-11-Te

TO: State Director
USDA, Rural Development, Temple, TX

ATTN: Management Control Office

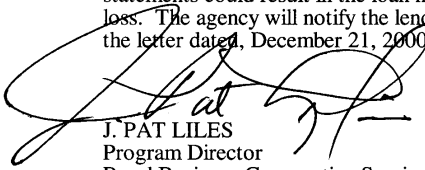
In response to your letter, dated November 20, 2001, the recommendations regarding the audit findings are as follows:

Recommendation No. 1 - The guaranteed portions had previously been sold on the secondary market; consequently, when the loans became delinquent to the holders, USDA Rural Development was required to honor the guarantee. The lender subsequently failed and is in the process of being liquidated by the State appointed receiver. The agency has consulted the Office of General Council (OGC) and OGC has filed a proof of claim with the receiver for the government's portion of loan. The agency and OGC are presently proceeding to obtain recovery from the available assets of the failed lender and will be forced to accept recovery based upon court ordered disbursement of liquidated assets. This office recommends that insurance companies be prohibited from obtaining guarantees under the program as eligible lenders.

Recommendation No. 2 - Same as recommendation No. 1

Recommendation No. 3 - The agency believes that the lender acted prudently because the lender relied upon certification from the interim lender's counsel that the facility had been built in accordance with all state regulations. The lender has proceeded to file suit and collect, through the defendant's errors and omission insurance, the maximum collection allowed by the courts. However, the agency will submit the facts surrounding this loan to OGC, for an opinion, if the final loss claim may be reduced by any negligent servicing. Based upon OGC's opinion, the agency will reduce or void any final loss claim of the lender.

Recommendation No. 4 - The agency has already notified the lender in a letter dated, December 21, 2000, that failure to maintain collateral and failure to timely submit annual financial statements could result in the loan note guarantee being deemed unenforceable in the event of a loss. The agency will notify the lender again of its responsibilities in the next 60 days. A copy of the letter dated, December 21, 2000, is attached for your review.


J. PAT LILES
Program Director
Rural Business-Cooperative Service

Attachment

*USDA Rural Development is an Equal Opportunity Lender, Provider and Employer.
Complaints of discrimination should be sent to:
USDA, Director, Office of Civil Rights, Washington, DC 20250-9410*

