



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

RURAL DEVELOPMENT  
RURAL BUSINESS – COOPERATIVE SERVICE  
LENDER SERVICING OF BUSINESS AND  
INDUSTRY GUARANTEED LOANS  
FLORIDA



**Audit Report No.  
34601-3-At  
JANUARY 2002**



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL  
Southeast Region - Audit  
401 West Peachtree Street, Suite 2328  
Atlanta, Georgia 30308  
TEL: 404-730-3210 FAX: 404-730-3221



DATE: January 28, 2002

REPLY TO

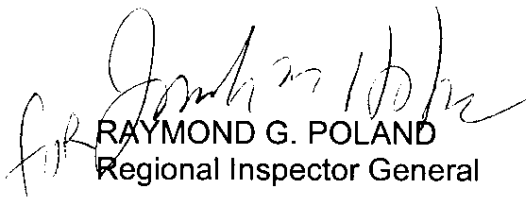
ATTN OF: 34601-3-At

SUBJECT: Rural Development - Lender Servicing of  
Business and Industry Guaranteed Loans-Florida

TO: Charles W. Clemons, Sr.  
State Director  
USDA – Rural Development  
Florida State Office  
P.O. Box 147010  
Gainesville, FL 32614-7010

This report presents the results of the subject audit. Rural Development's January 8, 2002, response to the draft report is included as exhibit B with excerpts and the Office of Inspector General's position incorporated in the Findings and Recommendations section of the report.

We agree with management decision on Recommendation Nos. 2, 3, and 4. Follow your internal agency procedures in forwarding final action correspondence to the Office of Chief Financial Officer. We can reach management decision on Recommendation Nos. 1, 5, 6, and 7 when RD furnishes the information requested. In accordance with Department Regulation 1720-1, please furnish a reply within 60 days. Please note that the regulation requires a management decision to be reached on all recommendations within 6 months of report issuance.

  
RAYMOND G. POLAND  
Regional Inspector General

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# EXECUTIVE SUMMARY

## RURAL DEVELOPMENT RURAL BUSINESS – COOPERATIVE SERVICE LENDER SERVICING OF BUSINESS AND INDUSTRY GUARANTEED LOANS FLORIDA

AUDIT REPORT NO. 34601-3-At

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### RESULTS IN BRIEF

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We reviewed lender servicing of Business and Industry (B&I) guaranteed loans in Florida as part of a nationwide audit. The audit objectives were to determine if (1) loan proceeds were used as specified in the loan agreements and (2) lenders were properly servicing B&I guaranteed loans, monitoring collateral and submitting required documents to the Agency timely.

As of November 13, 2000, there were 84 borrowers with 106 outstanding loans totaling \$180.2 million in Florida. Six of the borrowers with loans totaling \$20.3 million were delinquent \$8.6 million. We reviewed the loans of two of the delinquent borrowers who had defaulted on their loans. The two loans had outstanding balances totaling \$5,450,000 and estimated losses of about \$1.9 million of which Rural Development (RD) had guaranteed 80 percent (\$1.5 million).

We did not find any misuse of the \$5,450,000 of loan proceeds. However, lenders did not properly service the two loans. The lenders did not (1) monitor the borrowers' operations adequately to ensure that loan collateral was properly accounted for and maintained, (2) take appropriate actions against one borrower that violated terms of the loan agreement, and (3) consider all available assets such as accounts receivable when completing liquidation plans. As a result, the risk of losses to the Government increased.

- The lenders did not ensure that collateral was properly accounted for and maintained. After the two borrowers defaulted, the lenders submitted liquidation plans to RD. The plans did not account for \$1,951,674 of collateral. Because of missing collateral, the loans

became under-secured with resulting losses estimated at about \$1.9 million of which RD guaranteed 80 percent.

- One of the borrowers violated terms of the loan agreement by (1) disposing of loan collateral valued at \$1,112,500, (2) incurring additional long-term debts totaling about \$3.9 million, and (3) failing to apply \$193,700 received for destruction of collateral to the loan account. The borrower did not obtain prior approval from the lender or RD before taking these actions. An estimated loss of about \$353,000 is expected on the loan.
- The lenders did not include liquid assets (e.g., accounts receivable) pledged as loan collateral in their liquidation plans or otherwise account for them. On their latest financial statements, the borrowers reported accounts receivable totaling \$2,379,990.

Lenders did not timely provide RD with annual written reports that analyzed the borrowers' financial health. As of November 13, 2000, the State office's tracking system showed that lenders had not provided RD with the required annual reports, accompanied by financial statements, for 41 of the 84 borrowers. Without accurate and timely financial analyses, neither lenders nor RD can properly monitor the financial condition of borrowers' for compliance with terms of the Loan Agreement.

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## **KEY RECOMMENDATIONS**

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Reduce the amount of the loss payments to be made to the lender of (a) Loan No. A by the value of the missing collateral and the value of the accounts receivable owned by the borrower at the time of loan liquidation and (b) Loan No. B by the value of the future Animal and Health Inspection Service (APHIS) payments to the borrower, missing collateral, and accounts receivable owned by the borrower at loan liquidation.

We also recommend that RD require lenders to (a) perform, at least annually, an inspection of all loan collateral pledged as security to ensure that all of it is accounted for and properly maintained, (b) provide RD with written documentation of collateral inspections and justification for missing collateral, (c) immediately notify RD upon discovery that a borrower has violated covenants of their loan agreement and take prompt actions to rectify the violations, and (d) obtain borrowers' current financial statements, physical inventory, accounts receivable, investments, and cash account records to account for all assets owned by the borrower when preparing liquidation plans.

RD should also put lenders on notice that failure to timely provide borrowers' written reports of their analyses of the financial statements is considered negligent servicing and could cause the loan guarantee to be unenforceable.

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**AGENCY RESPONSE**

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In its January 8, 2002, written response (see exhibit B) to the draft report, the RD State office agreed with the recommendations. The response pointed out that several of the recommendations had been implemented during the course of the audit, discussed ways and means for implementing the other recommendations, and discussed the need for National guidelines in several areas.

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# INTRODUCTION

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## BACKGROUND

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Rural Development (RD) operates a variety of loan programs including the Business and Industry (B&I) Guaranteed Loan Program. The program assists business development of the nation's rural areas and the employment of rural residents. B&I guaranteed loans achieve this purpose by bolstering the existing private credit structure through the guarantee of quality loans, which provide lasting community benefits. The guarantee authority is not intended to be used for marginal or substandard loans or for the relief of lenders having such loans. RD administers the program through its State offices. Private lending institutions make the loans with RD guaranteeing payment of up to 90 percent, including interest, in the event of a loss.

Guarantees are provided on loans made by traditional lenders such as commercial banks, and to a lesser extent, on loans made by other non-traditional lenders such as entities using investment capital and which are authorized by State law to engage in lending. The loans are made to most types of legal entities including for-profit and non-profit cooperatives, corporations, partnerships, individuals, public bodies, and Indian tribes. 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 RD National office must approve loans over \$5 million and generally offers a 70 percent guarantee for loans between \$5 and \$10 million, and 60 percent for loans exceeding \$10 million. Currently, the maximum loan is \$25 million.

Lenders are responsible for servicing the loans and for taking all actions that a prudent lender would perform in servicing its own portfolio of loans that are not guaranteed. Lenders are responsible for notifying RD officials of any violations of loan agreements. The loan note guarantee will be 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 collections of payments, ensuring compliance with the covenants and provisions in the Loan Agreement, analyzing financial statements, checking on payments of taxes and insurance premiums, and maintaining liens on collateral.

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## OBJECTIVES

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The audit objectives were to determine if (1) loan proceeds were used as specified in the loan agreements and (2) lenders were properly servicing loans, monitoring collateral, and submitting required documents to the Agency timely.

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## SCOPE

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The audit, conducted in accordance with generally accepted government auditing standards, covered RD B&I guaranteed loan operations in Florida for fiscal years 1998 through 2000. Other periods were reviewed as necessary. The audit was part of a nationwide audit of the B&I guaranteed loan program. The United States Department of Agriculture (USDA) Office of Inspector General's Southwest Regional office located in Temple, Texas, was the audit control point with overall responsibility for the audit.

As of November 13, 2000, there were 84 borrowers with 106 loans totaling \$180.2 million in Florida. Six of the borrowers, with loans totaling \$20.3 million, were delinquent \$8.6 million. We judgmentally selected for review two delinquent loans totaling \$5,450,000 on which the borrowers had defaulted (see table 1).

**Table 1**

LOAN NO.	LOAN DATE	AMOUNT	LOAN STATUS	ESTIMATED LOSS
A	12/18/96	\$2,950,000	Liquidated	\$1,567,075
B	10/14/93	\$2,500,000	In Default	\$ 353,000
TOTAL		\$5,450,000		\$1,920,075

Our sample selection was based on large dollar values and payment status of the loans. The loans were guaranteed at 80 percent.

Audit fieldwork was performed from November 2000 through June 2001, and included work at the RD State office in Gainesville, Florida, lenders' offices in Palm Beach Gardens, Florida, and Homestead, Florida, and one borrower's place of business in Homestead, Florida. We performed a desk review at the RD State office and visited the lenders and one borrower for a more in-depth review (see table 1).

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## METHODOLOGY

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To accomplish the audit objectives, we performed the following procedures:

- Interviewed RD officials and reviewed policies and procedures governing the B&I guaranteed loan program.



- Interviewed two lender representatives and one borrower.
- Reviewed loan records at the RD State office, lenders, and one borrower's business site.
- Inspected loan collateral located at one borrower's business site. Loan collateral for the other borrower selected for review had been liquidated at the time of our review.

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## FINDINGS AND RECOMMENDATIONS

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<b>CHAPTER 1</b>	<b>LENDERS DID NOT ADEQUATELY SERVICE B&amp;I GUARANTEED LOANS</b>
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### FINDING NO. 1

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We reviewed two loans totaling \$5,450,000 on which the borrowers had defaulted. We found that lenders did not (a) ensure that collateral was properly maintained and accounted for at liquidation, (b) take actions against borrowers that violated terms of the loan agreement, and (c) consider all available assets when completing liquidation plans on defaulted loans. Losses were estimated at \$1.9 million of which RD had guaranteed 80 percent (\$1.5 million) (see table 2).

**Table 2**

LOAN NO.	LOAN DATE	AMOUNT	LOAN STATUS	ESTIMATED LOSS	QUARANTEED AMOUNT
A	12/18/96	\$2,950,000	Liquidated	\$1,567,075	\$1,253,660
B	10/14/93	\$2,500,000	In Default	\$ 353,000	\$ 282,400
TOTAL		\$5,450,000		\$1,920,075	\$1,536,060

Our review of the loans disclosed that lenders were deficient in the following areas.

A. LENDERS DID NOT ADEQUATELY MONITOR AND ACCOUNT FOR LOAN COLLATERAL

The lenders did not perform adequate periodic inspections of the collateral to ensure that the security was properly accounted for and maintained. After the two borrowers defaulted, the lenders' liquidation appraisals and collateral inspections performed by auditors and RD staff disclosed that collateral with an original appraised value of \$1,951,674 was missing. As a result, the loans were under-secured and losses estimated at \$1,920,075 are expected on the loans. RD's share of the loss on the two loans is estimated to be about \$1,536,060 (80 percent).

Lender Agreements require that lenders inspect collateral as often as necessary to properly service the loan.

Our review of the two loans disclosed the following.

- Loan No. A - On December 18, 1996, the borrower received a \$2.95 million loan to refinance existing debt, purchase additional equipment, and obtain working capital to continue the operation of its business. The borrower's business was installation of proprietary systems for environmental remediation, dewatering, water reuse, and barrier wall technology. On December 22, 1997, the original lender sold the loan to another lender who assumed all servicing responsibilities.

The borrower pledged collateral with a net book value of \$3.9 million as security for the loan. The collateral included machinery and equipment valued at \$2,350,087; autos, trucks and trailers valued at \$502,205; and office equipment valued at \$85,276. The borrower planned to use loan funds of \$981,696 to purchase real estate valued at \$235,000 and machinery and equipment valued at \$746,696, which would become loan collateral.

On November 1, 1998, the borrower defaulted on the loan. On June 29, 1999, RD approved the lender's liquidation plan. During April and June 2000, the lender obtained collateral appraisals, which valued the machinery, equipment, vehicles, trailers, and real estate at \$829,550. We compared collateral listings at loan closing with those from the liquidation appraisal and found that 345 items of machinery, equipment, vehicles, trailers, and office equipment were not accounted for by the liquidation appraisals. The original appraised value of the 345 missing items totaled \$1,861,901 (see table 3).

**Table 3**

Type	At Loan Closing		At Liquidation		Missing Items	
	No. Of Items	Appraised Value 12/16/96	No. Of Items	Appraised Value 4/17/00	No.	Original Value 12/16/96
Machinery and Equipment	188	\$2,185,800	12	\$460,050	176	\$1,412,542
Autos, Trucks, and Trailers	70	441,031	13	53,700	57	364,083
Office Equipment	112	85,276	0	0	112	85,276
Real Estate	1	235,000	1	260,000	N/A	N/A
<b>TOTAL</b>	<b>371</b>	<b>\$2,947,107</b>	<b>26</b>	<b>\$773,750</b>	<b>345</b>	<b>\$1,861,901</b>

Examples of the missing items follows.

- Boom Trencher, Serial Number D5A1D021 – This item was acquired on February 2, 1996, at a cost of \$541,185. At loan closing in December 1996, the trencher’s book value was \$502,483. The April 17, 2000, liquidation appraisal did not list the trencher, there was no record to show its disposition, and the lender could not explain what happened to it.
- Trencher, Serial Number 25J0D078 – This item was acquired on December 31, 1995, at a cost of \$540,882. At loan closing in December 1996, the trencher’s book value was \$301,376. The April 17, 2000, liquidation appraisal did not list the item, there was no record to show its disposition, and the lender could not explain what happened to it.
- Mack Truck, 1994 Model Year - Serial Number 1M2P270Y4RM020678 – This item was acquired on August 9, 1996, at a cost of \$98,012. At loan closing in December 1996, the truck had a book value of \$93,929. On April 17, 2000, the liquidation appraisal did not list the truck, and the lender could not explain what happened to it.

Missing items included 21 automobiles and trucks that the lender failed to include on the Financing Statement, UCC-1, filed with the Florida Secretary of State.

During the time the lender of record owned this loan, it attempted to perform collateral inspections but a thorough inspection of all collateral was never completed. In a July 1, 1997, letter, an appraiser employed by the lender stated, *"I have completed the on-site inspection of the residential-commercial structure in connection with the above referenced loan. I understand there to be approximately \$4 million worth of various equipment and trucks also used as loan collateral; however, none of the equipment was on site. All equipment and trucks are at scattered locations throughout the United States, therefore none was viewed."* On August 13, 1998, a representative for the lender stated in a memorandum to the loan file that collateral was located at several sites and a collateral inspection would be completed on August 25 or 26, 1998. Further, the representative stated that she explained to the appraiser that he could look at one of something and didn't need to see each piece if they had *"lets say 10 of something"*. On August 25, 1998, a representative for the lender visited the borrower's main business site to inspect collateral but reported it was located in several States including Texas, California, Virginia, and Michigan.

RD performed the required annual lender visits for the loan but did not perform a physical inspection of the loan collateral during the life of the loan.

When we asked about the missing collateral, the lender could not explain the whereabouts of major missing items such as vehicles, trenchers, etc. We were unable to talk to the borrower because the business had closed and the borrower had left the area. We discussed the missing collateral with RD officials and they were unable to explain what happened to the collateral. After our discussion, the RD officials visited the lender and attempted to determine the status of the missing collateral but were unable to obtain an explanation from the lender.

On March 12, 2001, RD received a check for \$1,126,465 from the lender for RD's 80 percent portion of the \$1,408,082 in liquidation proceeds. The liquidation proceeds were derived from the sale of real estate and equipment for \$754,239. Another \$800,000 was paid by a guarantor and \$4,051 was received from insurance proceeds. Liquidation fees totaling \$150,208 was paid out of the proceeds. An estimated loss of \$1,567,075 is expected on the loan of which RD would absorb \$1,253,660 if the 80 percent guarantee is honored. As of June 1, 2001, RD had not received a loss claim from the lender and no loss payments had been made to the lender.

- Loan No. B – On October 14, 1993, the borrower received a \$2.5 million guaranteed loan. The borrower’s company, located in Homestead, Florida, packed and shipped for local producers tropical fruits to wholesalers and grocery stores. The borrower also owned 350 acres of lime trees whose fruit was processed through the packinghouse.

At loan closing the borrower pledged real estate, equipment and machinery, a lease on the packinghouse, and the company’s accounts receivable as collateral for the loan. A collateral listing submitted with the loan application showed total value of collateral at \$4,238,947. Machinery and equipment was valued at \$488,284. On March 14, 2000, the borrower defaulted on the loan and on October 24, 2000, the lender submitted a liquidation plan to RD for approval. On February 1, 2001, we visited the borrower’s place of business and performed a collateral inspection. We used the lender’s collateral listing prepared at loan closing to inventory the security property. We were unable to find 13 pieces of equipment valued at \$89,773. For example, a caterpillar forklift with an appraised value of \$5,000 could not be located. The lender did not perform a thorough inspection of the loan collateral until the loan was liquidated.

As of June 1, 2001, the lender was in the process of selling the remaining collateral and estimated a loss of about \$353,000 once liquidation is completed. The government’s share of the loss (80 percent) was estimated at \$282,400. At the end of audit fieldwork RD had not received a loss claim from the lender and no loss payments had been made to the lender.

B. LENDER DID NOT TAKE PRUDENT SERVICING ACTIONS AGAINST A BORROWER THAT VIOLATED TERMS OF THE LOAN AGREEMENT

One lender did not take prudent servicing actions when the borrower (Loan No. B) violated terms of the loan agreement. Without obtaining prior approval from the lender, the borrower (a) disposed of loan collateral valued at \$1,112,500, (b) incurred additional long-term debts totaling \$3,859,047, and (c) failed to apply payments received from the USDA’s Animal and Health Inspection Service (APHIS) for destruction of lime trees pledged as loan collateral. The violations negatively impacted the borrower’s repayment ability and contributed to the borrower’s default on the loan.

RD instructions<sup>1</sup> states, in part, 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.

The August 31, 1993, Loan Conditional Commitment stated that the borrower would not incur additional debt, other than in its operations and due within 1 year, nor assume the liabilities of others, without the prior written concurrence of the lender and RD.

The October 14, 1993, Loan Agreement specified that the borrower would not, without prior written consent of the lender, among other things, incur any additional indebtedness for borrowed money, any additional contingent liability, or assign, mortgage, pledge, encumber, grant any security interest in, or transfer any of borrower's assets, whether now owned or hereafter acquired, except in the of borrower's business. Further, as security for the loan, the borrower granted a security interest in collateral. This included among other things, all the borrower's accounts receivable and other forms of obligations evidencing any obligation for goods sold or leased, or services rendered, whether now existing and/or owned or hereafter acquired, as well as the proceeds of all the foregoing. In addition to the foregoing, all plants or crops growing or being on the property were pledged as security for the loan.

The borrower violated the following covenants of the Loan Agreement.

- Disposal of loan collateral – At loan closing on October 14, 1993, the borrower pledged as part of loan collateral a lease on a packinghouse which was an integral part of the business operation. The estimated value of the lease at loan closing was \$1,112,500 which was almost 50 percent of the amount of the loan. In 1997, the borrower, without informing the lender, terminated the packinghouse lease and entered into a new lease with the owner. The borrower then pledged the new lease as collateral to obtain a \$200,000 loan from another party. None of the \$200,000 loan was used to reduce the principal or interest on the B&I guaranteed loan. On August 26, 1999, after the lender became aware of the borrower's actions, the lender's attorney sent the borrower a letter threatening legal action unless the problem was corrected. However, the lender took no further action and at the end of audit fieldwork was uncertain as to who had first lien against the lease. RD officials were not aware of any

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<sup>1</sup> RD Instruction 4287.107, dated December 23, 1996.

legal actions taken by the lender against the borrower to re-establish the lender's superior lien position on the packinghouse lease.

Additional long-term debt – At loan closing, the borrower's financial statement listed total long-term liabilities of \$1,554,411. As of January 11, 2001, the borrower's financial statement reported total long-term liabilities of \$5,413,458 -- an increase of \$3,859,047 (see table 4).

**Table 4**

AS OF DATE	LONG-TERM LIABILITIES	CHANGE
4/30/93	\$1,554,411	N/A
4/30/94	\$3,410,000	\$1,855,589
4/30/96	\$3,360,000	(\$50,000)
1/31/00	\$5,671,036	\$2,311,036
1/11/01	\$5,413,458	(\$257,578)

Total liabilities listed on the borrower's January 11, 2001, financial statement included two loans from the Small Business Administration in the amount of \$741,000 and \$958,793, which were obtained on June 26, 1996. These loans, along with the other long-term debts, were obtained without prior approval from the lender or RD.

On December 5, 1996, the lender notified the borrower in writing of the borrower's violation of loan covenant restrictions in the Loan Agreement, which prohibited the borrower from incurring additional debt without written approval from the lender and the agency and to take immediate steps to pay the loan in full or rotate the debt to another lender. The borrower paid the loan current and the lender continued to work with the borrower although the borrower continued to incur additional debt without obtaining prior approval from the lender and RD.

- Application of Proceeds from loan collateral – In October and November 2000, the borrower received a total of \$1,365,026 in payments from APHIS for the destruction by the Federal and State governments of 59,531 lime trees due to infestation by citrus canker (see table 5).



**Table 5**

DATE	AMOUNT	NUMBER OF ACRES	TREES DESTROYED
10/31/00	\$100,100	25	4,792
10/31/00	260,260	65	14,185
11/01/00	193,700	50	8,241
11/01/00	770,900	200	29,650
11/29/00	26	0	1
12/06/00	40,040	10	2,663
TOTAL	\$1,365,026	350	59,531

The borrower did not apply any of the \$1,365,026 towards the B&I guaranteed loan to bring it current. The Financing Statement (Uniform Commercial Code-1 [UCC]) filed by the lender at loan closing on October 14, 1993, stated that in addition to other collateral, all plants or crops now or hereafter growing or being on property pledged as collateral would also serve as collateral for the loan. The UCC-1 listed a 50-acre lime grove owned by the borrower as collateral. The borrower received a \$193,700 APHIS payment on this grove for the destruction of trees which served as collateral, and will receive an additional APHIS payment for about the same amount for loss of future income.

APHIS officials stated that the law required the agency to make all loss payments directly to the commercial grower with no provisions for making the payments jointly or assigning the payments to other parties (e.g., lien holders). APHIS officials said regulations did not require growers to replant citrus trees and prohibited them from replanting citrus trees on land where infected trees were removed for at least 2 years from the date the trees were destroyed.

According to APHIS officials, additional payments are to be made to commercial growers for loss of future income from the trees' fruit. These additional payments are expected to be about the same dollar amount as the first payments. APHIS officials said these additional payments would be made once the Office of Management and Budget approved regulations authorizing the payments.

The borrower could receive an additional \$1.2 million in payments from APHIS, including \$193,700 for the 50-acres of collateral trees. We reported this information to the lender who referred the matter to its legal counsel to determine if there were options available for getting access to the payments. On

June 13, 2001, we issued a management alert to Florida RD officials recommending they notify the lender to take necessary legal actions to intercept future APHIS payments made to the borrower.

At a minimum, the lender should take legal actions to obtain the \$193,700 APHIS payment the borrower will receive on the 50-acre grove listed on the UCC-1.

C. LENDERS DID NOT CONSIDER ALL LOAN COLLATERAL WHEN LIQUIDATING LOANS

The lenders did not include accounts receivable pledged as loan collateral in their liquidation plans. On their latest financial statements, the borrowers reported accounts receivable totaling \$2,379,990 which were pledged as security for the loan. However, the lenders liquidation plans did not include an evaluation of liquid assets. The plans only included real estate, machinery, and equipment. RD instructions<sup>2</sup> require that a lender's liquidation plan must include, among other things, a full and complete listing of all collateral including any personal or corporate guarantees. Further, the lender should take action to maximize recovery from all collateral, including personal and corporate guarantees. The liquidation plan must include the recommended liquidation methods for making the maximum collection possible on the indebtedness.

Our review of the two loans disclosed the following.

- Loan No. A - On May 21, 1999, after the borrower defaulted on a \$2.95 million loan, the lender submitted a liquidation plan to RD for approval. The borrower's June 30, 1998, balance sheet (the last financial statements obtained from the borrower) listed \$2,064,713 in accounts receivable.

The Loan Conditional Commitment for Guarantee, dated September 30, 1996, required the borrower to pledge its security interest in all assets, i.e., accounts receivable, inventory, equipment, furniture and fixtures, deposits, etc. The security interest in accounts receivable and contracts receivable were subordinate to another creditor's \$550,000 line of credit.

In an October 31, 1996, letter the original lender informed the borrower that the application for the loan had been approved subject to certain terms and conditions. One of the conditions

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<sup>2</sup> RD Instructions 4287.157, dated December 23, 1996.

required the borrower to pledge as part of the loan collateral a second security interest in accounts receivable and contracts receivable.

The lender did not include accounts receivable in its liquidation plan. Therefore, no attempt was made to recover any part of the outstanding loan principal through collection of accounts receivable owned by the borrower. We asked the lender why the borrower's accounts receivable were not considered. The lender replied that the bank was not aware that the borrower had any accounts receivable and that other creditors were suing the borrower for any remaining assets. The lender had not obtained updated financial information since June 30, 1998.

At the end of audit fieldwork, the lender had sold all remaining loan collateral and an estimated loss of about \$1.6 million was expected on the loan of which the RD guarantee is 80 percent.

- Loan No. B - On October 24, 2000, after the borrower defaulted on a \$2.5 million loan, the lender submitted a liquidation plan to RD for approval. The borrower's financial statement for the year 2000, dated January 11, 2001, listed accounts receivable totaling \$315,277. The Loan Agreement listed the borrower's accounts receivable as part of the collateral pledged to secure the loan.

The lender did not include the borrower's accounts receivable in the liquidation plan. We asked the lender why they did not consider the borrower's accounts receivable when liquidating the loan. The lender replied that the bank had not received a copy of the borrower's January 11, 2001, financial statement and was not aware the borrower had any accounts receivable. We asked RD officials why the lender did not address the borrower's accounts receivable in their liquidation plan. RD stated that it informed the lender that the liquidation plan needed to be revised to include the accounts receivable. However, at the end of audit fieldwork, the lender had not provided RD with a revised liquidation plan that included the borrower's accounts receivable.

The lender estimates a loss of about \$353,000 on the loan once liquidation is completed. In our June 13, 2001, management alert to Florida RD officials, we recommended they notify the lender to obtain the borrower's accounts receivable to recover the loss on the loan.

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## RECOMMENDATION NO. 1

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In consultation with the Office of the General Counsel, take action to reduce the amount of the loss payments made to the lender of (a) Loan No. A by the value of the missing collateral and the value of the accounts receivable, and (b) Loan No. B by the value of the future APHIS payments to the borrower, the value of missing collateral, and accounts receivable owned by the borrower.

### RD Response

In its January 8, 2002, response to the draft report, the RD State Office agreed with the recommendation. Also the response stated:

*\* \* \*Since the lender has not yet submitted a Final Loss Claim, no loss payments have been paid. These actions will be taken when the loss claim is received and processed.*

### OIG Position

To achieve a management decision, we will need the results of action taken to reduce the loss claims of both lenders.

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## RECOMMENDATION NO. 2

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Require lenders to (a) perform, at least annually, an inspection of all loan collateral to ensure that all collateral is accounted for and properly maintained and (b) provide RD with written documentation of collateral inspections and justification for missing collateral.

### RD Response

In its January 8, 2002, response to the draft report, the RD State Office agreed with the recommendation. The response did note that:

*\* \* \*These recommendations were incorporated into the Florida Conditional Commitment (Form 4279-3, Attachment A) approximately six (6) months ago for all B&I guaranteed loans. Since lenders appear to have different interpretations of 'reasonable, timely and prudent' servicing, it is hoped that the conditions outlined in the excerpts attached (pages 3 and 8) will define several minimum servicing actions.*

*Since this appears to be a nationwide issue, it would seem appropriate to incorporate the recommendations on a*

*nationwide basis, i.e., Administrative Notice, Procedural Notice, or Management Letter.*

**OIG Position**

We agree with the management decision.

---

**RECOMMENDATION NO. 3**

---

Require RD staff to perform and document a collateral inspection on problem loans during annual visits to lenders and borrowers.

**RD Response**

In its January 8, 2002, response to the draft report, the RD State Office agreed with the recommendation. The response did note that:

*\* \* \*Timeframe for action will be immediate and ongoing.*

**OIG Position**

We agree with the management decision.

---

**RECOMMENDATION NO. 4**

---

Require lenders to (a) immediately notify RD upon discovery that a borrower has violated covenants of their loan agreement and (b) take prompt actions to rectify the violations.

**RD Response**

In its January 8, 2002, response to the draft report, the RD State Office agreed with the recommendation. The response did note that:

*\* \* \*This action was implemented approximately six (6) months ago in the same manner as Recommendation No. 2 above.*

**OIG Position**

We agree with the management decision.

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**RECOMMENDATION NO. 5**

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Require lenders to obtain borrowers' current financial statements, inventory, accounts receivable, investment, and cash account records to account for all assets owned by the

borrower when preparing liquidation plans.

**RD Response**

In its January 8, 2002, response to the draft report, the RD State Office agreed with the recommendation. The response did note that:

*\* \* \*Timeframe for action will be immediate and on going.*

*\* \* \*This action is only possible where the borrower is cooperative during a liquidation. Our experience has shown that only about 1 in 10 borrowers in liquidation provide this information voluntarily. A few others have provided information as a result of court orders.*

**OIG Position**

To achieve management decision, we need information on what actions lenders will be required to take when borrowers do not cooperative.

**CHAPTER 2****LENDERS DID NOT PROVIDE REQUIRED  
BORROWER FINANCIAL DATA TIMELY****FINDING NO. 2**

RD did not ensure that lenders submitted annual written reports on borrowers' financial health. As of November 13, 2000, the RD State office tracking system showed that lenders were delinquent in providing the agency with the annual reports and financial statements for 41 of the 84 borrowers. Lenders did not place a high priority on obtaining and providing these reports to RD and RD was not enforcing the requirement. Without timely financial analyses, neither lenders nor RD can properly monitor the financial condition of borrowers to determine if they are in compliance with terms of the Loan.

RD instructions<sup>3</sup> state that, "The lender must obtain from the borrower and forward to the agency the financial statements required by the Loan Agreement. The lender must submit annual financial statements to the agency within 120 days of the end of the borrower's fiscal year. The lender must analyze the financial statements and provide the agency with a written summary of the lender's analysis and conclusions, including trends, strengths, weaknesses, extraordinary transactions, and other indications of the financial condition of the borrower."

Information in the State office's tracking system showed that as of November 13, 2000, annual reports with accompanying financial statements had not been received for 41 of the 84 borrowers. The 41 borrowers had loans totaling \$87.5 million. All of the reports were overdue for at least 1 year and in some cases no reports had been received for four consecutive years (see table 6).

**Table 6**

LAST YEAR REPORT RECEIVED FOR	NO. OF LOANS	AMOUNT
1994	1	\$ 1,320,000
1995	1	1,617,000
1996	4	6,115,000
1997	10	23,335,000
1998	25	55,097,200
TOTAL	41	\$87,484,200

<sup>3</sup> Rd Instructions 4287.107(d) dated December 23, 1996.

Examples of the overdue reports follow.

- Loan No. C - The borrower received a \$1,320,000 loan on January 31, 1980, to refinance debt and remodel a truck stop. The conditional commitment required that annual audited financial statements be forwarded to the Lender within 120 days of fiscal year end. The last financial statement received by the agency was as of December 31, 1994.

As of June 30, 2001, the loan balance was \$516,913 and the borrower was current on payments. RD stated that the business had changed ownership, and the new owner has not been providing the statements.

- Loan No. D - The borrower received a \$3 million loan on January 28, 1992, to provide working capital and debt refinancing for a tomato packing and processing plant. The last financial statement received by the agency was as of December 31, 1997.

As of June 30, 2001, the loan balance was \$989,722 and the borrower was current on the loan payments.

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**RECOMMENDATION NO. 6**

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considered negligent servicing and could cause the loan guarantee to be unenforceable.

Require all lenders whose annual reports are overdue to submit them within 60 days and put the lenders on notice that failure to timely provide the agency with the annual reports is

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**RECOMMENDATION NO. 7**

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Develop internal procedures and controls to ensure lenders' submissions of the annual financial reports.

**RD Response**

In its January 8, 2002, response to Recommendation Nos. 6 and 7, the RD State Office agreed with them. In addition, it stated the following:

*\* \* \*A reminder was sent to all lenders on April 13, 2001 in conformance with AN 3572 (9/28/00). In addition, Florida has been sending reminders to lenders with overdue annual analysis' and financial statements semi-annually. A system has been put in place to follow-up on loans with overdue statements and to remind lenders of the consequences of negligent servicing.*



*\* \* \*We have attached a spreadsheet listing 90 active loan accounts as of 11/16/01. Of these, nine (9) are classified as bankruptcy or liquidation. There are an additional 17 loans where annual financial statements have not been received. This represents a marked improvement over the period reviewed by the audit team.*

**OIG Position**

To achieve a management decision on the two recommendations, we need details of the system put in place to follow-up on overdue statements, and result of actions taken to obtain the 17 overdue statements.

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## EXHIBIT A – SUMMARY OF MONETARY RESULTS

RECOMMENDATION NO.	DESCRIPTION	AMOUNT	CATEGORY
1	Losses on Loan Nos. A and B	\$1,536,060	Questioned Costs and Loans, Recovery Recommended

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## EXHIBIT B – RD STATE OFFICE RESPONSE TO DRAFT REPORT

Page 1 of 4



United States  
Department of  
Agriculture  
Rural Development

Florida/Virgin Islands  
4440 Northwest 25th Place  
Post Office Box 147010  
Gainesville, FL 32614-7010

OFFICE OF THE STATE  
DIRECTOR  
Telephone: 352-338-3482  
Fax: 352-338-3450  
TDD: 352-338-3499  
[www.rurdev.usda.gov/fl](http://www.rurdev.usda.gov/fl)

January 8, 2002

SUBJECT: Rural Business – Cooperative Service  
Lender Servicing of B & I Guaranteed Loans, Florida  
34601-2-AT

TO: Raymond G. Poland  
Regional Inspector General  
Office of Inspector General  
401 W. Peachtree Street, NW  
Suite 2328  
Atlanta, GA 30308

We have completed a review of the Official Draft Report on the subject audit.

The following is our response to the findings and recommendations of the audit team:

**Finding No. 1**

**Recommendation No. 1**

- (a) Agreed
- (b) Agreed

Note: Since the lender has not yet submitted a Final Loss Claim, no loss payments have been paid. These actions will be taken when the loss claim is received and processed.

**Recommendation No. 2**

- (a) Agreed
- (b) Agreed

Note: These recommendations were incorporated into the Florida Conditional Commitment (Form 4279-3, Attachment A) approximately six (6) months ago for all B&I guaranteed loans. Since lenders appear to have different interpretations of "reasonable, timely and prudent" servicing, it is hoped that the conditions outlined in the excerpts attached (pages 3 and 8) will define several minimum servicing actions.

*Rural Development is an Equal Opportunity Lender. Complaints of discrimination should be sent to:  
Secretary of Agriculture, Washington, D.C. 20250-0700*

PAGE TWO  
Audit Response  
34601-2-AT

Since this appears to be a nationwide issue, it would seem appropriate to incorporate the recommendations on a nationwide basis, i.e., Administrative Notice, Procedural Notice, or Management Letter.

**Recommendation No. 3**

Agreed. Timeframe for action will be immediate and ongoing.

**Recommendation No. 4**

- (a) Agreed
- (b) Agreed

This action was implemented approximately six (6) months ago in the same manner as Recommendation No. 2 above.

**Recommendation No. 5**

Agreed. Timeframe for action will be immediate and ongoing.

Note: This action is only possible where the borrower is cooperative during a liquidation. Our experience has shown that only about 1 in 10 borrowers in liquidation provide this information voluntarily. A few others have provided information as a result of court orders.

**Finding No. 2.**

**Recommendation No. 6 and No. 7**

Agreed. A reminder was sent to all lenders on April 13, 2001 in conformance with AN 3572 (9/28/00). In addition, Florida has been sending reminders to lenders with overdue annual analysis' and financial statements semi-annually. A system has been put in place to follow-up on loans with overdue statements and to remind lenders of the consequences of negligent servicing.

Note: We have attached a spreadsheet listing 90 active loan accounts as of 11/16/01. Of these, nine (9) are classified as bankruptcy or liquidation. There are an additional 17 loans where annual financial statements have not been received. This represents a marked improvement over the period reviewed by the audit team.

Page 3

Attachment A to Form 4279-3

5. INSURANCE:

- A. Hazard insurance with a standard mortgage clause naming the lender as beneficiary is required in an amount which is at least the greater of the depreciated replacement value of the loan security or the amount of the loan balance. Hazard insurance includes fire, windstorm, lightening, hail, explosion, riot, civil commotion, aircraft, vehicle, marine, smoke, public liability, property damage, flood or mudslide or other hazard insurance that may be required to protect the collateral.

Borrower and guarantor(s) shall purchase and maintain hazard insurance on all collateral, for maximum insurable values, with lender named as mortgagee and/or lender loss payee, as applicable, by endorsement to policy(s), which must contain a "Standard Mortgage Clause," and a "Lender's Loss Payable Clause" as applicable, providing that lender and/or its assigns shall be paid under the policy regardless of the actions of, or insurer's defenses against the borrower.

- B. Worker's compensation insurance, if required in accordance with Florida State law.
- C. Borrower shall maintain general liability insurance for not less than one million dollars (\$1,000,000).

6. FINANCIAL STATEMENTS:

Annual audited financial statements prepared on an accrual basis by a Certified Public Accountant are required for [REDACTED] and they will be forwarded to the lender within 120 days of fiscal year end. The financial statements will be prepared using generally accepted accounting principals and they will be properly footnoted. The lender will provide RBS with an analysis of this annual statement **WITHIN 30 DAYS OF RECEIPT**. Quarterly in-house financial statements, which do not have to be reviewed, are also to be submitted to the lender within 60 days of the end of quarter with copies forwarded to RBS.

A current financial statement less than 60 days old, is required at loan closing for the corporation, the partnership and individuals. An annual personal financial statement and year-end tax return must be submitted annually.

The guarantors must submit an annual personal financial statement within 120 days of year end and year-end tax returns.

24. LENDER SERVICING REQUIREMENTS

Lender must service the loan in a reasonable, timely and prudent manner. Servicing actions will include, but will not be limited, to:

- A. Quarterly financial statements from borrower will be reviewed and forwarded to RBS within 30 days of receipt. When violations of loan covenants exist, an analysis of these statements is required along with recommendations and/or planned curative actions.
- B. The lender is responsible for obtaining and forwarding to the Agency the financial statements required by the Loan Agreement. The lender is responsible for providing the Agency with (1) an analysis of the borrower financial statements (including spreadsheets), (2) a written trend analysis that compares borrower year-to-year historical financial information, and (3) a borrower ratio comparison to industry standards for similar size businesses. The lender's written analysis to the Agency should include the borrower's strengths, weaknesses, extraordinary transactions, term loan agreement violations, and other indications of the financial condition of the borrower. The lender will submit the annual financial statements to the Agency, along with its spreadsheets and written analysis, within 30 days of receipt from the borrower. Failure to obtain the required financial statements or to document efforts to obtain financial statements could result in the loan guarantee being unenforceable due to negligent servicing.
- C. Annual financial statements and tax returns of all guarantors will be forwarded to RBS.
- D. A minimum of one comprehensive annual collateral inspection. This will include detailed inspection of all personal property serving as collateral. A report of the status, condition and disposition of the collateral will be submitted to RBS following the inspection(s). This may be made a part of the annual analysis.
- E. Lender will conduct an annual UCC Search to determine lien state of collateral and the extent to which other debt has been incurred.