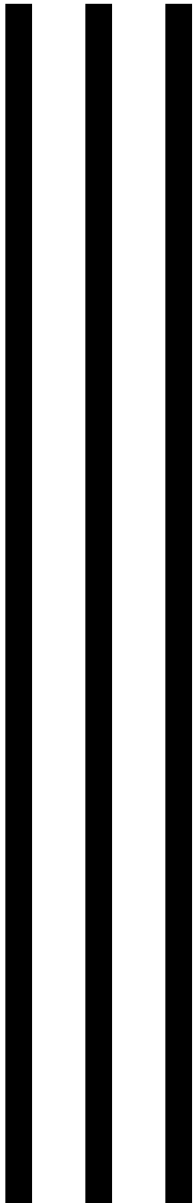


USDA



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
BANGOR, MAINE



**Report No.
34601-9-Te
NOVEMBER 2001**



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Southwest Region

101 South Main, Suite 324

Temple, Texas 76501



DATE: November 28, 2001

REPLY TO

ATTN OF: 34601-9-Te

SUBJECT: RBS B&I Guaranteed Loans – Rural Development State Office, Bangor, Maine

TO: Mr. Michael W. Aube
State Director
Rural Development
967 Illinois Avenue, Suite 4
Bangor, ME 04402

This report presents the results of our audit of lender servicing in the Rural Development Business and Industry (B&I) guaranteed loan program in Maine. The Maine Rural Development State Office's response to the draft report, dated November 14, 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 the recommendations in the report. In accordance with Departmental Regulation 1720-1, final action should be taken within 1 year of each management decision. Correspondence concerning final actions should be addressed to the Office of the Chief Financial Officer.

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
BANGOR, MAINE**

REPORT NO. 34601-9-Te

RESULTS IN BRIEF

This audit was conducted as part of a nationwide audit of the 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 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 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.

At the Maine Rural Development State Office (SO), we performed an initial review of six B&I guaranteed loans with five different lenders. These loans were for amounts of \$1 million or greater and were either delinquent in their loan payments or were considered problem loans. From these six borrowers, we identified two for in-depth evaluation. Borrower A did not comply with loan covenants and borrower B was delinquent. Katahdin Trust Company, Inc. (KTC) made loans to both of the borrowers.

We did not find any reportable conditions with borrower B, but we determined that borrower A did not comply with its loan covenants. The requirements that borrower A was not required to meet for the year ended December 31, 1999, included: providing annual financial statements, meeting minimum working capital and tangible net worth requirements, and the requirement that stockholders invest capital into the business.

On January 22, 2001, the SO granted the waiver for the borrower's breach of these loan covenants. This waiver was granted without a plan to bring the borrower back into compliance even though the borrower was technically insolvent, had a low liquidity level, had a significant decrease in net worth, had an insufficient repayment ratio, and, historically, was not in compliance with loan covenants. In the lender's analysis of the borrower's financial report, which occurred 2 months after the waiver was granted, the lender made no representation that the borrower could reopen and return to profitability. The lender also stated that it would not financially support the borrower's efforts to return to profitability.

We also found that the SO's waiver was authorized (signed) at the SO by a loan specialist. The SO informed us that this authority had been delegated to the loan specialist level. The granting of a waiver without a plan to bring the borrower back into compliance with the loan covenants increased the risk of a loss on the government-guaranteed loan.

KEY RECOMMENDATIONS

Develop a plan of action to assist borrower A to comply with its loan covenants and obtain guidance from the RBS National Office on the validity and legal ramifications of granting waivers for covenant violations and the delegation of authority for granting such waivers.

AGENCY RESPONSE

In a letter dated November 14, 2001, the SO informed us they had held two meetings with the borrower and the lender to discuss the audit report and covenant violations, and the borrower's efforts to improve its operations and performance. It is the intent of the SO to continue closely monitoring the borrower's performance and the lender's servicing actions such that the government's interests are protected to the maximum extent possible. Also, the SO has requested guidance from the National office on the validity and legal ramifications of granting waivers for covenant violations and the proper delegations of authority for such waivers. See exhibit B.

OIG POSITION

We agree with the management decisions.

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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 credit 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. This limit includes the guaranteed and non-guaranteed portions, the outstanding principal, and 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 interest 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 payment of taxes and insurance premiums, and maintaining liens on collateral.

Borrower A is a family owned and operated forest products company. It was established and has been in continuous operation since 1894. Borrower A and its wholly owned subsidiary (a chip plant) were incorporated in 1994. (The subsidiary was created in large part to obtain a more favorable worker's compensation insurance premium, but the chip company was discontinued and ceased operations in 1998.) Borrower A operates a sawmill, planing mill, and chip plant in Sherman's Station, Maine. The company markets its lumber out of State through approximately 25 wholesalers. Borrower A has been marketing with two of these wholesalers for over 80 years. Borrower A sells nearly 90 percent of its lumber out of State, primarily to New England and the Mid-Atlantic States. Occasionally, loads are shipped to the Mid-West, California, Europe, and the Far East.

Borrower A received a \$5 million B&I 80 percent guaranteed loan from KTC. The loan was closed on March 31, 1997. Borrower A used the loan to restructure debt and construct a milling plant.

As of January 29, 2001, Maine Rural Development had nine borrowers with loans classified as problem/delinquent loans. Of these nine borrowers, three were in liquidation, two were classified as more than 30 days delinquent, and four were problem loans. The nine loans total \$21,387,000.

OBJECTIVES

Our audit objective was to determine if the lender properly serviced the B&I guaranteed loan.

SCOPE

We performed this audit as part of a nationwide review of the B&I guaranteed loan program. Maine 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 February to March 2001 at the Maine Rural Development SO in Bangor, Maine. We conducted interviews, reviewed loan files, and conducted collateral inspections in Sherman's Station, Presque Isle, Gardiner, and Augusta, Maine. Coverage included B&I guaranteed loan activity during fiscal years 1998, 1999, and 2000.

Since January 1, 1990, the Maine Rural Development SO has issued 87 loan note guarantees with lending institutions totaling over \$125 million, a segment of the 3,150 loans totaling over \$4.1 billion made nationally by the agency. As of October 17, 2000, the Maine B&I guaranteed loan portfolio had 56 unpaid loans totaling \$72.8 million on loans made since January 1, 1990, a segment of the 2,420 unpaid loans totaling over

\$3.2 billion nationally. From this universe, we judgmentally selected for review six loans that totaled \$1 million or more that were classified as either a delinquent or problem loan. These loans totaled \$19.9 million. From these six loans, we identified two totaling \$13 million with potential problem areas for an in-depth lender evaluation. One of the loans was delinquent and one violated loan covenants. Both loans were provided by the same lender.

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 objectives, we examined: (1) Rural Development instructions, policies, and procedures related to the B&I guaranteed loan program, (2) Rural Development SO records related to the borrowers' loans, (3) the lenders' records related to the borrowers' loans, and (4) the borrowers' records to determine if lenders were properly servicing the loans. We interviewed borrowers, lenders, and Rural Development SO personnel.

FINDINGS AND RECOMMENDATIONS

CHAPTER 1	WAIVER GRANTED FOR BORROWER'S NONCOMPLIANCE OF LOAN COVENANTS
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FINDING NO. 1

We found that borrower A was not in compliance with its loan covenants and the SO had agreed with the lender to waive these requirements. The waiver was granted

without a plan to correct the problems. The requirements that borrower A was not required to meet included: providing annual financial statements, meeting minimum working capital and tangible net worth requirements, and the requirement that stockholders invest capital into the company. We also question the level in the SO at which the waiver was agreed to.

In our opinion, the granting of a waiver without a plan to bring the borrower back into compliance with the loan covenants increased the risk of a loss on the government-guaranteed loan.

Rural Development Form 4279-4, Lender's Agreement, paragraph IV C 1, dated October 1996, states 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 that the lender will notify in writing USDA and the borrower of any violations. Neither the lender's agreement nor any Rural Development instructions or administrative notices address granting the borrower a waiver from complying with the loan covenants.

On March 19, 2000, the RBS Administrator issued a letter granting Rural Development State Directors limited waiver authority, but the extent of the authority is unclear. The letter states that in no case may the State Director diminish the condition of the loan and it must be determined that the borrower's cash flow is sufficient to continue to service all current debt.

We found that borrower A was not operating in compliance with the following covenants:

Covenants 11 and 12 required the borrower to submit annual financial statements within 90 days of year-end and audited financial statements within 120 days. This was not done.

Covenant 13 required the stockholders of borrower A to invest adequate capital into the business to maintain minimum tangible net worth levels. This was not done.

Covenant 14 required the borrower to maintain a debt-to-tangible net worth ratio of not more than 7.5 to 1. The ratio at the time of our audit was a negative 4.67 to 1.

Covenant 15 required the borrower to maintain minimum tangible net worth greater than \$1 million. At the time of our audit, the borrower's tangible net worth was a negative \$1,480,282.

Covenant 16 required the borrower to maintain debt service coverage of at least 1.5 to 1. At the time of our audit, the actual ratio was a negative .04 to 1.

Covenant 19 required the borrower to maintain a minimum working capital level of \$500,000. The working capital balance at the end of the 1999 business year was a negative \$1,973,460.

On January 22, 2001, the lender notified the SO that the borrower was not in compliance with its loan covenants for the year ended December 31, 1999, and requested a waiver from these requirements. Even though the request was late and the borrower was not complying with significant requirements of its loan, on January 22, 2001, a loan specialist in the SO signed and approved the agreement to waive the requirements of these covenants. We found no plan for the lender to bring the borrower back into compliance.

The waiver from these requirements was granted 2 months before the lender performed an analysis of borrower A's 1999 financial statement. The lender's analysis showed major defects in borrower A's financial condition including: a going concern issue raised by borrower A's CPA; financial information being over 1 year old; decreasing trends in sales, net profit, and gross profit; low liquidity; the borrower being technically insolvent; slow payment history; no updated financial history on any of the guarantors; and a history of not complying with loan covenants.

Also, by granting the borrower a waiver from complying with the loan covenants, the borrower's CPA was not obligated to report the violations in the company's annual financial statements. Without the waiver, violations of the loan covenants would have meant that the loan was callable. In accordance with Financial Accounting Standards Board Statement No. 78, callable debts should be classified as a current liability. By not classifying the debt as a current liability, the borrower's financial strength could be misstated.

The lender also stated that it would not represent that the borrower could reopen and return to profitability, and that the lender would not financially support such an undertaking. According to their loan officer, the borrower

could not continue without a cash infusion into the business. The only recourse without the cash infusion would be to sell the assets and liquidate the business.

We also questioned the level in the SO at which the waiver was agreed to. As stated, a loan specialist at the SO signed the waiver. When we discussed delegation of authority with the RBS National Office, we were told that this type of authority should not be delegated below the State Director level.

During our exit conference, The SO asserted the loan specialist had developed a workout plan with borrower A before granting the waiver. The document provided to our auditor was notes of an annual visit with KTC. No workout plan was prepared.

RECOMMENDATION NO. 1

Develop a plan of action to assist borrower A to comply with its loan covenants.

Rural Development Response

The SO has held two meetings with the borrower and the lender to discuss the borrower's efforts to improve its operations and performance. It is the intent of the SO to continue closely monitoring the borrower's performance and the lender's servicing actions such that the government's interests are protected to the maximum extent possible. See exhibit B.

OIG Position

We agree with the management decision for Recommendation No. 1.

RECOMMENDATION NO. 2

Obtain guidance from the RBS National Office on the validity and legal ramifications of granting waivers for covenant violations for this loan and future guaranteed loans and the

proper delegation of authority to agree to such waivers.

Rural Development Response

The SO has requested guidance from the National office on the validity and legal ramifications of granting waivers for covenant violations and the proper delegations of authority for such waivers.

OIG Position

We agree with the management decision for Recommendation No. 2.

EXHIBIT A – SUMMARY OF MONETARY RESULTS

FINDING NUMBER	RECOMMENDATION NUMBER	DESCRIPTION	AMOUNT	CATEGORY
1	1	Lender negligent in servicing B&I guaranteed loan	\$4,000,000	Questioned Loan – No Recovery Recommended
TOTAL			\$4,000,000	

EXHIBIT B – AUDITEE’S RESPONSE TO THE DRAFT REPORT



United States
Department of
Agriculture

Michael W. Aube
State Director

Rural
Development

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November 14, 2001

Mr. Robert E. Gray
Regional Inspector General for Audit
Office of Inspector General, USDA
101 South Main, Suite 324
Temple, TX 76501

RE: RBS B&I Guaranteed Loans – Maine

Dear Mr. Gray:

I am writing in response to your audit report concerning RBS B&I guaranteed loans in Maine dated October 24, 2001.

Two recommendations were made, and I will address each individually.

Recommendation #1: Develop a plan of action to assist borrower A to comply with its loan covenants.

Response: A meeting was held with the lender and borrower on January 11, 2001, just eleven days prior to concurrence in the lender's recommendations. At the time of the meeting, the borrower's efforts to improve its operations and performance were discussed. Furthermore, the possibility of the sale of certain company assets and repayment of the debt in full were also discussed. Finally, the outstanding audit report and covenant violations were specifically discussed on that date and documentation of such is included in the case file. Therefore, we maintain that there were, in fact, several courses of action under consideration for protecting the interests of the lender and the government at that time. Any injection of additional capital simply to comply with loan covenants would be fruitless without a strong and immediate upsurge in the lumber and flooring markets. In light of the fact that the borrower had been paying the equivalent of one and one-half payments (approximately \$91,000) per month for the preceding 13 months, the actions discussed at the January 11, 2001, meeting were considered responsible and prudent under the circumstances.

Subsequently a meeting was held October 23, 2001, at which time the liquidation of assets and application of proceeds to the debt were discussed. It is the intent of the State Office to continue closely monitoring the borrower's performance and the lender's servicing actions such that the government's interests are protected to the maximum extent possible.

Rural Housing
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Rural Business-Cooperative
Service

Rural Utilities
Service

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Complaints of discrimination should be sent to:
USDA, Director, Office of Civil Rights, Washington, D.C. 20250-9410

Recommendation #2: Obtain guidance from the RBS National Office on the validity and legal ramifications of granting waivers for covenant violations for this loan and future guaranteed loans and the proper delegations of authority to agree to such waivers.

Response: Request for guidance on these issues was submitted to our National Office of even date. We will advise you of their response when it is received.

Exhibit A indicated an amount of \$4,000,000. We assume this refers to the original loan, guaranteed at 80 percent, which was \$5,000,000. The loan balance has since been paid down to \$2,503,900 (as of September 13, 2001). We do not anticipate any loss to the government at this time.

We firmly believe that the lender has made every reasonable effort in servicing this loan and has not been negligent in any way. Equally firmly, we believe that the government should honor its commitments and obligations under its guarantee.

Please contact Alan C. Daigle at 207-990-9168 if you have any questions.

Sincerely,



MICHAEL W. AUBE
State Director

