
AUDIT OF RTC MORTGAGE TRUST 1994-N1

Audit Report No. 00-006
March 17, 2000

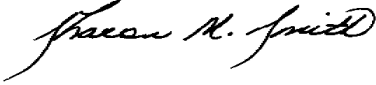


OFFICE OF AUDITS

OFFICE OF INSPECTOR GENERAL

DATE: March 17, 2000

TO: Gail Patelunas, Deputy Director
Asset Management Branch
Division of Resolutions and Receiverships



FROM: Sharon M. Smith
Assistant Inspector General

SUBJECT: *Audit of RTC Mortgage Trust 1994-N1* (Audit Report No. 00-006)

This report presents the results of an audit of Resolution Trust Corporation (RTC) Mortgage Trust 1994-N1. The Office of Inspector General (OIG) performed this audit in response to a request from the Federal Deposit Insurance Corporation's (FDIC) Division of Resolutions and Receiverships (DRR) to audit various trusts.¹ Mortgage Trust 1994-N1, created on January 31, 1994, consisted of a class A certificateholder—1994-N1 Associates, LP—and a class B certificateholder—the RTC.

BACKGROUND

The RTC had the authority to create trusts that sold, through competitive bid sales, certificates representing a percentage of beneficial ownership in those trusts. One of those RTC-created trusts, Mortgage Trust 1994-N1 (the Trust), consisted of 511 loans with a principal balance of approximately \$406 million.

The objective of the Trust, organized as a Delaware business trust, was to dispose of the assets purchased from the RTC as promptly as possible in a manner that maximized economic return. On January 31, 1994, the RTC signed a deposit trust agreement with Wilmington Trust Company, the trustee. The trustee was responsible for ensuring that all parties to the transaction fulfilled their respective obligations under the deposit trust agreement.

In exchange for the assets, the RTC received from the trustee cash and two types of equity certificates—the controlling class A certificate and the noncontrolling class B certificate. The RTC, in turn, sold the class A certificate to 1994-N1 Associates, LP, which consisted of four investors—Bankers Trust, Sterling American Properties, BEI Management, and an individual investor. The RTC contracted with Aldridge, Eastman, and Waltch (AEW) to assist in its oversight responsibilities and oversee its class B interest in the Trust.

¹December 31, 1995, marked the RTC's legislatively mandated sunset date. Responsibility for all RTC-related work ongoing as of that date transferred to the FDIC in accordance with the *RTC Completion Act of 1993*.

The class A certificate provided for the holder to receive 49 percent of the Trust's income and be responsible for the Trust's daily operations. The class B certificateholder was entitled to the remaining 51 percent of income. The class A certificateholder entered into a servicing agreement with one of its partners—BEI Management—to service the Trust's mortgage loans and manage, market, and dispose of the Trust's assets. In November 1994, BEI Management changed its name to AMRESKO Management (AMRESKO).

The Trust, under an agreement with the Bank of America National Trust and Savings Association (the bond trustee), issued \$117 million of commercial, loan-backed bonds to third-party institutional investors through open-market transactions. As the class A certificateholder liquidated the Trust's assets, the proceeds were first used to retire the bonds and any remaining funds were then distributed to the class A and class B certificateholders. The bonds were retired in January 1996.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of the audit was to determine whether AMRESKO charged the Trust only allowable expenses and accurately accounted for and reported income. The audit covered the Trust's operations from its inception on January 31, 1994, through October 31, 1998.

To accomplish the objective, we interviewed FDIC personnel from the Agreement and Case Management Section, Oversight and Monitoring Branch, DRR. Additionally, we reviewed applicable FDIC policies and procedures relating to the administration of equity partnerships. We also interviewed personnel from AEW—DRR's oversight contractor—and AMRESKO—the Trust's servicer.

Our audit focused on the Trust's income and expenses from loan servicing, operating assets, and the sale or other disposition of assets. We randomly sampled 10 of the 511 assets to verify whether AMRESKO accurately accounted for and properly reported the Trust's income and charged the Trust only allowable expenses. For the 10 assets sampled, we tested the receipt of income from loan payments, operation of foreclosed assets, and asset dispositions through settlements or sales. Those assets represented \$8 million of the Trust's \$184 million in revenues as of October 31, 1998.

For the first 5 of the 10 assets sampled, we determined whether related expenses were allowable under the terms of the Trust's agreements. We also reviewed all of AMRESKO's and the class A certificateholder's overhead expenses charged to the Trust as well as AMRESKO's servicing fees. In total, we reviewed \$19.4 million of the \$60.5 million in expenses charged to the Trust.

We did not evaluate AMRESKO's system of internal controls because the OIG concluded that it could meet the audit objective more efficiently by conducting substantive tests rather than placing reliance on the internal control system. The OIG conducted the audit from October 1998 through December 1999 in accordance with generally accepted government auditing standards.

RESULTS OF AUDIT

For the 10 sampled assets, AMRESKO accurately accounted for and properly reported the Trust's income. However, we questioned \$718,735 of unallowable expenses that AMRESKO paid from the Trust's funds. Table 1 summarizes the questioned costs by expense type.

Table 1: Summary of Questioned Costs

Expense Type	Amount Questioned
Unallowable fees paid to AMRESKO affiliates	\$536,979
Unallowable asset servicing fees	104,268
Unallowable class A certificateholder expenses	59,822
Unallowable miscellaneous expenses	17,666
Total	\$718,735

Source: OIG analysis of the Trust's expenses.

Unallowable Fees Paid to AMRESKO Affiliates

AMRESKO billed the Trust \$536,979 for an in-house tax consulting group. AMRESKO billed the Trust and paid itself despite the prohibition in the Trust's servicing agreement and other documents against payments to affiliates of either the servicer or the class A certificateholder. Both AMRESKO and class A certificateholder officials stated that the in-house tax consulting services were in addition to AMRESKO's normal servicing responsibilities. The officials added that the services were performed at the discretion of the class A certificateholder and, therefore, not subject to the prohibition against payments to affiliates.

We disagree with the AMRESKO and class A certificateholder officials on both points. The servicing agreement required AMRESKO to establish subsidiary corporations and limited partnerships, owned by the Trust, to take title to foreclosed properties. AMRESKO's in-house tax consulting group compiled information to file the subsidiary corporations' and limited partnerships' federal, state, and local tax returns and performed other tax-related functions for the Trust. Accounting for the subsidiary corporations and limited partnerships, including the tax consequences of operating the subsidiaries, was necessary to protect the Trust's assets and, therefore, a responsibility of the servicer.

We also disagree with the assertion that the affiliate prohibition did not apply to services performed at the discretion of the class A certificateholder. The servicing agreement clearly prohibits any payment of the Trust's funds to affiliates of either the servicer or the class A certificateholder. The deposit trust agreement prohibits the class A certificateholder from violating any term of the Trust's documents, which include the servicing agreement. Accordingly, any payment to an affiliate of the servicer or class A certificateholder, regardless of whether at the class A certificateholder's discretion, violated the terms of the deposit trust agreement.

We believe that the prohibition against the use of affiliates was included to safeguard the Trust against self-dealing on the part of either the servicer or the class A certificateholder. The use of its in-house tax consulting group provided AMRESKO with additional revenues and profits not contemplated under the Trust’s documents. Such arrangements raise concerns as to whether the charges were reasonable and necessary and, in fact, benefited the Trust. Accordingly, we questioned \$536,979 paid to AMRESKO for its tax consulting group.

While we consider the entire payment made to AMRESKO for its tax consulting group to be unallowable because of the aforementioned reasons, we also identified that AMRESKO marked up its direct cost associated with the tax consulting group. Using AMRESKO’s analysis of markups of direct costs,² we estimated that AMRESKO billed the Trust \$236,471 more than it incurred for the tax consulting group as shown in table 2.

Table 2: AMRESKO’s Markup of Tax Consulting Group Costs

Employee Status	Direct Cost	Markup	Total Billed
AMRESKO employees	\$235,509	\$207,012	\$442,521
Temporary employees	64,999	29,459	94,458
Total	\$300,508	\$236,471	\$536,979

Source: OIG analysis of the Trust’s expenses.

Unallowable Asset Servicing Fees

In addition to its monthly servicing fees, AMRESKO billed the Trust an additional \$104,268 in unallowable servicing fees, which included the reconstruction and reconciliation of loan files and bonuses paid to its asset managers. AMRESKO was responsible for servicing the assets, and the fee schedule included in the servicing agreement specified AMRESKO’s compensation for all servicing activities. The servicing agreement allowed AMRESKO to subcontract—at its own cost—for all or a portion of its servicing requirements. Accordingly, we questioned \$104,268 in asset servicing fees that AMRESKO billed in addition to the specified monthly servicing fees. AMRESKO billed the Trust additional servicing fees as follows:

- \$83,433 for staff time relating to the reconstruction and reconciliation of the mortgage loan files, and
- \$20,835 for asset manager bonuses.

According to AMRESKO officials, the loan files were in disarray and need of updating and selected asset managers were paid incentive bonuses to continue employment through a major asset sale.

²AMRESKO prepared an analysis of its markup on this and three other trusts based on concerns raised by the OIG in another report entitled *Audit of RTC Mortgage Trust 1992-NI* (audit report number 99-035 dated August 23, 1999).

Unallowable Class A Certificateholder Expenses

AMRESKO paid \$59,822 from the Trust's funds for unallowable expenses related to the class A certificateholder's operations. Neither the deposit trust agreement nor the servicing agreement provided for reimbursement of those expenses, which included

- \$1,101 in partnership expenses for the class A certificateholder,
- \$8,845 in due diligence expenses,
- \$14,844 in legal fees, and
- \$35,032 in travel and entertainment expenses.

The \$1,101 that AMRESKO paid for partnership expenses were for photo copies of the class A certificateholder partnership documents, which, according to the class A certificateholder's law firm, were provided to the investors in the class A certificateholder partnership. The \$8,845 that AMRESKO paid for due diligence expenses included the class A certificateholder's travel, entertainment, and administrative expenses incurred before the formation of the Trust.

The \$14,844 in legal fees that AMRESKO paid the class A certificateholder were for services relating to the class A certificateholder's operations as well as services provided to the Trust. Because the law firm did not separate its bills to the Trust and the class A certificateholder, we could not determine to which entity they applied. Accordingly, we questioned the total legal fees. The legal services billed included preparing the class A partnership amendments and modifications, the Trust's compliance certification, and analyses of the deposit trust agreement and the servicing agreement.

In addition, AMRESKO paid the class A certificateholder \$35,032 for travel and entertainment expenses. Generally, the expenses appeared to be for the class A certificateholder's partners to attend partnership meetings. However, the invoices in most cases lacked receipts or other support and appeared excessive.

Neither the deposit trust agreement nor the servicing agreement contain provisions for the reimbursement of due diligence costs, legal fees, travel and entertainment expenses, or partnership administration costs incurred by the class A certificateholder.

Miscellaneous Unallowable Expenses

AMRESKO charged the Trust \$17,666, of which \$1,826 was unsupported, for unallowable miscellaneous expenses. The Trust's servicing agreement provided that disbursements from the Trust's funds had to be directly related to the management and liquidation of the Trust's assets.

However, AMRESO charged expenses to the Trust that were either unrelated to asset management and liquidation or unsupported as follows:

- \$7,897 for travel, duplicating, and delivery expenses incurred before the Trust's closing;
- \$4,080 for tax return preparation when no expense was paid by AMRESO;
- \$3,793 for entertainment, including \$534 for a baseball game outing and \$696 for a nightclub outing for class A certificateholder executives and AMRESO staff;
- \$1,826 for unsupported overhead and other miscellaneous expenses;
- \$60 for an employee's CPA license; and
- \$10 for a credit card fee.

Class A certificateholder officials stated that the miscellaneous charges were normal business cost to enhance employee moral and those expenses were reasonable given the overall performance of the Trust. However, the servicing agreement limited use of the Trust's funds to expenses necessary for management and liquidation of the Trust's assets. The miscellaneous expenses listed above were not necessary for those purposes and were, therefore, unallowable.

CONCLUSIONS AND RECOMMENDATIONS

AMRESO accurately accounted for and properly reported the Trust's income for the sampled assets reviewed. However, AMRESO charged the Trust \$718,735 for expenses that were not allowable under the terms of the servicing agreement or the deposit trust agreement. Accordingly, we recommend that the Deputy Director, Asset Management Branch, DRR, take the following actions:

- (1) Disallow \$536,979 in fees paid to AMRESO affiliates and require AMRESO to reimburse the Trust (questioned cost of \$273,859 representing the FDIC's 51-percent share).
- (2) Disallow \$104,268 in unallowable servicing fees paid to AMRESO and require AMRESO to reimburse the Trust (questioned cost of \$53,177 representing the FDIC's 51-percent share).
- (3) Disallow \$59,822 in operating expenses paid to the class A certificateholder and require AMRESO to recover those funds and reimburse the Trust (questioned cost of \$30,509 representing the FDIC's 51-percent share).
- (4) Disallow \$17,666 (of which \$1,826 is unsupported) in miscellaneous expenses paid to AMRESO and require AMRESO to reimburse the Trust (questioned cost of \$9,010 representing the FDIC's 51-percent share, of which \$931 is unsupported).

CORPORATION COMMENTS AND OIG EVALUATION

On February 18, 2000, the Deputy Director, DRR, provided a written response to a draft of this report. The Deputy Director's response agreed with the recommendations and provided the requisites for a management decision on each of the four recommendations. The Deputy Director's response is presented as appendix I to this report.

A summary of the Deputy Director's response to recommendation 1 and our analysis follows. The response to recommendations 2, 3, and 4 is not summarized because the actions planned or completed are identical to those recommended.

Disallow \$536,979 in fees paid to AMRESKO affiliates and require AMRESKO to reimburse the Trust (questioned cost of \$273,859 representing the FDIC's 51-percent share): The Deputy Director agreed that payments to affiliates were not allowable under the Trust agreements. However, the Deputy Director stated that to the extent that the questioned payments, including any imputed markup, were reasonable and within industry standards for such services, DRR would not pursue reimbursement of the expenses because they were incurred in good faith. The Deputy Director added that it would be inequitable not to pay the questioned amounts because the Trust benefited from the services. Although the Deputy Director's response contained the requisites for a management decision, we disagree with the Deputy Director's reasons for not seeking reimbursement for the fees paid to AMRESKO affiliates. In addition to the fees being unallowable under the terms of the Trust agreements, the use of affiliates provided AMRESKO with additional revenues and profits through a self-dealing arrangement. Such an arrangement raises concerns over whether the charges were reasonable and necessary and, therefore, benefited the Trust as asserted by the Deputy Director.

Appendix II presents management's proposed action on our recommendations and shows that there is a management decision for each recommendation in this report. Based on the audit work, the OIG will report questioned costs of \$366,555 (of which \$931 is unsupported) in its *Semiannual Report to the Congress*.

FDIC


Federal Deposit Insurance Corporation

Washington D.C. 20429

Division of Resolutions and Receiverships

DATE: February 18, 2000

MEMORANDUM TO: Sharon M. Smith
Assistant Inspector General

FROM: Gail Patelunas 
Deputy Director, DRR

SUBJECT: OIG Draft Report Entitled
RTC Mortgage Trust 1994 – N1

On December 17, 1999 the Office of the Inspector General (OIG) issued its draft report on the results of an audit of the RTC Mortgage Trust 1994-N1 (Trust), in which the FDIC is the Class B Certificateholder (Class B). As noted in the report, OIG selected this Trust for review in response to DRR's request for an audit of various trusts. The report concludes that the Servicer, AMRESKO Management (AMRESKO), accurately accounted for and properly reported the Trust's income; however, the Trust was charged \$718,735 for expenses that were not allowable under the terms of the transaction documents.

Following are Management's responses to the areas questioned in the audit report.

1. *AMRESKO Management inappropriately charged the Trust \$536,979 in unallowable fees for an in-house tax consulting group.*

Management agrees in principle with the OIG's position that restrictions on payments to affiliates apply to expenses authorized under the Deposit Trust Agreement (DTA) as well as to those under the Servicing Agreement. However, to the extent that the questioned payments including any imputed "mark-up" are reasonable and within industry standards for such services, DRR will not pursue reimbursement of the expenses as they were incurred in the good faith belief that they were payable and it would be inequitable not to pay them under the facts and circumstances because the Trust benefited from the services.

2. *AMRESKO Management improperly billed the Trust \$104,268 for work done on the reconstruction and reconciliation of loan files.*

RTC Mortgage Trust 1994 - N1 Draft Audit Report Response
Page 2

Management concurs that the Reconstruction and Reconciliation project is an activity that is within the scope of normal servicing activities, and therefore does not constitute an "operating or administrative expense" payable under the DTA at the direction of the Class A Holder. Management will seek recovery of \$104,268 in expenses charged to the Trust for this project.

3. *Disallow payment of \$14,844 for legal fees and \$44,978 (total \$59,822) for expenses related to the Class A Certificateholders' operations.*

Management concurs with the OIG's finding that \$14,844 in legal expenses are related to the Class A Certificateholders only, and are not related to the operation of the Trust. We also agree that \$44,978 in Class A operating expense be disallowed. Therefore, reimbursement will be sought for a total of \$59,822 in disallowed legal fees and Class A expenses under Recommendation #3.

4. *AMRESO Management improperly paid miscellaneous expenses totaling \$17,666.*

Management concurs with the OIG's finding and will request reimbursement in the amount of \$17,666 for these expenses.

Within thirty days of the issuance of the final report by the OIG, Management will issue a demand letter requesting that AMRESO or the Class A Holder, as appropriate, reimburse the Trust \$181,756 (of which the FDIC will receive \$92,696 as its 51% share) the amount agreed to as disallowed costs.

cc: Nick Ravichandran, OIG
Cynthia Shaughnessy, Legal
Doug Stinchcum, DRR
Hank Abbot, DRR
Dean Eisenberg, DRR
Joci Spector, DRR
Edward Dox, AEW

MANAGEMENT RESPONSES TO RECOMMENDATIONS

The Inspector General Act of 1978, as amended, requires the OIG to report on the status of management decisions on its recommendations in its semiannual reports to the Congress. To consider the FDIC's responses as management decisions in accordance with the act and related guidance, several conditions are necessary. First, the response must describe for each recommendation

- the specific corrective actions already taken, if applicable;
- corrective actions to be taken together with the expected completion dates for their implementation; and
- documentation that will confirm completion of corrective actions.

If any recommendation identifies specific monetary benefits, FDIC management must state the amount agreed or disagreed with and the reasons for any disagreement. In the case of questioned costs, the amount that the FDIC plans to disallow must be included in management's response.

If management does not agree that a recommendation should be implemented, it must describe why the recommendation is not considered valid.

Second, the OIG must determine that management's descriptions of (1) the course of action already taken or proposed and (2) the documentation confirming completion of corrective actions are responsive to its recommendations.

This table presents the management responses that have been made on recommendations in our report and the status of management decisions. The information for management decisions is based on management's written response to our report.

Rec. Number	Corrective Action: Taken or Planned / Status	Expected Completion Date	Documentation That Will Confirm Final Action	Monetary Benefits	Management Decision: Yes or No
1	The Deputy Director, DRR, agreed with our recommendation. However, the Deputy Director stated that DRR would not pursue recovery of the questioned costs—including any imputed markup—to the extent that they were reasonable and within industry standards for such services.	04/30/00	Deputy Director's response.	\$-0-	Yes
2	The Deputy Director, DRR, agreed with our recommendation and stated that DRR would seek recovery of the questioned costs.	04/30/00	Deputy Director's response and demand letter.	\$53,177	Yes
3	The Deputy Director, DRR, agreed with our recommendation and stated that DRR would seek recovery of the questioned costs.	04/30/00	Deputy Director's response and demand letter.	\$30,509	Yes

Rec. Number	Corrective Action: Taken or Planned / Status	Expected Completion Date	Documentation That Will Confirm Final Action	Monetary Benefits	Management Decision: Yes or No
4	The Deputy Director, DRR, agreed with our recommendation and stated that DRR would seek recovery of the questioned costs.	04/30/00	Deputy Director's response and demand letter.	\$9,010	Yes