
AUDIT OF RTC MORTGAGE TRUST 1994-N2

Audit Report No. 00-007
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-N2* (Audit Report No. 00-007)

This report presents the results of an audit of Resolution Trust Corporation (RTC) Mortgage Trust 1994-N2. 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-N2, created on December 15, 1994, consisted of a class A certificateholder—1994-N2 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-N2 (the Trust), consisted of 404 loans with a principal balance of approximately \$345 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 December 15, 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-N2 Associates, LP, which consisted of four investors—Bankers Trust, Sterling American Properties, AMRESKO Management (AMRESKO), 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—AMRESKO—to service the Trust's mortgage loans and manage, market, and dispose of the Trust's assets.

The Trust, under an agreement with the State Street Bank and Trust Company (the bond trustee), issued \$118.9 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 during 1997.

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 December 15, 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 404 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 \$2.6 million of the Trust's \$94.8 million in revenue 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 \$31.3 million of the \$75.7 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 \$818,224 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	\$394,684
Unallowable asset servicing fees	366,871
Unallowable class A certificateholder expenses	44,537
Unallowable miscellaneous expenses	12,132
Total	\$818,224

Source: OIG analysis of the Trust's expenses.

Unallowable Fees Paid to AMRESKO Affiliates

AMRESKO billed the Trust \$394,684 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 \$394,684 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 costs associated with the tax consulting group. Using AMRESKO’s analysis of markups of direct costs,² we estimated that AMRESKO billed the Trust \$153,046 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	\$162,775	\$143,080	\$305,855
Temporary employees	78,863	9,966	88,829
Total	\$241,638	\$153,046	\$394,684

Source: OIG analysis of the Trust’s expenses.

Unallowable Asset Servicing Fees

In addition to its normal monthly servicing fees, AMRESKO billed the Trust \$366,871 in unallowable servicing fees, which included an additional flat monthly fee, asset file maintenance fees, and payments for employee bonuses and temporary employees. 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 \$366,871 in asset servicing fees that were in addition to the specified monthly servicing fees. AMRESKO billed the Trust additional servicing fees as follows:

- \$336,875 for additional flat monthly servicing fees,
- \$20,548 for staff time relating to the reconstruction and reconciliation of the mortgage loan files,
- \$3,136 for temporary employees, and
- \$6,312 for asset manager bonuses.

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-N1* (audit report number 99-035, dated August 23, 1999).

The servicing agreement provided for a monthly servicing fee for each asset based on asset value. However, beginning in February 1995, AMRESKO started billing the Trust an additional flat monthly fee of \$6,875 for servicing the pool of assets. Through February 1999, AMRESKO billed the Trust a total of \$336,875 in additional servicing fees. According to AMRESKO officials, the class A certificateholder was concerned that AMRESKO did not have enough asset managers to handle all of the Trust's assets and agreed to compensate AMRESKO for additional personnel until the number of assets was reduced. The officials also stated that AMRESKO should have discontinued the additional servicing fee after December 1995 because the number of assets that the Trust held decreased below an established threshold. However, the officials added that AMRESKO continued to charge the additional monthly fee until February 1999 when we requested information on servicing fees charged to the Trust.

In April 1999, AMRESKO reimbursed the Trust \$261,250 to cover the period after December 1995 but did not reimburse the Trust for the remaining \$75,625 for the period from February 1995 through December 1995. Although the class A certificateholder authorized the payments, the additional servicing fees were not allowed by the servicing agreement. Accordingly, AMRESKO should reimburse the Trust \$75,625 that it was paid for the period February 1995 through December 1995.

According to AMRESKO officials, the \$20,548 billed for reconstruction and reconciliation of the mortgage loan files was necessary because the loan files were in disarray and need of updating. The officials said that the \$6,312 billed for bonuses was for incentive payments to selected asset managers to continue employment through a major asset sale. However, those expenses as well as the \$3,136 paid for temporary employees were for activities covered by the normal servicing fee.

Unallowable Class A Certificateholder Expenses

AMRESKO paid \$44,537 from the Trust's funds for unallowable travel and entertainment expenses of the class A certificateholder. Generally, the expenses appeared to be for the class A certificateholder's partners to attend partnership meetings. Neither the deposit trust agreement nor the servicing agreement contained provisions for the reimbursement of travel and entertainment expenses incurred by the class A certificateholder.

Miscellaneous Unallowable Expenses

AMRESKO charged the Trust \$12,132 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, AMRESKO billed expenses to the Trust that were unrelated to asset management and liquidation as follows:

- \$7,419 for entertainment, including \$534 for a baseball game outing and \$1,629 for a nightclub outing for class A certificateholder executives and AMRESKO staff;
- \$4,643 for duplicate payments to a temporary employment agency;
- \$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

AMRESKO accurately accounted for and properly reported the Trust's income for the sampled assets reviewed. However, AMRESKO charged the Trust \$881,110 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 \$394,684 in fees paid to AMRESKO affiliates and require AMRESKO to reimburse the Trust (questioned cost of \$201,289 representing the FDIC's 51-percent share).
- (2) Disallow \$366,871 in unallowable servicing fees paid to AMRESKO and require AMRESKO to reimburse the Trust (questioned cost of \$187,104 representing the FDIC's 51-percent share). AMRESKO reimbursed the Trust \$261,250 in April 1999, leaving an additional \$105,621 to be reimbursed.
- (3) Disallow \$44,537 in travel and entertainment expenses paid to the class A certificateholder and require AMRESKO to recover those funds and reimburse the Trust (questioned cost of \$22,714 representing the FDIC's 51-percent share).
- (4) Disallow \$12,132 in miscellaneous expenses paid to AMRESKO and require AMRESKO to reimburse the Trust (questioned cost of \$6,187 representing the FDIC's 51-percent share).

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 \$394,684 in fees paid to AMRESKO affiliates and require AMRESKO to reimburse the Trust (questioned cost of \$201,289 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 \$417,294 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 – N2

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-N2 (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 \$818,224 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 \$394,684 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 \$366,871 in unallowable servicing fees including \$336,873 in flat monthly fees. AMRESKO reimbursed the Trust \$261,250 in April, 1999, leaving \$105,621 to be reimbursed.*

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Management concurs with the recommendation that the additional servicing fees should be disallowed. We will seek recovery of \$105,621 in expenses improperly charged to the Trust.

3. *Disallow payment of \$44,537 for travel and entertainment expenses paid to the Class A Certificateholders.*

Management concurs with the OIG's finding that \$44,537 in Class A Certificateholder expenses should be disallowed and will seek reimbursement for that amount.

4. *AMRESKO Management improperly paid miscellaneous expenses totaling \$12,132.*

Management concurs with the OIG's finding and will request reimbursement in the amount of \$12,132 for these expenses.

Within thirty days of the issuance of the final report by the OIG, Management will issue a demand letter requesting that AMRESKO or the Class A Holder, as appropriate, reimburse the Trust \$162,290 (of which the FDIC will receive \$82,768 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 the costs were reasonable and within industry standards for such services.	04/15/00	Deputy Director's response and demand letter.	\$-0-	Yes
2	The Deputy Director, DRR, agreed with our recommendation and stated that DRR would seek recovery of the questioned costs.	04/15/00	Deputy Director's response and demand letter.	\$187,104	Yes
3	The Deputy Director, DRR, agreed with our recommendation and stated that DRR would seek recovery of the questioned costs.	04/15/00	Deputy Director's response and demand letter.	\$22,714	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.	04/15/00	Deputy Director's response and demand letter.	\$6,187	Yes