

Office of Inspector General



August 1, 2000
Audit Report No. 00-033

Audit of Residual Interests from Asset
Disposition Decisions by Settlement and
Workout Asset Teams

**Material has been redacted from this
document to protect personal privacy,
confidential or privileged information.**



DATE: August 1, 2000

TO: Mitchell Glassman, Director
Division of Resolutions and Receiverships



FROM: Sharon M. Smith
Assistant Inspector General

SUBJECT: *Audit of Residual Interests from Asset Disposition Decisions by Settlement and Workout Asset Teams* (Audit Report No. 00-033)

This report presents the results of the Office of Inspector General's (OIG) audit of residual interests from Settlement and Workout Asset Team (SWAT) asset disposition decisions. The audit addressed whether the Federal Deposit Insurance Corporation (FDIC) monitored the SWAT decisions and received any residual interests in SWAT assets, if applicable. Initially, we intended to review the FDIC's monitoring of Special Asset Resolution Group (SARG) decisions also. However, our review of SARG decisions disclosed that the SARG asset dispositions were generally low in dollar value compared to the SWAT actions sampled, involved cash settlements without residual interests, and were actively monitored by FDIC account officers. Accordingly, we limited the scope of our audit to SWAT decisions.

BACKGROUND

The Resolution Trust Corporation (RTC)¹ implemented the SWAT program in April 1992 to evaluate distressed assets with complex, high-profile arrangements and develop strategies to maximize recoveries. The SWAT program operated in the RTC's headquarters in Washington, D.C., and six field offices located in Atlanta, Georgia; Newport Beach, California; Dallas, Texas; Denver, Colorado; Kansas City, Missouri; and Valley Forge, Pennsylvania. Each office delegated authority to SWATs to resolve problem assets. SWATs included four people—a businessperson and an attorney from the private sector and two staff members from the RTC. SWATs developed asset disposition plans that included restructuring and refinancing complex loans, forgiving debt, and taking residual interests in anticipated cash flows or future sales of the underlying collateral.

¹As provided in the *RTC Completion Act of 1993*, the RTC went out of existence on December 31, 1995, and the FDIC took over its functions on January 1, 1996.

The RTC/FDIC Transition Task Force included the RTC's SWAT program in its best practice review and recommended implementation of the SARG program as an extension of the SWAT program. SARGs consisted of a minimum of three FDIC employees who had authority to make decisions at the field office level. Unlike SWAT, the use of outside business contractors and outside legal counsel was optional. According to the recommendation, SARGs were to resolve assets where more complicated SWATs were not necessary or cost effective. The task force recommended that the FDIC continue the SARG program for inherited RTC assets and complex and litigious FDIC assets. The task force left the use of SARGs to the discretion of the regional directors. The FDIC adopted the task force's recommendation and implemented the SARG program in December 1995.

SWATs and SARGs were not designed to be asset managers. Instead, the members of those groups made asset disposition decisions, which asset managers then implemented. SWATs and SARGs recorded their decisions in case memoranda or asset disposition plans, which documented authorized settlements, workouts, litigation, or bankruptcy proceedings. Day-to-day asset monitoring responsibilities remained with the applicable account officer or asset management contractor. Once the RTC/FDIC or its contractors implemented the specified SWAT/SARG action, they sent the related documentation to the Corporation's permanent files.

OBJECTIVES, SCOPE, AND METHODOLOGY

The audit objectives were to determine whether the FDIC monitored SWAT decisions and received any residual interests in SWAT assets, if applicable. To accomplish our objective, we interviewed Division of Resolutions and Receiverships (DRR) personnel located in the FDIC's headquarters and Hartford, Connecticut, and Dallas, Texas, offices to determine who was responsible for monitoring SWAT decisions and where related records were stored.

We judgmentally selected a sample of seven SWAT actions encompassing 81 assets and totaling \$697.7 million for detailed review. We selected our sample from the only available master list, dated November 1993, containing 1,305 assets with a book value of \$7.7 billion. We selected one SWAT action each from the Dallas, Texas; Denver, Colorado; Newport Beach, California; and Valley Forge, Pennsylvania; field offices. We also selected three actions from the Washington, D.C., headquarters office, which appeared to handle a majority of the largest SWAT actions.

For each SWAT action in our sample, we requested DRR to provide copies of SWAT action plans, case memoranda, and settlement and closing documents. Because DRR could not locate many of the requested documents, we used the FDIC's record storage and retrieval system to search for the documents in off-site storage. We located some of the needed documents through that process. For four of the sampled actions where we could identify borrowers, we contacted the borrowers or servicers directly and obtained settlement and closing documents, tax returns, partnership or corporate documents, and/or management representations concerning subsequent sales and refinancings. We also reviewed documentation provided by the Division of Finance (DOF) that supported the FDIC's receipt of funds from the SWAT actions included in our sample.

For one SWAT action, we requested the borrower to provide property tax returns; financial statements; financial investor documents; and closing documents on the sale, disposition, or transfer. The FDIC held a residual interest in net cash flow and net sales proceeds on that partnership property, and we requested an accounting of the FDIC's residual interest in the property. However, the borrower did not provide the financial investor documents or an accounting of the FDIC's residual interest. Accordingly, we calculated the FDIC's residual interest in net cash flow and net sales proceeds from the tax returns, financial statements, and closing documents.

We did not evaluate DRR's internal controls over SWAT assets because the OIG concluded that it could meet the audit objectives more efficiently by conducting substantive tests rather than placing reliance on internal controls. The OIG conducted the audit from March 1999 through January 2000 in accordance with generally accepted government auditing standards.

RESULTS OF AUDIT

There is no indication that the FDIC monitored residual interests from closed SWAT actions after the RTC closed on December 31, 1995. In addition, DRR could not locate an inventory of SWAT actions other than the November 1993 master list that we located. Therefore, we believe that the November 1993 list may not be a complete list of all SWAT actions. Moreover, DRR did not maintain a list of residual interests resulting from SWAT actions, and the November 1993 list did not specify which actions contained residual interests. Our sample of seven SWAT actions included

- a \$135 million SWAT action for which DRR could not locate any records;
- two SWAT actions for which the FDIC did not receive \$3,484,124 in residual interests;
- two SWAT actions with provisions for residual interests, but contingent events required to trigger the residual interests did not transpire; and
- two SWAT actions resulting in cash settlements without any residual interests.

Because there was no monitoring of residual interests from closed SWAT actions after the RTC ceased operations, the FDIC has no assurance that it received all residual interests due from those SWAT actions.

SWAT ACTIONS NOT MONITORED AFTER THE RTC CLOSED

There is no indication that the FDIC monitored residual interests in closed SWAT actions after the RTC closed. DRR officials could not provide an inventory of SWAT actions. However, an OIG search of RTC records obtained from off-site storage facilities located a "SWAT Master List of Assets" dated November 30, 1993. That list provided the type and location of each asset as

well as the borrower, lending institution, and asset book value. Because the SWAT program continued past November 1993, we believe the November 1993 list may not be a complete list of all SWAT actions.

According to DRR officials, many of the RTC account officers and asset management contractors responsible for monitoring the assets did not transition into the FDIC resulting in a loss of the historical knowledge of the SWAT actions. Further, the Corporation either archived the majority of the records relating to SWAT actions in off-site storage or could not find them. In addition, there is no indication that DOF and DRR had procedures in place to monitor any residual interests in the SWAT assets. According to a DRR senior internal review specialist, SWAT assets resolved and closed out by the RTC before its sunset were not transitioned into the FDIC. Accordingly, those assets did not appear on the FDIC’s asset tracking systems and DRR officials did not have readily available records of those dispositions. DRR could not locate the SWAT action plans for the seven sampled SWAT actions or a list of residual interests in SWAT assets that required long-term monitoring.

NO ASSURANCE THAT THE FDIC RECEIVED ALL RESIDUAL INTERESTS DUE FROM SWAT ASSET DISPOSITIONS

We were able to locate documentation such as action plans, case memoranda, and settlement and closing documents for six of the seven actions in our sample. Neither the OIG nor FDIC could locate any records for the remaining action, which had a book value of \$135 million. For the six actions where documentation was available, the FDIC did not receive residual interests totaling \$3,484,124 for two of the actions (actions number 5 and 7 in table 1). Two other actions included residual interest provisions, but the contingent events required to trigger those provisions did not occur. The remaining two actions were cash settlements with no residual interest provisions. Table 1 shows the sampled actions.

Table 1: SWAT Actions Reviewed

Action Number	Book Value of Assets	Residual Interest	Comments
1	\$237,166,857	\$ 0	No residual interest—cash settlement.
2	135,000,000	Unknown	Records could not be located.
3	116,000,000	0	Triggering event of residual interest did not occur.
4	78,906,608	0	Triggering event of residual interest did not occur.
5	72,000,000	84,124	Net cash flow interest.
6	50,786,703	0	No residual interest—cash settlement.
7	7,801,333	3,400,000	Missing collateral—pledged insurance policy.
Totals	\$697,661,501	\$3,484,124	

Source: SWAT inventory dated November 30, 1993, and OIG analysis of SWAT records.

Residual Interests on Two SWAT Actions Not Collected

Contingent events triggered the residual interest provisions for two of the seven actions in our sample. However, the FDIC did not receive the net cash flow payment or the life insurance policy pledged as collateral on the residual note and was not aware that the two residual interests were due.

The SWAT settlement for action number 5 shown in table 1 was between the borrower and the RTC as receiver for Columbia Savings and Loan Association and involved four borrower-related general partnerships. One of those general partnerships owned a 20-acre business complex located in Orange County, California. The RTC transferred a Columbia partnership's interest in the business complex to a borrower-related general partnership. In exchange, the RTC received a \$2.35 million note and a 40-percent residual interest in net cash flow from operating the business complex and net proceeds from the sale of the business complex.

The settlement documents included a residual interest agreement with formulas for determining the FDIC's residual interest in both the net cash flow and net sales proceeds. According to information on the federal income tax returns provided by the borrower and another entity that subsequently purchased the business complex, the FDIC should have received \$84,124 in net cash flow.² However, no evidence was available to show that the FDIC received the residual net cash flow interest.

The SWAT settlement for action number 7 shown in table 1 involved restructuring an \$8.5 million outstanding principal loan balance, which included creating a residual interest. The settlement created a \$6.5 million installment note, \$1.5 million installment note, and \$3.4 million residual interest note. The RTC immediately sold the \$6.5 million note at a discount. It later sold the other two notes to the RTC Mortgage Trust 1995-S/N2 (the Trust) in which the RTC was a 51-percent owner. The servicer for the Trust subsequently accepted a \$1 million payoff for the \$1.5 million note and released the collateral for both notes. In addition, the servicer converted the \$3.4 million residual interest note into an installment note maturing on July 29, 2001. That note became delinquent after one payment. The SWAT restructuring agreement required the borrowers to use their best efforts to obtain and maintain life insurance on the president of the borrowing entities. The agreement required insurance totaling the lesser of \$3.4 million or the outstanding principal balance of the residual interest note. According to a vice president with the Trust's servicer, the life insurance requirement would remain in effect until the borrowers paid the entire principal.

We informed DRR of the life insurance requirement in August 1999. DRR issued a letter to the servicer in September 1999 requesting that it make every effort to obtain the life insurance policy. In a letter dated September 22, 1999, the servicer asked the borrowers whether they had obtained the policy. As of March 9, 2000, the loan was still delinquent and the servicer had not received a response from the borrowers. According to the servicer and DRR officials, they do not expect the borrowers to willingly obtain the life insurance policy.

²Because encumbrances exceeded the selling price of the business complex, there were no net proceeds from the sale of the property. Accordingly, the FDIC was not due any residual interest payment on net sales proceeds.

CONCLUSIONS AND RECOMMENDATIONS

There is no indication that the FDIC monitored residual interests in closed SWAT actions after the RTC ceased operations. DRR officials could not provide an inventory of SWAT actions or residual interests resulting from SWAT actions. Accordingly, there is no assurance that the FDIC has received all residual interests due from SWAT assets. Although a large number of high-dollar, high-profile assets were included in SWAT actions, much of the institutional knowledge relating to those assets was lost when the RTC closed. Consequently, we concur with DRR officials that locating SWAT action plans and identifying residual interests would be very difficult. Accordingly, we are not making any recommendations regarding those assets but rather are leaving it to FDIC management's discretion regarding what, if any, action to take. However, for two of the seven SWAT actions in our sample, we identified residual interests of \$84,124 in net cash flow on one and a \$3.4 million life insurance policy pledged as collateral on the other. Accordingly, we recommend that the Director, DRR, take the following actions:

- (1) Collect from the borrower-related general partnership \$84,124 (questioned cost) in net cash flow residual interest (action number 5 in table 1).
- (2) Obtain from the installment note borrowers a \$3.4 million life insurance policy pledged as collateral (action number 7 in table 1).

We provided borrower names and other specifics of the SWAT actions related to these two recommendations to DRR during the course of our audit.

CORPORATION COMMENTS AND OIG EVALUATION

On July 25, 2000, the Associate Director, Internal Review, DRR, provided a written response to a draft of this report. The Associate Director's response agreed with recommendation 1 and disagreed with recommendation 2 in the draft report. Although the Associate Director's response disagreed with recommendation 2, DRR's actions cited in the response met the intent of the recommendation. Accordingly, the response provided the requisites for a management decision on both recommendations. Appendix I to this report presents the Associate Director's response. A summary of the Associate Director's response to recommendation 2 and our analysis follows. We did not summarize the response to recommendation 1 because the actions planned or completed are identical to those recommended. With respect to recommendation 1, the OIG has provided DRR with records related to the global settlement and residual interest, legal documents associated with the sale of Koll Center Orange, and partnership agreements and tax returns. We will continue to work with DRR to provide the information needed to fully address our recommendation.

Obtain from the installment note borrowers a \$3.4 million life insurance policy pledged as collateral (action number 7 in table 1) (recommendation 2): The Associate Director disagreed with the recommendation. He stated that it appears the borrowers used their "best efforts" to obtain the required life insurance policy, which met the requirements of the agreement. During our audit, we notified DRR that the FDIC had sold the note to a trust and the

servicer for the trust—not the FDIC—would have to obtain the life insurance policy. Accordingly, DRR contacted the servicer who in turn attempted to obtain the life insurance policy from the borrowers. Counsel for the borrowers responded that the borrowers had tried to obtain the required life insurance coverage but were unsuccessful due to the age and medical history of the principal to be insured. DRR’s attempt—through the servicer—to obtain the life insurance policy met the intent of recommendation 2 and, accordingly, provided the requisites for a management decision.

Appendix II presents management’s proposed actions 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 \$84,124 in its *Semiannual Report to the Congress*.



Federal Deposit Insurance Corporation

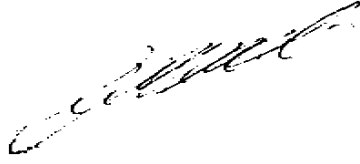
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Office of the Director

Division of Resolutions and Receiverships

July 25, 2000

MEMORANDUM TO:Sharon M. Smith
Assistant Inspector General**FROM:**Giovanni G. Recchia 
Associate Director (Internal Review)**SUBJECT:**Audit of Residual Interest from Asset Disposition
Decisions by Settlement and Workout Asset Teams

Thank you for the opportunity to respond to the referenced audit. We apologize for the delay in responding and we thank the OIG for their assistance in providing some of the documentation necessary for us to make a Management Decision on these Recommendations.

Primarily, the delay in responding can be attributed to our efforts at researching the Koll Company transaction. There were a number of related and somewhat complex Koll transactions that were combined under the SWAT umbrella and involved in a global settlement during 1993. Because of the age and complexity of these assets, researching the history of the Koll settlement in order to arrive at a Management Decision was extremely difficult and time-consuming. The Koll settlement involves a large number of parties, including what appears to be five limited partnerships holding large properties with an underlying appraised value of approximately \$200 Million.

OIG RECOMMENDATION:

Collect from the borrower-related general partnership \$84,124 (questioned cost) in net cash residual (action number 5 in table 1).

DRR RESPONSE:

- Based upon the information supplied by the OIG, DOF and it's own research, DRR management agrees with the OIG Recommendation. DRR also agrees with the questioned cost of \$84,124.

It appears that income derived by the limited partnership, during calendar year 1994, should allow the FDIC to make a claim for recovery of the residual. Complicating the situation, however, is the complexity of the settlement agreement containing a crosshatch of indemnities and provisions which need to be further reviewed and analyzed from both a business and a Legal perspective.

DRR will complete and document its initial review and decision regarding collection efforts for this asset by year-end 2000. If litigation is required, it is unlikely that effort will be completed before year-end 2001. These timeframes, however, are contingent upon the continuing cooperation of the OIG in providing assistance and documentation from their already completed research. Without the OIG's assistance, DRR may need to duplicate some of the extensive research already conducted in the process of developing the OIG's Audit Report.

OIG RECOMMENDATION:

Obtain from the installment note borrowers a \$ 3.4 million life insurance policy pledged as collateral (action 7 in table 1).

DRR RESPONSE:

Management disagrees with the OIG Recommendation and does not agree with the associated amount of \$3.4 million. DRR disagrees with the recommendation and the amount of \$3.4 million because DRR management feels that the parties have fulfilled their responsibilities, in view of the language in the Loan Restructure Agreement ("Agreement"), regarding obtaining life insurance on the life of **[redacted]**.

The Agreement, dated December 30, 1992, had a number of provisions, one of which stated that:

[Redacted] shall use their best efforts to obtain and maintain insurance on the life of **[redacted]** with an insurance company licensed to do business in the Commonwealth of Virginia...in the face amount of the lesser of \$3,400,000 or the outstanding principal balance of the Residual Note..."

It appears that the RTC did not obtain the referenced life insurance policy on **[redacted]** during the period from the date of the Agreement in 1992, until the asset was sold by RTC to Trust 1995 S/N 2 (Trust) on September 1, 1995. DRR is also unaware of any attempt by the RTC, between 1992 and its dissolution, to initiate legal action to compel the acquisition of the life insurance policy. It also appears that the RTC did not require the escrow of any premium payments for the life insurance policy pursuant to the settlement agreement. There also did not appear to be any effort to tie the insurance to a "Key Officer" type of policy. Also, it is noted that **[redacted]** was not personally a party to the restructuring and signed only in his capacity as a corporate officer.

The current Servicer for the Trust which owns the asset has recently attempted to obtain the life insurance policy. The response to the Servicer's request, provided by

Attorney **[redacted]** stated, in part:

“...Please be advised that **[redacted]** have made several attempts since 1992 to obtain life insurance coverage on the life of my father, **[redacted]**, as required by the 1992 Loan Restructure Agreement as modified. These attempts have been unsuccessful due to his age and medical history...”

Based upon the historical background of this asset and the additional information obtained to date, it appears that the “best efforts” language of the Agreement has been met. It does not appear that DRR has further recourse or enforcement venue to obtain the referenced life insurance on the life of **[redacted]**.

cc: OICM
Ms. Whited
Mr. Eisenberg
Mr. Hoffman

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 it should implement a recommendation, it must describe why it does not consider the recommendation 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 management's responses on recommendations in our report and the status of management decisions. The OIG based the information for management decisions 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 Associate Director, Internal Review, DRR, agreed with the recommendation and stated that DRR will seek recovery of the questioned costs.	12/31/00	Settlement agreement.	\$84,124	Yes
2	The Associate Director, Internal Review, DRR, disagreed with the recommendation. He stated that the borrowers used their best efforts to obtain the designated life insurance policy but could not do so because of the principal's age and medical history. Although unsuccessful, DRR tried to obtain the policy through the loan servicer for the trust that purchased the loan. Accordingly, DRR met the intent of our recommendation.	07/25/00	Associate Director's response.	\$-0-	Yes