SUN NLF, LIMITED PARTNERSHIP
STERLING PACIFIC ASSETS, ROSEVILLE, CALIFORNIA

Audit Report No. 99-030
July 28, 1999

OFFICE OF AUDITS

OFFICE OF INSPECTOR GENERAL

DATE: July 28, 1999

MEMORANDUM TO: John F. Bovenzi, Director
Division of Resolutions and Receiverships

FROM: Steven A. Switzer
Deputy Inspector General for Audit

SUBJECT: *Sun NLF, Limited Partnership*
Sterling Pacific Assets, Roseville, California
(Audit Report No. 99-030)

The Office of Inspector General (OIG) recently completed an audit of Sun NLF, Limited Partnership. The partnership, created on May 6, 1993, consists of a general partner, Sun Partners, and a limited partner, the Resolution Trust Corporation (RTC).[1] The Division of Resolutions and Receiverships (DRR) contracted with Aldridge, Eastman, and Waltch (AEW) to assist in DRR's oversight responsibilities and to oversee DRR's limited partnership interest in the national land fund transaction. Sterling Pacific Assets (SPA), whose subsidiary owns 5 percent of the general partner, provided financial management services for the partnership, and Sterling Pacific Management Services, Inc. (SPMS), another SPA subsidiary, provided asset management services.

This is the fifth audit of the RTC equity partnership program conducted by the OIG's headquarters audit staff since March 1997. In addition, the OIG's Dallas office staff audited this partnership previously and issued report number 96-089, *Income, Expenses, and Distributions of Two National Land Fund I Partnerships,* on August 15, 1996. That report covered the period of May 1993 through December 1994 and identified unallowable expenses of nearly $1.4 million that Sterling Pacific Assets allocated to Sun NLF. The unallowable expenses noted in the previous audit were resolved as part of a general compromise and settlement agreement and a mutual release agreement signed by the general and limited partners in April 1998.

DRR management contacted the OIG and requested the audit of this partnership because of the questioned costs noted in the previous OIG report. In addition, DRR asked the OIG to review the new cost allocation methodology developed as a result of the litigation settlement.

[1] In accordance with the RTC Completion Act of 1993, the RTC ceased to exist on December 31, 1995. Responsibility for all RTC-related work transferred to the FDIC as of that date.

BACKGROUND

The National Land Fund I initiative was a national program designed by the RTC to dispose of performing, non-performing, and sub-performing mortgage land loans and real estate. The RTC developed this initiative to allow assets to be sold to limited partnerships in which the RTC was the limited partner. Consequently, although the assets were sold, the RTC, and later the FDIC, retained a limited partnership interest in the assets and benefited monetarily from the operations of the partnership.

In April 1993, the RTC selected SunChase Holdings, Inc., as the winning bidder for five of the six pools of assets offered in the National Land Fund I initiative. SunChase Holdings, Inc., then created a joint venture, Sun Partners, to become the general partner of Sun NLF. In managing the partnership, SunChase Holdings, Inc. delegated the day-to-day management to SPA.
The FDIC was a party to two lawsuits arising out of the sale of assets to this partnership. The first of these lawsuits commenced in December 1994 when Sun Partners, as general partner of Sun NLF, caused the partnership to sue the RTC, as seller of the assets, for an amount in excess of $6 million. The general partner alleged breaches of the Contribution Agreement through which assets were contributed to the partnership by the RTC. The FDIC initiated the second litigation in March 1998 against Sun Partners asserting claims related to expenses that Sun Partners charged to the partnership for work performed by SPMS. These expenses were identified in the previous OIG audit report, which included unallowable expenses of nearly $1.4 million that SPA allocated to Sun NLF.

Both lawsuits were settled when the parties signed a compromise and settlement agreement and a mutual release agreement in April 1998. According to the terms of the mutual release agreement, the FDIC had no recourse for questioning or disallowing partnership transactions incurred or occurring prior to September 1, 1997 unless there was criminal action on the part of the partnership or general partner. Given that the OIG had previously performed an audit through the end of 1994, partnership operations for the period January 1, 1995 through August 31, 1997 were unaudited per the terms of the mutual release agreement. During this unaudited period, the partnership reported $14.6 million in expenses and $120 million of income and made distributions to the partners of $72.9 million.

OBJECTIVE, SCOPE, AND METHODOLOGY

We performed an audit of SPA’s compliance with the partnership agreements for the period of September 1, 1997 through December 31, 1998. The objective of our audit was to determine whether SPA properly reported income and expenses and made appropriate distributions.

We interviewed FDIC personnel from DRR’s Asset Management Branch to become familiar with the nature of the transaction. To understand the process and controls for collecting, reporting, and paying expenses, we interviewed personnel at AEW and SPA. Our audit focused on areas we considered to be material to the trust activity or vulnerable to noncompliance.

During the audit period, the partnership reported expenses of $4.4 million and income of $57.8 million and made distributions to the partners of $56.3 million. The expenses of the partnership included the non-accountable allowance (section 5.02 expenses) paid to the general partner to defray its expenses in performing its duties as a general partner. The non-accountable expense payment is calculated based on the value of assets remaining to be managed by the partnership. Sun Partners received over $645,000 in non-accountable expense payments during the 16 months of our audit period. We judgmentally selected 8 months during which the general partner received over $322,000 in non-accountable expense payments.

The expenses of the partnership also included expenses for asset-specific charges (section 5.03 expenses). These expenses totaled over $3.7 million for the period, and we considered $1.6 million of that amount material to the financial statements and vulnerable to noncompliance. This material amount included over $665,000 of expenses related to labor and overhead that was reviewed separately as part of the review of the personnel cost allocation methodology. Of the remaining $915,666 of section 5.03 expenses, we judgmentally selected a sample of 47 items totaling $428,990.

Our review of the partnership's $57.8 million in income was divided into two parts. During the audit period, the partnership received $43.3 million from the sales of 42 assets. We judgmentally selected 11 of these asset sales, totaling $22.6 million in sales revenue, for review. The partnership also reported $14.5 million in other revenue from which we judgmentally selected a sample of $9.1 million.

Finally, the partnership made 17 distributions to the partners during our audit period for total distributions of $56.2 million. We judgmentally selected six of these distributions, totaling $29.1 million, for review.

At the conclusion of our fieldwork, we provided SPA the preliminary finding. We have incorporated, as appropriate, their views in this report.

We did not review the internal control systems for either SPA or SPMS because we concluded that the audit objective could be met more efficiently by conducting substantive tests rather than placing reliance on their respective internal control systems. Accordingly, we do not express an opinion on internal controls. We conducted the audit from November 1998 through April 1999 in accordance with generally accepted government auditing standards.

We also reviewed the new cost allocation methodology to determine if it reasonably allocated costs to the partnership. The results of this review will be reported to DRR program officials under separate cover.

RESULTS OF AUDIT

Generally, SPA complied with the provisions of the partnership documents and properly accounted for partnership funds and distributions. The partnership documents specified that the daily management of the partnership was vested in the general partner who was required to maintain books and records that recorded the financial activity and condition of the partnership. However, during our review of asset-specific expenses (section 5.03 expenses), we noted $17,504 of expenses that should not have been paid from partnership funds. There were no errors noted in our sample of the section 5.02 expense payment calculations. Likewise, there were no errors noted in the samples of sales proceeds, other income, or partnership distributions.

Reversal of Litigation-Related Expenses

The partnership paid $17,504 for litigation-related travel and postage expenses not allowed by the terms of the partnership documents. We selected a sample of $428,990 in expenses paid by SPA for asset-specific charges. Section 5.03 of the partnership agreement defined the types of expenses to be paid from partnership funds. This section was also modified by the compromise and settlement agreement signed in April 1998. Among the expenses not allowed by these agreements were charges related to the litigation between the partnership and the FDIC. In our sample, we identified $185,538 in expenses related to the lawsuits of which the general partner had already reimbursed the partnership $168,034. However, the remaining $17,504 for litigation-related travel and postage had not been reimbursed at the time of our audit. SPA employees stated that these items had been overlooked in their original search for expenses. When our findings were discussed with SPA officials, they stated that corrective action would be taken. In a letter dated March 5, 1999, SPA stated that they made an adjusting entry to the financial statement to account for the $17,504 in litigation-related expenses questioned by the audit, plus an additional $13,001. This additional amount was not included in our sample, but was found through SPA's subsequent review of the accounts. SPA provided documentation to support the $30,505 in lawsuit-related expenses.

Recommendation

We recommend that the Assistant Director, Agreement Management Group, DRR:

(1) Disallow $30,505 for unallowable expenses related to the litigation between the partnership and the FDIC. (Questioned costs of $15,253 represent the Corporation's share of these expenses.)

CORPORATION COMMENTS AND OIG EVALUATION

On July 13, 1999, the Deputy Director, DRR, provided a written response to the draft report. The response is presented in Appendix I to this report.

The Deputy Director stated that she agreed with the disallowance of $30,505 in unallowable litigation expenses. In addition, DRR has requested that SPA provide documentation to confirm that the partnership has been reimbursed. DRR expects resolution of these issues by September 30, 1999.

The Corporation's response to the draft report provided the elements necessary for management decision on the report's recommendation. Therefore, no further response to this report is necessary. Appendix II presents management's proposed action on our recommendation and shows that there is a management decision for the recommendation in this report.

FDIC

Appendix I

Federal Deposit Insurance Corporation
Washington D.C. 20429 Division of Resolutions and Receiverships

DATE: July 13, 1999

MEMORANDUM TO: Steven A. Switzer
Deputy Inspector General for Audit

FROM: Gail Patelunas
Deputy Director
Division of Resolutions and Receiverships

SUBJECT: OIG Draft Report: Entitled *Sun NLF, Limited Partnership Sterling Pacific Assets, Roseville, California (Audit #98-703)*

On June 28, 1999 the Office of the Inspector General (OIG) issued its draft report on the results of an audit of **Sun NLF** (Land Fund I), in which the FDIC is the .sole limited partner. The OIG selected this Trust for review in response to DRR's request for an audit. FDIC-DRR requested this audit to review new cost allocations methodology developed as part of an April 1998 settlement agreement with the general partner arising from questioned costs noted in a 1996 audit

The report concludes that generally Sterling Pacific Assets (SPA), the servicer for the partnership, "complied with the provisions of the partnership documents and properly accounted for partnership funds and distributions." It did recommend, however, that $30,505 in questioned costs for unallowable expenses related to the litigation between the partnership and FDIC be disallowed.

We agree with the finding and recommendation that the $30,505 in unallowable litigation expenses be disallowed. In a March 5, 1999 letter to the OIG, SPA stated that an adjusting entry had been made to the partnership accounts. A request that SPA provide documentation to confirm that the partnership has been reimbursed for these expenses has been issued and is attached. We expect resolution of these issues by September 30, 1999.

cc: Vijay Deshpande
John Bovenzi
Giovanni Recchia
Dean Eisenberg
Joci Spector
Ed Dox, AEW

MANAGEMENT RESPONSES TO RECOMMENDATIONS

The Inspector General Act of 1978, as amended, requires the OIG to report the status of management decisions on its recommendations in its semiannual reports to the Congress. To consider 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 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 and subsequent discussions with management representatives.

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 Corporation agreed with the recommendation. The Corporation agreed to disallow $30,505 in questioned costs for unallowable expenses related to litigation between the partnership and the FDIC. The Corporation's prorated share of the unallowable expenses totaled $15,253.	September 30, 1999	Documentation provided by Sterling Pacific Assets	$15,523 disallowed costs	Yes