U.S. Department of Agriculture

Office of Inspector General
Northeast Region

Audit Report

Rural Business-Cooperative Service
Business and Industry Direct Loan
Lehigh Coal and Navigation Company

Report No. 34004-08-Hy
January 2007

UNITED STATES DEPARTMENT OF AGRICULTURE
OFFICE OF INSPECTOR GENERAL
Northeast Region
Suite 2-2230
5601 Sunnyside Avenue, Stop 5300
Beltsville, Maryland 20705-5300

January 31, 2007

REPLY TO
ATTN OF: 34004-08-Hy

TO: Gary H. Groves
State Director
Rural Development

ATTN: Trudy S. Moore
Assistant to the State Director

FROM: Gil H. Harden /s/
Regional Inspector General
for Audit

SUBJECT: Rural Business-Cooperative Service (RBS) Business and Industry (B&I) Direct Loan to Lehigh Coal and Navigation Company

This memorandum report presents the results of the subject audit. This audit was initiated in response to a hotline complaint regarding the administration of two B&I direct loans totaling $9 million that were approved by RBS on August 31, 2001. The loans were to provide "long-term financing for refinancing, working capital, and paying loan closing fees in association with the operation of a coal mine property." The allegations stated that (1) the borrower had not repaid any of the principal or interest on the $9 million in loans, (2) RBS allowed the sale of collateral pledged as security for the loans, (3) RBS paid the borrower's delinquent taxes, and (4) the mine had not been re-opened and none of the 230 employees had been rehired.

We determined that some principal and interest had been paid and the sale of the collateral and payment of the borrower's delinquent taxes were preformed in accordance with Rural Development's (RD) Instructions.[1] However, as a result of paying off and refinancing pre-existing debt, the remaining loan funds were not sufficient to restart coal production and rehire the laid off employees as stated in the allegations. As of July 14, 2006, the borrower only paid $1,062,887 in principal and interest. The borrower

[1] RD Instruction 4287-B, Loan Servicing (§4287.113) (December 23, 1996) and RD Instruction 1951-E, Servicing and Collections (§1951.227) (August 5, 1998).

was in default for $4,186,285, which included past due principal, interest, and protective advances.[2] Approximately $6 million was still outstanding.

We concluded that RBS State officials properly invoked foreclosure proceedings in a timely manner on May 9, 2005. RBS informed the borrower that to stop the foreclosure process they had to take steps to remedy the default or pay the loan in full. Subsequent to the conclusion of our fieldwork on July 20, 2006, the borrower was able to obtain financing from outside investors. On July 25, 2006, RBS executed a forbearance agreement[3] which ceased foreclosure proceedings and allowed the company to resume operations. On July 28, 2006, the financing agreement was completed, and according to the terms of the forbearance agreement, RBS received payment of $1,410,242 for past due interest on the loans and repayment of protective advances. To ensure the unpaid portion of the two B&I loans is fully secured, RBS should obtain documentation to support the agency's first lien position and sufficient value on all corporate assets used to secure the unpaid portion of the two B&I loans. In addition, RBS should prepare an analysis that supports the borrower's repayment ability with the additional financing provided by the outside investors. The analyses should include such things as, cash flow analysis, equity position, and the latest audited financial statements.

Based on the financial information present in the State office files, the RBS Pennsylvania State Office, at the time of loan making, did not adequately assess the financial condition of the borrower. RBS officials did not ensure creditworthiness and repayment ability or enforce the terms noted in the Letter of Conditions,[4] which led to the purpose of the loans not being met. However, due to the B&I Direct Loan Program no longer being funded, we are not making any recommendations related to the loan making process.

In the agency's response dated January 16, 2007 (see Attachment A), RBS provided documents showing that USDA has first lien position and sufficient collateral to secure the unpaid portion of the two B&I direct loans. Also, the agency prepared an analysis supporting that the borrower has adequate repayment ability with the additional financing provided by outside investors. Because RBS' response contained a number of documents, we did not include them in the report. However, we incorporated applicable portions of the response, along with our position, into the report and accepted RBS' management decision on each of the recommendations.

BACKGROUND:

The B&I Direct Loan Program has not been funded since September 30, 2001. However, existing loans continue to be serviced in accordance with the Code of Federal Regulations (C.F.R.), Title 7, Part 1980, Subpart E, Section 1980.401 through 1980.500, revised January 1, 2001. The B&I Direct Loan Program provided loans to public entities and private parties who could not obtain credit from other sources. However, the program was not intended for marginal or substandard loans. Direct loans

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[2] Protective advances were payments made by RBS for the borrower's past due real estate taxes in order to protect the Federal Government's security on the loans.

[3] RBS agreed to place a hold on the foreclosure proceedings while giving the borrower an opportunity to correct items of default according to a strict timetable**.** RBS did not afford the Office of Inspector General (OIG) an opportunity to review the terms and conditions of the agreements prior to being finalized.

[4] Letter of Conditions is a letter issued by RBS to a borrower setting forth the conditions made in the direct loan.

were made primarily to finance sound business projects that created or retained jobs for businesses located in rural areas with populations less than 50,000. State offices could approve loans up to $5 million and the National office had the authority to approve loans up to $15 million.

The State office had the responsibilities of ensuring compliance with covenants and provisions of the loan documents, obtaining and analyzing financial statements, verifying payments of taxes and insurance premiums, obtaining and maintaining liens on collateral, ensuring sufficient collateral is pledged to secure the entire debt to the Government, and collecting loan payments.

On September 13, 2001, RBS authorized the use of funds for this borrower, and on February 28, 2002, RBS closed on two loans totaling $9 million. The purpose of the loans was to refinance debt, provide working capital, and pay loan closing fees in association with the operation of a coal mine property. The loan repayment was setup with monthly payments of interest only for the first six months and monthly payments of interest and principal thereafter. However, before the initial six month interest only period had expired, the borrower requested and was granted two extensions of interest only payments. Therefore, payments were due to resume on February 28, 2004, but the borrower continued to experience financial problems and was unable to make full payments.

Since 2004, the borrower has been placed in involuntary Chapter 7 Bankruptcy twice by creditors. Both bankruptcies were dismissed after the borrower and creditors negotiated a settlement. In addition, on two occasions, RBS paid protective advances to prevent local property tax authorities from seizing and liquidating the collateral real estate to pay past due property taxes. Also, in December 2004, RBS approved the sale of a truck that had been listed on the collateral list in order for the company to generate enough funds to pay Internal Revenue Service (IRS) judgments.

The company continued to experience equipment failures and labor issues which resulted in loss of production and sales revenue. As a result, the borrower was unable to operate or make full and timely payments to RBS. On September 9, 2004, RBS initiated foreclosure procedures by issuing the initial notice of monetary and non-monetary default to the borrower, and on May 9, 2005, RBS accelerated the payment dates of the loans. RBS was unable to continue with the foreclosure process until the borrower exhausted all appeal options. The borrower appealed the acceleration through the Director, National Appeals Division, who issued a notice on June 7, 2006, stating that a hearing would be rescheduled for August 1, 2006. In the meantime, based on the advice of RBS State officials, the borrower was actively seeking financing from other sources. An agreement was made with a third party for the presale of coal. RBS executed a forbearance agreement on July 25, 2006, to stop foreclosure proceedings. On July 28, 2006, the borrower obtained financing, totaling $12.5 million, from outside investors, and according to the terms of the forbearance agreement, RBS received $1,410,242 for the payment of past due interest and protective advances.

OBJECTIVE:

Our overall objective was to determine the validity of the allegations made in the hotline complaint. Specifically, we determined (1) the amount of principal and interest paid on the loans, (2) if the sale of collateral and the payment of the borrower's delinquent taxes were made in accordance with RD instructions, and (3) if the company had re-opened and rehired 230 miners. We also performed a review of the expenditure of $9 million in loans and evaluated RBS' servicing of the loans in regards to foreclosure procedures.

SCOPE AND METHODOLOGY:

To accomplish the objectives of our audit, we interviewed appropriate RBS State office personnel, examined pertinent documentation, and reviewed applicable policies and procedures. In addition, we reviewed the borrower's case file to determine the validity of the allegations made in the hotline complaint. This work included an assessment of the borrower's financial condition, loan documents, expenditure of funds to determine if the loan proceeds were used as specified, and the loan servicing process from fiscal years (FY) 2001 to 2006.

In order to address the allegation regarding the sale of collateral, we performed a physical inventory and inspection on May 3, 2006. We judgmentally selected collateral with the highest dollar value which totaled 75 percent of the dollars pledged to secure the loan. [5] The fieldwork was performed from March 20, 2006 to July 20, 2006. We performed work at the RBS Pennsylvania State Office in Harrisburg, Pennsylvania, and at the borrower's place of business in Pottsville, Pennsylvania.

RBS did not afford OIG the opportunity to review the terms and conditions of the forbearance and financing agreements prior to finalization. Therefore, we did not review them and did not provide input or an opinion on the terms outlined in these documents.

We conducted the audit in accordance with Government Auditing Standards established by the Comptroller General of the United States.

AUDIT RESULTS:

We determined that RBS officials properly invoked foreclosure proceedings in a timely manner for these loans on May 9, 2005. However, we questioned whether the State office should have made the direct loan because of the borrower's poor financial condition. The RBS Pennsylvania State Office had not adequately assessed the borrower's creditworthiness and ability to repay the loan or enforce the terms noted in the Letter of Conditions which led to the purpose of the loans not being met. As of the end of our fieldwork, July 20, 2006, the borrower was in default to RBS for $4,186,285, that included $2,949,381 in past due principal, $702,145 in past due interest, and $534,759 in unpaid protective advances. Based on past conditions, it is uncertain that the company will be a profitable and viable coal producer without this additional financing.

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[5] The dollar value calculated excluded the value of the land.

Response to Allegations in the Hotline Complaint

Our work disclosed the following regarding the four allegations made in the hotline complaint.

1. The borrower had not repaid any of the principal or interest on the $9 million in loans.

   As of July 14, 2006, the borrower had repaid $1,062,887 in principal and interest. However, the borrower was in default for $4,186,285, which included past due principal, interest, and protective advances.

2. RBS allowed the sale of collateral pledged as security for the loans.

   The sale of the collateral was in accordance with regulations. In December 2004, RBS approved the sale of a truck listed on the collateral listing in order for the borrower to generate enough funds to pay the IRS judgments.

3. RBS paid the borrower's delinquent taxes.

   RBS paid $1,518,218 in delinquent taxes to protect the Federal government's interest. This included $983,459 at loan closing in February 2002, for payroll, school district, income, and property taxes. On two occasions (November 2004 and June 2005) during the servicing of the loans, RBS paid past due property taxes. As of July 2006, principal and interest past due on these protective advances was $534,759.

4. The mine has not re-opened and none of the 230 employees were rehired.

   The borrower was unable to rehire the 230 employees and restart coal production due to the company's financial problems. At the time of our review, the company was only operating with 39 employees.

Borrower's Creditworthiness was Questionable

Inadequate Analysis of Borrower's Financial Condition. We identified problems in the loan making process that question the borrower's creditworthiness and repayment ability. We found that over 70 percent of the $9 million (more than $6.3 million) was disbursed at loan closing to refinance debt, pay past due delinquent taxes and assessments, satisfy prior judgments filed against the company, and pay closing costs, which were not all noted in the Loan Agreement or the Letter of Conditions. However, due to the B&I Direct Loan Program no longer being funded, we are not making any recommendations regarding loan making.

We found the following evidence in the borrower's case file:

- The borrower's loan application listed over $14 million in outstanding debt.
- The borrower was not current on its debts.

- A total of $431,120 was disbursed at loan closing to satisfy 20 outstanding judgments filed against the company for lack of payment.
- A total of $983,459 was disbursed at loan closing for delinquent taxes and assessments from 1998 to 2001.
- A Dun and Bradstreet Report,[6] dated June 21, 2001, indicated that this borrower was an exceptionally high financial risk.
- Numerous violations were issued by the Pennsylvania Department of Environmental Protection (DEP), such as failure to perform necessary reclamation.[7]

We were unable to interview RBS State officials that approved, closed, and disbursed the loan funds because they are no longer with the agency. According to the current RBS State officials, the loan should not have been approved. RBS State officials attributed the questionable actions made during that period to the lack of knowledge and expertise in the direct loan making process. According to regulations,[8] the B&I Direct Loan Program was not intended for marginal or substandard loans.

RD regulations[9] require the State office to certify that it has completed a comprehensive analysis "and there is reasonable assurance of repayment ability based on the borrower's history, projections and equity, and the collateral to be obtained." We analyzed the documentation that the State officials reviewed and its certification of the borrower. The certification did not appear to be based on the existing facts, however, the State office still certified to the borrower's repayment ability.

RBS Did Not Enforce the Letter of Conditions. According to the Letter of Conditions, dated September 13, 2001, the loan funds were to provide long-term financing for refinancing debt ($2,472,420), working capital ($6,487,580), and pay loan closing fees ($40,000) in association with the operation of a coal mine property. We identified the following questionable payments:

Description	Approved Amount per Letter of Conditions	Actual Amount Disbursed at Loan Closing	Questionable Payments
Debt Refinancing	$2,472,420	$4,355,365	$1,882,945
Assessments	$0	$27,900	$27,900
Judgments	$0	$431,120	$431,120
Delinquent Taxes	$0	$955,559	$955,559
Closing Costs	$40,000	$545,639	$505,639
Total	**$2,512,420**	**$6,315,584**	**$3,803,164**

We question whether these disbursements should have been authorized because the borrower did not comply with the requirements outlined in the Letter of Conditions. According to a RBS loan official, these additional disbursements were appropriate

6 Dun and Bradstreet provide credit reports that are used to review the credit history of a borrower.
7 Environmental reclamation work is done by refilling the mine pits in order to restore the land to its original state.
8 Title 7, Section 1980.401 (b) (January 1, 2001).
9 RD Instruction § 4279.161 (16) Filing pre applications and applications (December 23, 1996).

because they fell under the category of working capital, which could include accounts payable, current debt, long-term debt, and current expenses. Based on RD Instruction 1980.402, working capital should be used to provide the company with a cash flow so that the business can fund the cost of its day-to-day operations. We concluded that the use of funds for debt refinancing, assessments, judgments, delinquent taxes, and closing costs did not appear to be consistent with funding day-to-day operations. Further, we did not find any waivers or amendments to the Letter of Conditions issued.

While reviewing the propriety of the sale of collateral, we found that the State office had not filed the lien verification prior to loan closing, as required by the State of Pennsylvania. In December 2004, the borrower requested permission to liquidate certain equipment, and as such a lien search was performed. The search revealed that RBS did not record a Uniform Commercial Code Form 1 (UCC-1) financing statement on the borrower's personal property when the loan was made. Regulations[10] require the State office to ascertain that no claim or liens of supplies of machinery and equipment or other parties are against the collateral of the borrowers that would adversely affect the collateral of the borrower when the security instruments are filed. Without lien verification, the State office was unable to ascertain whether other creditors held a higher lien position. On December 27, 2004, a UCC-1 financing statement was recorded with the Pennsylvania Department of State. As a result, RBS found that the IRS held a priority lien on the borrower's personal property.

Purpose of Loans Not Met

RBS issues loans that are intended to enhance the quality of life for all rural Americans by providing leadership in building competitive businesses and sustainable cooperatives that can prosper in the global marketplace. We found that after disbursements were made at loan closing to pay off and refinance pre-existing debt, only $2,684,416 from the working capital funds was available, which according to RBS officials, was not enough to start coal production and rehire the laid off employees. The borrower had not fulfilled the purpose of the direct loan, based on the following:

- Based on RBS' analysis and discussions with company officials, essential equipment used to mine and process coal had not been operating on a continuous basis since 2000. This was due to unexpected repairs and unusual weather patterns. During our visit to the coal mine property, we found portions of the mine were shut down and not producing coal. Trucks and excavating and processing equipment required to run the mine remained inoperative at the time of our visit.

- Due to financial and operational problems, the borrower compiled an extensive violation history with the Pennsylvania DEP (failure to backfill, failure to submit quarterly yardage figures, and unauthorized mining). Since 2000, the Pennsylvania DEP issued at least 51 notices of violation, several permit suspensions, and fines estimated at $210,000. In April 2006, the Pennsylvania DEP issued a six-month suspension of the borrower's mining permit for failure to comply with reclamation requirements. However, the suspension allowed the

[10] 7 C.F.R., Subpart E, 1980.443 (c) (1) (January 1, 2001).

borrower the option to reinstate its permit earlier if a change was made in the company's top management that was acceptable to the Pennsylvania DEP.

- From 2000 to 2006, the number of employees had decreased from 263 to 39. The loan application showed that 230 employees were to be rehired. According to a RBS and company official, there were no plans to rehire additional employees because the current staffing level was sufficient to efficiently operate the coal mine.

Events Subsequent To Fieldwork

Due to lower than planned coal production, diminished revenues, foreclosure, and the suspension of mining operations, RBS encouraged the borrower to seek other means of financing to become a profitable and viable coal producer. Subsequent to the conclusion of our fieldwork, the borrower obtained additional financing, totaling $12.5 million from outside investors that came together as a special-purpose limited partnership to make a bulk presale purchase of high quality coal silt.[11] According to RBS officials, the new financing will help provide funds to repair vital equipment necessary for the coal mine to become operational. In addition, control of day-to-day mining operations and financial matters were assumed by the partnership. The company also appointed a new president and chief executive officer as required by the Pennsylvania DEP.

The State office sought and obtained the National office's approval to allow the company to enter into this agreement. The National office stipulated that the State office take the necessary steps to ensure the agency had a valid first mortgage on all real estate, machinery, and equipment and that there were no intervening judgments or other liens outstanding. According to the State office, neither the forbearance nor the new financing agreement changed the terms and conditions outlined in the loan agreement with RBS, dated February 28, 2002.

Based on RBS' analysis of the investment plan and the company's financial projections, RBS executed a forbearance agreement on July 25, 2006 to stop foreclosure procedures upon certain conditions, such as (1) payment of past due interest and protective advances, (2) satisfying outstanding payroll withholding taxes with the IRS, (3) establishing an escrow account to ensure future real estate taxes are paid timely, and (4) review and approval of all legal documents associated with the transaction by the regional attorney. To ensure that the unpaid portion of the two B&I loans is fully secured, RBS should obtain documentation to support the agency's first lien position and sufficient value on all corporate assets. In addition, RBS should prepare an analysis that supports the borrower's repayment ability with the additional financing provided by outside investors. The analyses should include such things as, cash flow analysis, equity position, and the latest financial statements.

On July 28, 2006, the financing agreement was completed, and according to the terms of the forbearance agreement, RBS received payment of $1,410,242 for past due interest on the loans and repayment of protective advances. According to RBS officials, the

[11] Coal silt is currently used in steel mills, electric power plants for fuel, municipal water treatment facilities for filtration, and the charcoal briquette industry.

forbearance agreement allows for a significant capital investment, reducing liabilities, and strengthening working capital and equity. Based on the National Office Loan Committee Report, the Pennsylvania State Director concluded that the new financing agreement will permit the borrower to stay in business, eliminates the need for foreclosure costing the government and the tax payers millions of dollars, and is the best of all alternatives to achieve repayment. Because these events took place after the conclusion of our fieldwork, (July 20, 2006), and we were not made privy to the negotiations, we were unable to provide any input or an opinion on the forbearance agreement or on the terms outlined in the financing agreement.

RECOMMENDATIONS:

Recommendation 1: Obtain documentation to support that RBS has a first lien position and sufficient value on all collateral used to secure the unpaid portion of the two B&I direct loans.

Agency Response:

RBS obtained a copy of the First American Title Insurance Policy dated March 2002, indicating that RBS has a first lien on the real estate collateral. In addition, RBS provided a lien search from the Pennsylvania Department of State dated November 16, 2006, stating that RBS has a priority UCC-1 chattel lien on all equipment pledged at the time of the loan. RBS has evaluated the borrower's collateral securing the loans and demonstrated that the borrower has sufficient collateral to secure the outstanding loan balance.

OIG Response:

We accept RBS' management decision.

Recommendation 2: Prepare an analysis that supports that the borrower has adequate repayment ability of the B&I direct loans with the additional financing provided by outside investors. The analyses should include such things as, cash flow analysis, equity position, and the latest audited financial statements.

Agency Response:

RBS provided a five year cash flow projection from 2006 through 2010. The analysis demonstrated that the borrower has adequate repayment ability. RBS also provided a copy of the latest financial statements dated September 30, 2006, which was prepared by the company but not audited.

OIG Response:

The financial statements were not audited as specified in the recommendation, however, based on the actions taken by RBS to address recommendation 1 and this recommendation, we accept RBS' management decision.

Please follow your internal agency procedures for reporting final action to the Office of the Chief Financial Officer. Please note that Departmental Regulation 1720-1 requires final action to be completed within 12 months of management decision.

We appreciate the courtesies and cooperation extended to our staff during this review.

Attachment

USDA Rural Development

United States Department of Agriculture
Rural Development
Pennsylvania State Office
www.rurdev.usda.gov/pa

January 16,2007

Mr. Gil H. Harden
Regional Inspector General for Audit
USDA - Office of Inspector General
Northeast Region
Suite 2-2230
5601 Sunnyside Avenue, Stop 5300
Beltsville, MD 20705-5300

Re: Attn of 34004-08-HY
Lehigh Coal and Navigation Company ("LC&N")
Response to Recommendations contained within the Discussion Draft
Report dated December 5, 2006

Dear Mr. Harden:

This constitutes our response to the recommendations included in your draft report dated December 5, 2006.

Recommendation 1. Obtain documentation to show that RBS has a first lien position and sufficient value on all collateral used to secure the unpaid portion of the two B&I direct loans:

Response:

A. Attached is a copy of the First American Title Insurance Policy dated March 2002 indicating that RBS has a first lien on the real estate collateral.

B. Attached is a lien search from the Pennsylvania Department of State dated November 16, 2006 indicating that RBS has a priority UCC-1 chattel lien.

C. The following is an evaluation of the collateral securing the LC&N loans demonstrating that sufficient collateral value exists to secure the outstanding loan balances.

Collateral:	Valuation:	Lien Position:	Market Value:	Discount:	Liquidation Value:
Real Estate:	Appraisal 9-12-00	1st	$11,000,000	-20%	$8,800,000
M & E:	Book 9-30-06	1st	$28,405,190	-100%	0

Accounts Receivable:	Book 9-30-06	1st	$1,099,386	-20%	$879,509
Total:					$9,679,508
			Loan Balance (as of 9-30-2006)		$8,830,994
			Collateral Surplus		$848,514

Recommendation 2. Prepare an analysis that supports that the borrower has adequate repayment ability of the B&I direct loans with the additional financing provided by outside investors. The analysis should include such things as, cash flow analysis, equity position, and the latest audited financial statement:

Response:

A. Attached is a five year cash flow projection for 2006 through 2010

B. We have not received audited financial statements for the Borrower since the loans were made. The latest financial statements dated September 30, 2006, are company prepared. A copy is attached.

C. The equity position as of September 30, 2006 is as follows:

Item	Valuation	Common size
Current Assets	3,477,024	14%
Long term Assets	20,863,496	86%
Total Assets	24,340,520	100%
Current Liabilities	4,243,618	17%
Long term Liabilities	19,728,284	81%
Total Liabilities	23,971,902	98%
Net worth	368,618	2%

If you have any questions regarding this decision or need additional information, please contact J. Gregory Greco, Rural Business Specialist, at 717-237-2289, fax: (717) 237-2196, or email: gregory.greco@pa.usda.gov.

Sincerely,

GARY H. GROVES
STATE DIRECTOR