



U.S. Department of Agriculture

Office of Inspector General



Rural Business-Cooperative Service

Review of Lender with Business and Industry Guaranteed Loans

Audit Report 34099-8-Te
December 2010



United States Department of Agriculture
Office of Inspector General
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AUDIT
NUMBER: 34099-8-Te

TO: Judith A. Canales
Administrator
Rural Business-Cooperative Service

ATTN: John Purcell
Director
Financial Management Division

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

SUBJECT: Review of Lender with Business and Industry Guaranteed Loans

Summary

At the request of the Rural Business-Cooperative Service (RBS) national office, the Office of Inspector General (OIG) initiated audits to review loans within the Department of Agriculture's (USDA) Business and Industry (B&I) guaranteed loan portfolio of one of its lenders. This letter presents an overview of the five loans reviewed from the lender's portfolio.¹ The review results are based on our extensive fieldwork, which included such work as: interviews with RBS national and State office officials, the lender, bank officials, the borrowers, and the examiners of the Farm Credit Administration;² reviews and analyses of reports and supporting evidence from the Farm Credit Administration; and the issuance of Inspector General subpoenas, which were served to the lender and other third parties directly involved with each of the loans reviewed. Additionally, we issued a Fast Report³ for one of the loans reviewed, due to the potential risks found regarding the American Recovery and Reinvestment Act of 2009 (Recovery Act) funds provided for the B&I loan program.

¹ Audit Reports 34099-7-Te, issued September 2005; 34099-9-Te, issued June 2010; 34099-10-Te, issued December 2009; 34099-11-Te, issued September 2010; and 34099-12-Te, issued December 2009.

² In May 2007, Rural Development contracted with the Farm Credit Administration, through its Office of Examination, to conduct an examination of the subject lender and report on the findings and conclusions. The examination of the subject lender primarily focused on asset quality, portfolio management, capital adequacy, earnings (relative to capital accreditation), and liquidity. It also included a review of management areas, such as planning, internal controls, and information systems, as they related to the lending function.

³ Audit Report 34099-12-Te (1), issued June 2009.

Based on the five loans reviewed, we reported three material findings – lender misrepresentation, negligence in servicing the loans, and potential risks to Recovery Act funds.⁴ Moreover, we concluded that the lender’s misrepresentations should render two of the five Government’s loan note guarantees unenforceable. In addition, the lender’s negligence in servicing the loans needs to be evaluated by the agency to properly determine the consequences of each act.

Specific details about each of our reviews and the findings may be found in the five individual audit reports. A brief description of the findings has been included below.

Lender Misrepresented Information during the Loan Making Process

For two of the five loans reviewed, the lender misrepresented crucial information during the loan making process (see [exhibit A](#)). For example, as described in Audit Report 34099-11-Te, the lender misrepresented the borrower’s financial condition. At loan closing, [REDACTED] of guaranteed loan funds were used to pay a Federal tax lien owed by an affiliate of the borrower.⁵ According to the loan documentation submitted to RBS, these funds were intended to be used as working capital for the borrower. This change in financial condition and use of loan funds was not incorporated into the borrower’s balance sheet. Additionally, the lender did not rework the lender analysis or resubmit any loan documents showing the adjustment to the State office. The lender’s legal counsel could not provide documentation or an explanation as to why the lender did not ensure the borrower’s financial condition and eligibility once it obtained knowledge of the adjustments.⁶ If this adjustment had been made to the balance sheet and loan documentation, the borrower would not have met the minimum 10 percent tangible equity requirement and thus would not have been eligible for a B&I guaranteed loan.

Lender Was Negligent in Servicing the Loan

For three out of the five loans reviewed, the lender was negligent in servicing the loans (see [exhibit A](#)). For example, as described in Audit Reports 34099-9-Te and 34099-11-Te, the lender certified that several items of construction and/or improvements were or will be done. Based on the lender’s representations and responsibility to oversee that these improvements would be met after loan closing, the Rural Development State offices approved the loans and accepted the collateral as appraised at a higher dollar amount. However, when the properties

⁴ As defined in Rural Development’s instructions, misrepresentation is generally any material statement of alleged fact which is untrue, or partly untrue, or which is so stated as to lead to false conclusions. Furthermore, the agency defines negligent servicing as the failure to perform those services which a reasonably prudent lender would perform in servicing its own portfolio of loans that are not guaranteed. The term includes not only the concept of failure to act, but also not acting in a timely manner or acting in a manner contrary to which a reasonably prudent lender would act up to the time of loan maturity or until final loss is paid.

⁵ The borrower stated that the lender had to pay the Internal Revenue Service (IRS) tax lien because the real estate collateral used to secure the USDA B&I guaranteed loan was under this IRS tax lien. Additionally, per the Conditional Commitment, the lender was to obtain first-lien position on all collateral used in securing the loan.

⁶ Per an agreement made with the lender during another audit, all correspondence with the lender and any of its affiliates was to be addressed to their corporate general counsel. OIG did not contact the lender or any of its affiliates directly.

were reappraised and site visits were conducted by the State offices, the proposed construction and/or improvements had not been made, resulting in the loans being under-collateralized by approximately \$544,000 and [REDACTED].

Potential Risks for Recovery Act Funds

For one of the five loans reviewed, we identified two weaknesses in the B&I Guaranteed Loan Program that could put funds provided by the Recovery Act at risk (see [exhibit A](#)).⁷ Prior to the Recovery Act, as part of Audit Report 34099-12-Te, we found that the lender received an RBS loan note guarantee on a \$4 million loan and used leasehold property as the primary collateral for the B&I loan. In this instance, the borrower defaulted on the guaranteed loan, the lessor took possession of the leasehold property, and RBS was left with no collateral to offset its loss, caused by the borrower's default on the guaranteed loan. RBS officials explained that the Recovery Act and the B&I guaranteed loan regulations do not prohibit the agency from accepting leasehold property as collateral; however, they stated that leasehold property should not be accepted as the primary collateral for a loan.

In addition, we found that applicants who are involved in or affiliated with gambling operations can conceal that their revenue is derived from gambling and thus still have an opportunity to be considered eligible for a B&I guaranteed loan. According to B&I regulations,⁸ applicants are ineligible for a guaranteed loan if they derive more than 10 percent of their annual gross income from gambling operations. However, the Recovery Act prohibits borrowers from using any loan funds to facilitate gambling operations.⁹ We discussed this concern with RBS officials, who concurred that the agency should strengthen its internal controls to ensure the requirements of the Recovery Act are met.

Other Concerns

For one of the five loans reviewed, we found that the lender disclosed all required and necessary information to RBS. However, we were concerned by the collateral used to secure the loan and why the loan was approved. In Audit Report 34099-10-Te, we found that a majority of the collateral used to secure the loan was very specialized textile-related equipment. Prior to loan closing, the lender expressed substantial concerns that the present value of the collateral would not be available in a liquidation scenario and requested a 90 percent guarantee. Because the borrower was obtaining the loan to continue its business in an economically depressed area, RBS approved the loan and 90 percent guarantee. In October 2008, the borrower defaulted on the loan. While we had concerns that this loan should have been considered substandard and not

⁷ The Recovery Act provided approximately \$1.6 billion for guaranteed loans to the B&I Guaranteed Loan Program.

⁸ Title 7, *Code of Federal Regulations*, section 4279.114(h), dated January 1, 2003.

⁹ The Recovery Act, section 1604, dated January 6, 2009. This act was signed into law on February 17, 2009.

eligible for a B&I guarantee, the lender did not misrepresent or conceal significant deficiencies in the borrower's financial position and the decreasing value of the borrower's assets. Knowing this information, the State office, with RBS national office's concurrence, approved the loan.

If you have any questions or comments, please call me at (202) 720-6945, or have a member of your staff call Steve Rickrode, Director, Rural Development and Natural Resources Division, at (202) 690-4483.

We appreciate the courtesies and cooperation extended to us by members of your staff during these reviews.

Exhibit A: Summary of Audit Results

AUDIT REPORT	FINDINGS AND REPORTED CONDITIONS		AMOUNT	CATEGORY
34099-7-Te	1, 2	Lender's Misrepresentation Lead to Loan Note Guarantee Being Contested	\$2,502,954	Questioned Costs and Loans, Recovery Recommended
34099-9-Te	2	Negligent Servicing	\$544,000	Questioned Costs and Loans, Recovery Recommended
34099-10-Te	4	No Misrepresentation		No Questioned Costs
34099-11-Te	1, 2	Lender's Misrepresentation Lead to Loan Note Guarantee Being Contested	\$4,019,657 ¹⁰	Questioned Costs and Loans, Recovery Recommended
34099-12-Te	3	No Misrepresentation		No Questioned Costs
TOTAL			\$7,066,611	

Findings and Reported Conditions Legend

- 1) Lender Misrepresented Information during the Loan Making Process
- 2) Lender Negligently Serviced the Loan
- 3) Potential Risks for Recovery Act Funds
- 4) Other Concerns

The above table, Summary of Audit Results, summarizes the Findings and Reported Conditions for each of the five audits performed as well as the monetary results, if applicable.

¹⁰ This amount factors in the [REDACTED] of under-collateralization due to the lender's negligence in servicing the loan. Per Audit Report 34099-11-Te, Recommendation 2, if the agency does not recover the guaranteed amount (\$4,019,567), the agency should determine and recover damages caused by the lender's negligence in servicing this loan. At a minimum, the agency should recover [REDACTED] due to the under-collateralization.