



U.S. Department of Agriculture

Office of Inspector General

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## **Rural Business-Cooperative Service**

### **Review of Lender with Business and Industry Guaranteed Loan in Louisiana**

Audit Report 34099-11-Te  
September 2010

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U.S. Department of Agriculture  
Office of Inspector General  
Washington, D.C. 20250



DATE: September 29, 2010

REPLY TO  
ATTN OF: 34099-11-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 Loan in Louisiana

This report presents the results of the subject audit. Your response to the official draft report, dated March 3, 2010, is included at the end of this report with excerpts and the Office of Inspector General's (OIG) position incorporated into the Findings and Recommendations section of the report.

Based on the response, management decisions have not been reached for any of the recommendations contained in the subject report. The information needed to reach management decision on the report's two recommendations is set forth in the OIG Position section after each recommendation. In accordance with Department Regulation 1720-1, please furnish a reply within 60 days providing the information requested in the OIG Position section. Please note that the regulation requires a management decision to be reached within a maximum of 6 months from report issuance, and final action to be taken within 1 year of each management decision.

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

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# **Review of Lender with Business and Industry Guaranteed Loan in Louisiana**

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## **Executive Summary**

The Rural Business-Cooperative Service (RBS) is an agency within the Department of Agriculture's (USDA) Rural Development mission area. RBS guarantees loans made by private lenders to borrowers in the Nation's rural areas. Loans guaranteed by the Business and Industry (B&I) Guaranteed Loan Program are intended to improve the economic and environmental climate in rural communities by supporting businesses.

In a letter, dated March 6, 2007, the RBS national office asked the Office of Inspector General (OIG) to review the loan portfolio of one of its lenders because of the elevated default rates of its loans. This report presents the results of our review of 1 of 4 loans from the lender's portfolio of 34 loans.<sup>1</sup> The borrower for this loan is a [REDACTED] company based in Louisiana. On June 28, 2000, the borrower obtained a loan note guarantee of 80 percent on a \$5 million loan. Loan funds were approved to construct a new building, purchase equipment, refinance debt, provide working capital, and cover closing costs.

We found that the lender misrepresented<sup>2</sup> the financial condition of the borrower. At loan closing, the borrower's working capital was reallocated to pay [REDACTED] for an affiliate's delinquent Federal taxes. This change in financial condition and use of loan funds was not incorporated into any of the borrower's loan documents and resubmitted to the Louisiana State Rural Development office (State office). If this adjustment had been properly made to the loan documents, the borrower would not have been eligible for a B&I guaranteed loan. Also, the lender did not ensure that almost \$2 million in loan funds was deposited in accounts controlled by the lender. Although the construction funds were to be used to build a new building, the building was never constructed.<sup>3</sup>

Finally, the lender did not ensure that the loan was secured by adequate collateral. The property used as collateral was appraised based on future improvements that were never made, which left the loan under-collateralized by [REDACTED]. After the borrower became delinquent, the agency was required by Federal regulation to repurchase the loan note guarantee from the secondary market holder for \$4,019,657—more than the original \$4 million of the loan note guarantee due to accrued interest and fees. The lender's legal counsel did not willingly provide additional documentation or explanation as to why the lender did not ensure the completion of construction and the financial condition of the borrower. Because of these misrepresentations, RBS should require the lender to repay these funds.

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<sup>1</sup> As of March 31, 2007, the lender had 34 B&I guaranteed loans, valued at approximately \$92.6 million, of which 15 were either in default or liquidation, with a potential loss to the Government of about \$30.9 million. OIG received information concerning the March 31, 2007, portfolio from the Farm Credit Administration.

<sup>2</sup> 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. Rural Development Instruction 1980-E, appendix G, XXI(c), dated February 25, 1987.

<sup>3</sup> Subsequent to loan closing, the original improvements were determined to be unfeasible by the Corps of Engineers. The lender and borrower agreed that the remaining loan funds would be used at other [REDACTED] owned by the borrower. However, the lender did not notify RBS of these changes or obtain the agency's concurrence.

## **Recommendation Summary**

OIG recommends that RBS recover \$4,019,657 paid to repurchase the loan note guarantee, plus accrued interest and other fees due to the lender's misrepresentation and failure to ensure that almost \$2 million in loan funds was deposited in accounts controlled by the lender. Further, OIG recommends that if the agency does not recover the full guaranteed loss, RBS should determine and recover damages caused by the lender's negligent servicing in this case. The lender did not ensure that the loan was secured by adequate collateral. At a minimum, the agency should recover [REDACTED] due to the under-collateralization.

## **Agency Response**

RBS' written response, dated March 3, 2010, stated that the lender in this case is in bankruptcy. RBS filed a proof of claim to recover payments made to the holder after the loan defaulted, based on the lender's inappropriate use of the loan proceeds. Subsequently, RBS obtained an opinion from Office of the General Counsel (OGC)<sup>4</sup> that stated RBS was without a regulatory basis for action against the lender for inappropriate use of loan proceeds. As a result, RBS stated that it was unable to proceed and retracted its proof of claim and is without further recourse.

## **OIG Position**

The basis for the OGC opinion used by RBS does not prevent the agency from proceeding with a different course of legal action, other than its proof of claim, to recover the recommended funds. The actions needed to reach management decision on the report's two recommendations are provided in the OIG Position section after each recommendation.

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<sup>4</sup> We did not include the opinion as an attachment to this report at the request of OGC.

## Background & Objectives

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### Background

RBS operates loan programs intended to assist in the business development of the Nation's rural areas and promote the employment of rural residents. The purpose of the B&I Guaranteed Loan Program is to improve, develop, or finance business, industry, and employment, and improve the economic and environmental climate in rural communities. These loans are not intended for borrowers in substandard financial circumstances.

To accomplish its mission, RBS, through the B&I Guaranteed Loan Program administered by Rural Development State offices, guarantees loans made by private lenders. A lender provides the loan to the borrower, and Rural Development guarantees repayment of a percentage of the loan if the borrower defaults. The guarantee allows the lender to have additional capital available for other loans.

Regulations require lenders to be responsible for loan origination, servicing the loan, and taking servicing actions of a prudent lender.<sup>5</sup> Regulations also state that a guarantee constitutes an obligation supported by the full faith and credit of the United States and is incontestable except for fraud or misrepresentation, of which a lender or holder has actual knowledge at the time it becomes such a lender or holder, or which a lender or holder participates in or condones.<sup>6</sup>

As of March 31, 2007, the lender had 34 B&I guaranteed loans, totaling approximately \$92.6 million, 15 of the 34 loans were either in default or in liquidation, with a potential loss to the Federal Government of approximately \$30.9 million.

### Objective

The objective of our review was to determine if the lender complied with program regulations.

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<sup>5</sup> Title 7, *Code of Federal Regulations* (CFR), section 4279.1(b), dated January 1, 2000.

<sup>6</sup> 7 CFR 4279.72(a), dated January 1, 2000.

## ***Section 1: Inappropriate Actions by Lender***

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### **Finding 1: Lender Misrepresented Key Factors in Securing Guaranteed Loan**

The lender did not ensure loan funds were used for their intended purposes. At loan closing, the lender used loan funds designated as working capital to pay an Internal Revenue Service (IRS) tax lien for an affiliate of the borrower. In addition, the lender did not ensure that construction and equipment funds of almost \$2 million were maintained in a lender-controlled escrow account as required. These actions caused the loan note guarantee to be unenforceable. The \$4,019,657 used to repurchase the loan from the secondary market should be recovered from the lender.

According to Federal regulations, a loan note guarantee constitutes an obligation supported by the full faith and credit of the United States and is incontestable except for fraud or misrepresentation, of which a lender or holder has actual knowledge at the time it becomes such lender or holder, or which a lender or holder participates in or condones.<sup>7</sup>

#### ***Lender Misrepresented Borrower's Financial Condition***

On the date of loan closing, June 28, 2000, the lender used [REDACTED] in guaranteed loan funds to pay a Federal tax lien owed by an affiliate of the borrower.<sup>8</sup> 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. If this adjustment had been properly made to the balance sheet and loan documentation, the borrower would not have been eligible for a B&I guaranteed loan. Furthermore, the lender's legal counsel could not provide additional 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.<sup>9</sup>

According to Federal regulations, the lender is to certify that the borrower has a minimum of 10 percent tangible balance sheet equity on the date of closing and issuance of the loan note guarantee. This allows Rural Development to measure the borrower's financial soundness.<sup>10</sup>

Also, the conditional commitment, dated April 17, 2000, states that prior to the issuance of the loan note guarantee, the lender will provide Rural Development with a balance sheet prepared by an independent certified public accountant (CPA), certifying the borrower has a minimum tangible balance sheet equity position of 10 percent. The certification will include a balance sheet of the borrower as of the date of issuance of the loan note guarantee, determined in accordance with generally accepted accounting principles.

On June 26, 2000, the IRS issued a Federal tax lien of [REDACTED] against an affiliate of the borrower. At loan closing, on June 28, 2000, a disclosure statement was added to the lender's

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<sup>7</sup> 7 CFR 4279.72(a), dated January 1, 2000.

<sup>8</sup> The borrower stated that the lender had to pay the 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.

<sup>9</sup> 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.

<sup>10</sup> 7 CFR 4279.131(d), dated January 1, 2000.

agreement (agreement between lender and borrower), which explained that some conditions differed from the conditional commitment. One of the differences was the tax lien on the borrower's affiliate. The disclosure was part of the loan closing settlement statement. However, in an interview, the CPA stated that his firm did not have knowledge of these differences (including the tax lien) because it was not given a detailed loan closing settlement statement. Therefore, the balance sheet was not revised to reflect the changes.

An official from the State office stated that Rural Development was not aware that the working capital was used to pay the debt of an affiliate and not the borrower.

On the date of loan closing, June 28, 2000, the borrower's CPA prepared a cover letter with an attached balance sheet, dated March 31, 2000. The balance sheet was prepared by the borrower and used by the lender at closing to certify that the borrower met the minimum 10 percent tangible balance sheet equity. The balance sheet showed a [REDACTED] percent tangible balance sheet equity.

Factoring in the depletion of the borrower's working capital to pay an affiliate's tax debt, the borrower would have had only [REDACTED] tangible net equity at loan closing. Therefore, the borrower did not meet the minimum 10 percent tangible balance sheet equity and would not have qualified for the guaranteed loan.

#### ***Lender Misrepresented That Funds Would Be Maintained in Secure Account***

On June 28, 2000, the loan closed and the lender certified that all conditions in the conditional commitment had been met. The conditional commitment specified that \$3.1 million of the loan funds would be designated for construction, machinery, and equipment<sup>11</sup> and required that these funds be placed in a secured account controlled by the lender and borrower. This account would be pledged as collateral for the guaranteed loan, and draws from the account would be made only with the approval of the lender.

However, we found that on June 30, 2000, the closing attorney for the lender wired approximately \$2 million that was designated for machinery and equipment directly to the borrower's operating bank account (the lender had no authority over this account) in Louisiana. On July 3, 2000, the amount was transferred to an escrow/distribution account (in the name of both the lender and borrower), and 2 days later, July 5, 2000, all but \$100,000 of the amount was transferred to the borrower's repurchase account<sup>12</sup> in which the lender had no authority. On July 14, 2000, the borrower agreed to a standard escrow account with the lender, which allowed the borrower to take advantage of the earned interest payments while satisfying the escrow requirement of USDA.

However, we confirmed that the construction and building funds were not moved from the Louisiana bank to the standard escrow account. Therefore, the lender misrepresented that the escrowed funds were placed in a secured account. Additionally, even after realizing this arrangement was not in compliance with the conditional commitment, the lender continued to leave the money in commingled accounts of the borrower, did not obtain control of the loan funds, and failed to inform Rural Development.

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<sup>11</sup> \$1.3 million was allocated for construction, and \$1.8 million was allocated for machinery and equipment.

<sup>12</sup> A repurchase account allows a business to earn interest on excess balances maintained in an operating account.

## Recommendation 1

Recover the \$4,019,657 paid to repurchase the loan note guarantee, plus accrued interest and other fees.

### Agency Response

RBS's written response, dated March 3, 2010, stated that the lender in this case is in bankruptcy. RBS filed a proof of claim to recover payments made to the holder after the loan defaulted, based on the lender's inappropriate use of the loan proceeds. The lender challenged the claim stating that RBS misinterpreted the legal standards for lender liability. Subsequently, RBS obtained an opinion from OGC confirming that RBS was without a regulatory basis, based on the lender's inappropriate use of loan proceeds. As a result, RBS stated that it was unable to proceed and retracted its proof of claim and is without further recourse.

### OIG Position

The basis for the OGC opinion used by RBS does not prevent the agency from proceeding with a different course of legal action, other than its proof of claim, to recover the recommended funds. The proof of claim, based on the inappropriate use of loan proceeds was informally challenged by the lender and later withdrawn by the agency. The withdrawal does not bind or affect recoveries based on misrepresentation and negligence, upon which the \$4,019,657 recommended recovery is based. To reach management decision, RBS needs to pursue all available options it has to recover the \$4,019,657 paid to repurchase the loan note guarantee, plus accrued interest and other fees.

## Finding 2: Lender Was Negligent in Servicing the Loan

The lender did not ensure the loan was properly collateralized. This occurred because the lender did not ensure loan funds were used to construct a new building and other improvements.<sup>13</sup> As a result, the property never reached the projected value, which left the loan under-collateralized by [REDACTED].

When a loan note guarantee is issued, the lender agrees to adequately supervise any construction being performed relating to the value of the collateral securing the loan. According to Federal regulations, it is the responsibility of the lender to comply with all requirements for making, securing, servicing, and collecting the loan. In addition, the guarantee will be unenforceable by the lender to the extent any loss occurs due to the violation of usury laws, negligent servicing,<sup>14</sup> or failure to obtain the required security.<sup>15</sup> Furthermore, the collateral securing a loan note guarantee must be of sufficient value to protect the interest of the lender and the Government.<sup>16</sup>

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<sup>13</sup> Per an agreement made with the lender during Audit Report 34099-7-Te, 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.

<sup>14</sup> Per RD Administrative Notice (AN) No. 4421, which replaces RD AN No. 4347 (4280-B and 4287-B) that expired on March 28, 2008, negligent servicing is defined 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.

<sup>15</sup> 7 CFR 4279.72 (a), dated January 1, 2000.

<sup>16</sup> 7 CFR 4279.131(b), dated January 1, 2000. Note: The total appraised value of the collateral is discounted to 80 percent—the discounted value must equal or exceed the total amount of the loan.

The lender used the borrower's property in Louisiana to secure the \$5 million guaranteed loan. At the time of loan closing, this property appraised for [REDACTED] as it was then-constructed. This was not sufficient collateral to secure the loan. The lender used the appraised value, as improved, of [REDACTED], which included the construction of a new building and other improvements.

In February 2008, State office officials accompanied OIG on a site visit to the borrower's facilities in Louisiana. As part of this visit, these officials learned that the new building had not been constructed. According to the borrower, the original improvements were determined to be unfeasible by the Corps of Engineers. The lender and borrower agreed that the remaining loan funds would be used at other [REDACTED] owned by the borrower. However, the lender did not notify RBS of these changes or obtain the agency's concurrence. As a result, the lender violated the terms of the conditional commitment, which stated that construction would be completed, and failed to verify that the loan was properly collateralized.<sup>17</sup> The loan was under-collateralized by [REDACTED].<sup>18</sup>

## **Recommendation 2**

If the agency does not recover the full guaranteed loss (\$4,019,567), determine and recover damages caused by the lender's negligent servicing of this loan. At a minimum, the agency should recover [REDACTED] due to the under-collateralization.

## **Agency Response**

RBS's written response, dated March 3, 2010, stated that the lender in this case is in bankruptcy. RBS filed a proof of claim to recover payments made to the holder after the loan defaulted, based on the lender's inappropriate use of the loan proceeds. The lender challenged the claim, stating that RBS misinterpreted the legal standards for lender liability. Subsequently, RBS obtained an opinion from OGC confirming that RBS was without a regulatory basis based on the lender's inappropriate use of loan proceeds. As a result, RBS stated it was unable to proceed and retracted its proof of claim and is without further recourse.

## **OIG Position**

The basis for the OGC opinion used by RBS does not prevent the agency from proceeding with a different course of legal action, other than its proof of claim, to recover the recommended funds. The proof of claim, based on the inappropriate use of loan proceeds, was informally challenged by the lender and later withdrawn by the agency. The withdrawal does not bind or affect recoveries based on misrepresentation and negligence, upon which the \$4,019,657 recommended recovery is based. To reach management decision, RBS needs to pursue all available options it has to recover the \$4,019,657 paid to repurchase the loan note guarantee, plus accrued interest and other fees. Moreover, if RBS does not recover the full \$4,019,567, the agency needs to determine and recover damages caused by the lender's

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<sup>17</sup> The lender stated that the borrower's properties in [REDACTED] and [REDACTED] were part of the collateral for the loan. However, these properties were not appraised so we could not conclude what, if any, value these properties added to the collateral securing the guaranteed loan.

<sup>18</sup> This amount is calculated as \$5 million less [REDACTED] (80 percent of the "as-is" appraised value of [REDACTED]).

negligent servicing of this loan. At a minimum, the agency should recover [REDACTED] due to the under-collateralization.

## ***Scope and Methodology***

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This review concentrated on the lender RBS requested that we review and one of its B&I guaranteed loans to a borrower operating in Louisiana. To accomplish the objective, we reviewed regulations, policies, and procedures that provide guidance for the making, servicing, and liquidating of B&I guaranteed loans. We reviewed supporting documentation to verify the accuracy of the lender's applications, certifications, disbursement of funds, and other loan activities. Additionally, we reviewed documentation provided by RBS, and the Safe and Soundness review<sup>19</sup> conducted on the lender by the Farm Credit Administration. Specifically, we reviewed the State office loan files and the lender's files. We interviewed State office personnel, the borrower's CPA, the packager of the loan, clerks of court, IRS employees, Louisiana Department of Revenue employees, Louisiana Department of Labor employees, employees of the borrower's bank, and the borrower. We received and reviewed additional documentation from loan closing attorneys, and we visited the Louisiana site used to collateralize the guaranteed loan.

In February 2008, we conducted a site visit to one of the properties obtained for collateral. In March 2008, we issued subpoenas to obtain more detailed documentation from the lender, the borrower's bank, and the loan packager. Throughout the subpoena process, we corresponded with the lender's general corporate counsel via conference calls and e-mail. Fieldwork was performed from August 2007 to June 2009. As of October 2009, the lender was still undergoing bankruptcy proceedings, which were filed on September 30, 2008.

We conducted this performance review in accordance with generally accepted Government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

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<sup>19</sup>The review primarily focused on the lender's asset quality, portfolio management, capital adequacy, earnings (relative to capital accretion), 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.

## ***Abbreviations***

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AN	Administrative Notice
B&I	Business and Industry
CFR	Code of Federal Regulations
CPA	Certified Public Accountant
IRS	Internal Revenue Service
OGC	Office of the General Counsel
OIG	Office of Inspector General
RBS	Rural Business-Cooperative Service
State Office	Louisiana State Rural Development Office
USDA	Department of Agriculture

## **Exhibit A: Summary of Monetary Results**

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<b>FINDING NUMBER</b>	<b>RECOMMENDATION NUMBER</b>	<b>DESCRIPTION</b>	<b>AMOUNT</b>	<b>CATEGORY</b>
1	1	Lender Misrepresentation	\$4,019,657	Questioned Costs and Loans, Recovery Recommended

\* Total amount will increase due to the accrual of daily interest beginning on the date of the State office's demand letter.

This table describes the summary of monetary results, which are categorized as questioned costs and loans, recovery is recommended.

**USDA'S**

**RURAL BUSINESS-COOPERATIVE SERVICE**

**RESPONSE TO AUDIT REPORT**



United States Department of Agriculture  
Rural Development

March 3, 2010

SUBJECT: Official Audit Draft: Review of Lender with  
Business and Industry Guaranteed Loan in  
Louisiana (34099-011-TE)

TO: Gil Harden  
Assistant Inspector General  
for Audit Office of Inspector General

Attached for your review is Business Program's response dated February 25, 2010, to the Official Draft for the subject audit.

This response is being submitted for inclusion in the Final Report and your consideration to reach management decision on Recommendations 1 and 2 in the audit.

A copy of this response has is also being forwarded to the Office of Chief Financial Officer.

If you have any questions, please contact Arlene Pitter Bell of my staff at 202-692-0083.

/S/

JOHN M. PURCELL  
Director  
Financial Management Division

Attachment

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Web: <http://www.rurdev.usda.gov>

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United States Department of Agriculture  
Rural Development

February 25, 2010

TO: John M. Purcell  
Director  
Financial Management Division

SUBJECT: Review of Lender with Business and Industry Guaranteed Loan  
Program in Louisiana  
Office of Inspector General Audit Report 34099-011-TE

This is in response to the official draft findings and recommendations of the subject Office of Inspector General audit.

**Recommendation No. 1:**

Recover the \$4,019,657 paid to repurchase the loan note guarantee, plus accrued interest and other fees.

**Recommendation No. 2:**

If the agency does not recover the full guaranteed loss (\$4,019,567), determine and recover damages caused by the lender's negligent servicing of this loan. At a minimum, the agency should recover [REDACTED] due to the undercollateralization.

Agency Response

The lender in question is in bankruptcy. The Agency filed a proof of claim to recover payments it made to the holder after the loan defaulted, based on the lenders inappropriate use of the loan proceeds. The lender challenged the claim stating the Agency misinterpreted the legal standards for lender liability. Subsequently, the Agency obtained a legal opinion from the Office of the General Counsel (OGC) that confirmed the Agency was without regulatory basis for demanding reimbursement based on the lenders inappropriate use of loan proceeds. As a result the Agency, unable to proceed, retracted its proof of claim. Based on the legal opinion from the OGC, the Agency is without further recourse to collect on this loss.

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A copy of the referenced OGC opinion is attached. If you have questions or concerns, contact Nannie Hill-Midgett, Director, Oversight Coordination Staff at (202) 690-4100.

/S/

JUDITH A. CANALES  
Administrator  
Business and Cooperative Programs

Attachment