



U.S. Department of Agriculture

Office of Inspector General



## **Rural Business-Cooperative Service**

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

Audit Report 34099-9-Te  
June 2010



United States Department of Agriculture  
Office of Inspector General  
Washington, D.C. 20250



DATE: June 24, 2010

REPLY TO

ATTN OF: 34099-9-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 Maryland

## Summary

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

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 was a petroleum/convenience store retailer, owning multiple retail fuel and convenience stores in [REDACTED] and [REDACTED] Counties in Maryland. The coborrower was the fuel supplier for these locations. On April 16, 2002, the borrower and coborrower obtained a loan of \$3 million with a B&I guarantee of 80 percent. The loan was to be used to purchase land, make renovation improvements, refinance notes payable, provide working capital, and cover closing costs. Also, the loan was intended to improve the borrower's ability to create new jobs, produce additional revenue, manage cash, and increase profitability.

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

We found that the lender did not ensure that the borrower's collateral was sufficient to fully secure the guaranteed loan. At loan closing, four of six properties were appraised based on future improvements, and the lender certified that the improvements were or would be completed within the year. However, the lender did not monitor these proposed improvements and the upgrades were not accomplished, thus causing the loan to be under-collateralized. As a result, the loan was under-collateralized by at least \$544,000. The borrower refused to be interviewed, and the lender's legal counsel did not provide additional documentation or explanation as to why the lender did not ensure that the improvements were completed.

In June 2003, 14 months after loan closing, the borrower defaulted on the loan. Subsequently, the agency was required by Federal regulation to repurchase the loan note guarantee from the secondary market holder for approximately \$2.4 million.

## **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 the various 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. 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>2</sup>

As of March 31, 2007, the lender had 34 B&I guaranteed loans for 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>2</sup> Title 7, *Code of Federal Regulations* (CFR), section 4279.72(a), dated January 1, 2002.

## Scope and Methodology

This review concentrated on the lender that RBS requested we review and one of its B&I guaranteed loans to a borrower operating in Maryland. 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>3</sup> conducted on the lender by the Farm Credit Administration. Specifically, we reviewed the Delaware State Rural Development office's<sup>4</sup> (State office) loan files and the lender's files. We interviewed State office personnel, the borrower's Certified Public Accountant, and we attempted to contact and interview the borrower.

In March 2008, we issued a subpoena to obtain more detailed documentation regarding this loan from the lender. Throughout the subpoena process, we corresponded with the lender's general corporate counsel via conference calls and e-mail. Fieldwork was performed in August 2007 to June 2009. As of October 2009, the lender is 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.

### Finding 1: Lender Was Negligent in Servicing Loan

When the loan closed, it was collateralized by six properties in Maryland that had been appraised at \$3.7 million. These appraisals were based on the borrower making improvements to four of the properties. The improvements were scheduled to be completed before the end of 2002. We found, however, that the borrower did not complete these improvements, and the lender did not inspect the properties to ensure that the improvements were completed.<sup>5</sup> The borrower refused to be interviewed, and the lender's legal counsel did not provide additional documentation or explanation as to why the lender did not ensure that the improvements were completed. As a result, the loan was under-collateralized by at least \$544,000.

According to the appraisals conducted in February and April 2002, the appraised "as-is" value of the six properties was \$2,456,000.<sup>6</sup> However, four of the properties were expected to increase in value after the improvements were completed. Therefore, the lender used the accepted method of valuing the property "as improved" to value four of the six properties when it applied for the guarantee. This increased the value of the six properties to

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<sup>3</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.

<sup>4</sup> The Delaware State office oversees the B&I loans issued in the State of Maryland.

<sup>5</sup> 7 CFR 4279.156(b), dated January 1, 2002, and 7 CFR 4279.30(a)(v), dated January 1, 2002.

<sup>6</sup> This amount (\$2,456,000) was calculated as: the total appraised "as-is" value for the collateral (\$3,070,000) times the 80-percent real estate discount factor.

approximately \$3,692,000.<sup>7</sup> The lender certified, at loan closing, that the upgrades had been or would soon be completed to allow these increased values to be used.

In June 2004, the six properties used as collateral were reappraised, at the authorization of the lender, to determine a more accurate market value. We compared these appraisals with those conducted in February and April 2002, and found that few, if any, improvements for the four properties had been completed and that the appraised market value of the properties had decreased. The lender did not monitor these proposed improvements and the upgrades were not accomplished, thus causing the loan to be under-collateralized. Furthermore, when requested, the lender was unable to explain the lack of improvements or produce any documentation, inclusive of construction plans and the proposed upgrades for the four properties, to OIG. 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. The loan was under-collateralized by at least \$544,000.

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>8</sup> or failure to obtain the required security.<sup>9</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>10</sup>

For example, an appraisal, dated February 18, 2002, was based upon two phases of improvements to one of the retail motor fuel facilities. First, a new canopy would cover the addition of three card-reading, multipurpose dispensers for six fueling positions at new “drive-in” style islands. One new diesel pump was to be added under a new canopy. The second phase was for improvements to the convenience store, which would be remodeled and reimaged by removing the center wall and adding new floors and tile ceilings. These improvements would have increased the appraised value from \$420,000 to \$800,000 for the property, or an increase of \$380,000. However, a subsequent appraisal done on June 7, 2004, revealed that the canopy remained the same, and the appraisal of the convenience store made no mention of renovations being made to the interior. Also, no new pumps were installed.

Although the appraisal method of basing the value of the property “as improved” is an acceptable form of appraisal,<sup>11</sup> the lender failed to ensure that the improvements were made. Regulations state that, in part, the lender is responsible for supervising the construction of

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<sup>7</sup> This amount (\$3,692,000) was calculated as: the total appraised “improved” value for the collateral (\$4,615,000) times the 80-percent real estate discount factor.

<sup>8</sup> Per Rural Development Administrative Notice No. 4421, which replaces Rural Development Administrative Notice 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 in which a reasonably prudent lender would act up to the time of loan maturity or until final loss is paid.

<sup>9</sup> 7 CFR 4279.72(a), dated January 1, 2002.

<sup>10</sup> 7 CFR 4279.131(b), dated January 1, 2002. 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.

<sup>11</sup> 7 CFR 4279.144, dated January 1, 2002.

improvements.<sup>12</sup> Since the lender used the “as improved” appraisal values for four of the six properties, its responsibility was to oversee that the improvements were made as scheduled.

### **Recommendation 1**

Take necessary action to determine and recover damages caused by the lender’s negligent servicing of this loan. At a minimum, the agency should recover \$544,000, 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 the Office of the General Counsel (OGC)<sup>13</sup> 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. Specifically, the lender’s appeal, which was accepted by the agency and OGC, does not bind or affect recoveries based on negligence, upon which the \$544,000 recommended recovery is based. However, RBS’ withdrawal of its proof of claim, coupled with the lender’s bankruptcy, leaves no viable solutions for recovery. Therefore, we accept management decision for this recommendation.

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

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<sup>12</sup> 7 CFR 4279.30(a), dated January 1, 2002.

<sup>13</sup> We did not include the opinion at the request of OGC.

## Exhibit A: Summary of Monetary Results

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FINDING NUMBER	RECOMMENDATION NUMBER	DESCRIPTION	AMOUNT	CATEGORY
1	1	Lender Did Not Maintain Adequately Valued Collateral	\$544,000*	Questioned Costs and Loans, Recovery Recommended

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

**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 Maryland  
(34099-009-TE)

TO: Rod DeSmet  
Acting 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 Recommendation 1 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

1400 Independence Ave, SW • Washington, DC 20250-0700

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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 Maryland  
Office of Inspector General Audit Report 34099-009-TE

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

**Recommendation No. 1:**

Take necessary action to determine and recover damages caused by the lender's negligent servicing of this loan. At a minimum, the agency should recover \$544,000 due to the under-collateralization.

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 lender's 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.

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

1400 Independence Ave, SW • Washington, DC 20250-0700

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