U.S. Department of Agriculture

Office of Inspector General
Southwest Region

Audit Report

Rural Business-Cooperative Service Request Audit of Business and Industry Loan in Arkansas

Audit Report 34099-7-Te
September 2005

UNITED STATES DEPARTMENT OF AGRICULTURE
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September 29, 2005

TO: Roy G. Smith
Director
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FROM: Timothy R. Milliken /s/
Regional Inspector General
for Audit

SUBJECT: Audit Report 34099-7-Te - Request Audit of Business and Industry Loan in Arkansas

This report presents the results of our audit of a Business and Industry guaranteed loan in Arkansas. Your written response to the draft report is included as exhibit E with excerpts and the Office of Inspector General's position incorporated into the relevant sections of the report.

Based on the response, management decisions could not be reached for any of the recommendations. Documentation and/or actions needed to reach management decisions for the recommendations are described in the OIG Position section of the report.

In accordance with Departmental Regulation 1720-1, please furnish a reply within 60 days describing the corrective action taken or planned and the timeframes for implementation for those recommendations for which management decision has not been reached. Please note that the regulation requires a management decision to be reached on all findings and recommendations within a maximum of 6 months from report issuance, and final action to be taken within 1 year of each management decision to preclude being listed in the Department's annual Performance and Accountability Report.

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

Executive Summary

Rural Business-Cooperative Service Request Audit of Business and Industry Loan in Arkansas (Audit Report 34099-7-Te)

Results in Brief

At the request of the Rural Business-Cooperative Service (RBS), we initiated an audit of a Business and Industry (B&I) guaranteed loan made to a local oil and gasoline distributor in the State of Arkansas. The borrower's loan was for $3 million and had an 80-percent B&I guarantee. The RBS Administrator requested our assistance due to irregularities in the lender's loan making and servicing of the B&I guaranteed loans.

The loan was classified as delinquent as of March 2001. The lender had sold the loan note guarantee on the secondary market and refused to purchase it from the holder when the borrower defaulted. RBS was then required by law to purchase the loan note guarantee for $2,388,830 plus $114,124 in accrued interest for a total of $2,502,954. The purchase by RBS does not change, alter, or modify any of the lender's obligations to RBS arising from the loan or guarantee, nor does it waive any of RBS' rights against the lender.[1]

We found that the lender misrepresented information to RBS, did not comply with key provisions of the guaranteed loan, and used loan funds for unauthorized purposes. Specifically, we found that the lender:

- Misrepresented property values after receiving appraisals on the borrower's properties that were well below the amount needed to collateralize the loan. The lender then engaged a second appraiser whose appraisal was based on scheduled upgrades to the properties that would more than satisfy the collateral needed to secure the loan. However, the upgrades never occurred, and neither the lender nor the appraiser made visits to verify the status of the properties. Then, in order to secure the loan note guarantee, the lender certified to the Arkansas Rural Development State Office that the scheduled upgrades had been made when, in fact, they had not.

- Misrepresented that 19 (95 percent) of the 20 properties were operating and upgraded at loan closing as required by the conditional commitment. Documents show that 5 of the properties were not operational at loan closing; therefore, only 15 (75 percent) could have been operational. Also, further documentation strongly indicates that more properties were probably not operational at the time of loan closing. The lender did not visit all the sites to determine whether 95 percent of the properties were operational as required by the conditional commitment; rather, a statement from the borrower to that

[1] Title 7, Code of Federal Regulations (CFR), section 4279.78(b)(4).

effect was accepted. Subsequently, the lender certified to the State office that 95 percent of the properties were operational, when, in fact, they were not.

- Misrepresented that no major changes had occurred in the borrower's loan condition between the time the conditional commitment was signed and loan closing. Six months prior to loan closing, the borrower's motor fuel license was revoked by the State of Missouri. Two months prior to loan closing, the Environmental Protection Agency found 62 underground storage tank violations on 13 storage tanks on 4 of the properties used as loan collateral. Both of these conditions were major changes that would directly affect the borrower's income. Subsequently, the lender certified to the State office that no major changes had occurred in the borrower's loan condition between the time of the conditional commitment and loan closing.

- Used $75,000 of the guaranteed loan funds from an escrow account for unauthorized purposes. The lender paid a debt reduction arbitrator working for the borrower. This fee was not part of the loan note guarantee and was paid without the approval of RBS or the knowledge of the borrower.

Rural Development instructions provide that lenders are responsible for making and servicing the entire loan package and for taking all servicing actions that a prudent lender would perform in servicing its own portfolio of loans that are not guaranteed. The loan note guarantee is unenforceable by the lender to the extent any loss is occasioned by violation of usury laws, use of loan funds for unauthorized purposes, misrepresentation, fraud, or failure to obtain the required security regardless of the time at which the agency acquires knowledge of the foregoing.

A former vice president of the lender who processed this loan would not discuss the actions listed above with the Office of Inspector General. Present employees and the chief executive officer of the lender could not provide insight or documents to refute these misrepresentations.

Recommendations In Brief

We recommend that RBS (1) take action to contest the guaranty; (2) take necessary actions to recover the amount paid to repurchase the loan note guarantee, plus accrued interest; (3) debar the lender and its subsidiaries from the B&I Guaranteed Loan Program; and (4) recover the $75,000 from the lender.

Agency Response

In a letter dated September 26, 2005, RBS concurred with the findings and recommendations. The State office is preparing a demand letter to be presented to the lender for repayment of the principal and interest to the date of repayment. The loan note guarantee will be cancelled upon receipt of the repayment. If repayment is not made in full, RBS will initiate debarment proceedings against the lender, and initiate proceedings to recover the $75,000.

OIG Position

We agree with the planned course of action for Recommendations 1, 2, and 4. To reach management decision, we will need documentation showing the receipt of the repayment of funds and accrued interest. If the lender does not make full repayment, we will need a copy of the documentation sent to the lender to recover the $75,000. For Recommendation 3, the State office should consult with the RBS National Office to determine the lender's overall history before dismissing debarment.

Abbreviations Used in This Report

B&I	Business and Industry
CEO	Chief Executive Officer
CFR	Code of Federal Regulations
EPA	Environmental Protection Agency
OIG	Office of Inspector General
RBS	Rural Business-Cooperative Service
USDA	U.S. Department of Agriculture
UST	Underground Storage Tank

Table of Contents

Background and Objectives

Background

The Rural Business-Cooperative Service (RBS), an agency within the U.S. Department of Agriculture's (USDA) Rural Development mission area, operates loan programs that are intended to assist in the business development of the nation's rural areas and the employment of rural residents. The purpose of the Business and Industry (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. This purpose is achieved by bolstering the existing private credit structure through the guarantee of quality loans, which will provide lasting community benefits. It is not intended that the guarantee authority will be used for marginal or substandard loans or for relief of lenders having such loans.

To achieve the mission, the agency guarantees loans made by private lenders. A lender would provide the loan to the borrower, and Rural Development would guarantee repayment of a percentage of the loan in the event the borrower defaulted. The guarantee would allow the lender to have additional capital available for other loans.

Rural Development guarantees a maximum of 80 percent of loans $5 million or less, 70 percent of loans between $5 million and $10 million, and 60 percent of loans exceeding $10 million. Loan guarantees exceeding maximum percentages require concurrence of the RBS Administrator.

Once approved for a guaranteed loan, the lender and borrower enter into and sign a conditional commitment with Rural Development. The conditional commitment outlines the terms and conditions of the guaranteed loan and contains those provisions that the lender and borrower agree to perform.

The lender then submits a lender's certification, which certifies that the provisions contained in the conditional commitment have been or will be met. It also certifies that no major changes have been made in the loan's conditions and requirements, and that any construction has been or will be completed in accordance with plans and specifications.

Once the lender's certification is obtained, Rural Development issues the loan agreement, signed by the lender and the borrower, which mirrors the conditional commitment and contains the loan conditions and requirements. When the lender and borrower notify Rural Development that they have completed the requirements of the conditional commitment, Rural Development will issue the loan note guarantee. Only when Rural Development issues the loan note guarantee does the lender actually have the Government-backed guarantee.

The borrower was a wholesale distributor of motor fuels to 59 stores located in Northeast Arkansas and Southeast Missouri. Twenty of the stores were company owned but were leased by others, and the remaining 39 were independently owned stores.

On June 19, 2000, RBS provided an 80-percent B&I guarantee to the lender on a $3 million loan to the borrower. RBS' 80-percent guarantee was $2.4 million. The lender's settlement statement shows loan funds were actually paid for the following:

Debt Restructure and Payoffs	$1,698,150
Real Estate Improvements	150,000
Equipment	200,000
Closing Costs/Fees	144,500
Working Capital	807,350
Total	$3,000,000

The borrower stopped making payments on the guaranteed loan in January 2001. The borrower would not return the Office of Inspector General (OIG) staff's telephone calls or requests for an interview or to have business records reviewed.

The lender sold the guarantee on the secondary market and refused to repurchase the guarantee. After the lender's refusal, RBS was then required by statutes to repurchase the guarantee. The lender has filed a liquidation plan but has not liquidated any assets.

Objectives

Our objectives were to determine whether (1) the lender properly approved, serviced, and closed the loan to include monitoring collateral and submitting required documents to RBS, and (2) there is a correlation between the borrower's default, the loss to the Government, and the quality of lender loan making and servicing.

The lender did not comply with key provisions of the guaranteed loan documents. In addition, we found that the lender misrepresented to the Arkansas Rural Development State Office that key provisions of the loan agreements had been met. This occurred because the lender did not disclose all appraisals conducted prior to loan closing and did not enforce required provisions of the loan guarantee. Because of the lender's misrepresentation, the State office issued an 80-percent B&I loan note guarantee on a $3 million loan. The 80-percent guarantee amounted to $2.4 million.

Rural Development regulations[2] state that lenders have the primary responsibility for the B&I Guaranteed Loan Program. All lenders obtaining or requesting a B&I loan guarantee are responsible for:

- Processing applications for guaranteed loans;
- Developing and maintaining adequately documented loan files;
- Recommending only loan proposals that are eligible and financially feasible;
- Obtaining valid evidence of debt and collateral in accordance with sound lending practices;
- Supervising construction;
- Distributing loan funds;
- Servicing guaranteed loans in a prudent manner, including liquidation, if necessary;
- Following agency regulations; and
- Obtaining agency approval or concurrence, as required.

The guarantee constitutes an obligation supported by the full faith and credit of the United States and is incontestable except for fraud or misrepresentation. The amount of the loan note guarantee may be reduced up to the amount of damages suffered by the Government for lender negligence.

Rural Development instructions[3] provide that lenders are responsible for making and servicing the entire loan package and for taking all servicing actions that a prudent lender would perform in servicing its own portfolio of loans that are not guaranteed. The loan note guarantee is unenforceable by the lender to the extent any loss is occasioned by violation of usury laws, use of loan funds for unauthorized purposes, misrepresentation, fraud, or failure to obtain the required security regardless of the time at which the agency acquires knowledge of the foregoing.

[2] 7 CFR 4279.30(a)(1), dated January 1, 1999.
[3] 7 CFR 4287.107, dated January 1, 1999.

We found that the lender did not comply with key provisions of the guaranteed loan documents. Specifically we found that the lender:

- Misrepresented property values by concealing an appraisal.
- Misrepresented that 95 percent of properties were operating and upgraded.
- Misrepresented that no major changes had occurred in the borrower's loan condition.

Finding 1 Lender Misrepresented Property Values by Concealing Appraisal

Our review found the lender did not obtain valid evidence of collateral in accordance with sound lending practices as required by Rural Development regulations.[4] Prior to loan closing, the lender obtained two appraisals approximately 9 months apart. The two appraisals had a difference in appraised value of $2.8 million. The first appraisal for $1.5 million was not disclosed to the State office until December 2004, almost 4 years after the loan note guarantee was issued. As a result of the lender misrepresenting the fair market value of the borrower's 20 properties to the Arkansas Rural Development State Office, by concealing the first appraisal conducted in March 1999, the State office issued an 80-percent guarantee on a $3 million loan.

During our review of loan records, we discovered that three appraisals had been conducted between March 1999 and June 2002, as follows:

• March 1999	$1.5 Million	Appraiser A
• December 1999	$4.3 Million	Appraiser B
• June 2002	$1.1 Million	Appraiser C

The first appraisal (appraisal 1) had an effective date of March 22, 1999, and gave a fair market value of $1.5 million for the 20 properties. However, in order to collateralize the loan, the borrower's 20 properties needed to have a combined discounted appraised value of at least $3 million. The lender then contracted with appraiser B and submitted individual appraisals to the State office, dated December 15, 1999, on the 20 properties that totaled $4.3 million. This was enough to collateralize the $3 million B&I guaranteed loan.

Appraisal 1 stated that it was a limited appraisal. The client requested the scope of the appraisal report not to be limited to include only the estimated fair market value of the subject properties as of the date of the inspection, but also to include the estimated book asset value, on the assumption that the

[4] 7 CFR 4279.30(a)(1)(iv) and section 4270.144, dated January 1, 2000.

Environmental Protection Agency's (EPA) required upgrades have been met and installed, and that each subject property is operating at its optimum, and has established management policies and/or procedures in the following areas:

- Written management/policy procedures
- Written rental/lease agreements
- Quality maintenance and repair policies
- Proper record keeping and controlled inventories

Appraisal 1 stated that the above four management areas were not in place as of the date of inspection. In addition, appraisal 1 certified the value estimates are based on the assumption that all subject properties are not affected by unapparent conditions (i.e., conditions of the properties, their subsoil, or structures) which would render the subject properties more or less valuable than other wise comparable properties.

Appraiser A wrote the borrower on March 8, 1999, requesting more documentation. Appraiser A stated in the letter that it is paramount for the borrower to understand the necessity to provide reliable documentation that can be used to support a credible opinion of value needed to meet the terms with lender and USDA requirements. The appraiser further wrote there is nothing in the documentation that substantiates or will support the figures represented in the material given to them so far, except the bid/cost sheets projecting the cost of EPA upgrades required at each property. Appraiser A stated the borrower was aware that the value of the properties had been severely negatively impacted in having been closed under the authority of the EPA. The borrower wrote that, due to a fire at his company office in 1997, his records were destroyed and he could not provide the records to appraiser A.

Table 1 below shows the appraised value of each of the 20 properties as certified in appraisal 1:

Address	City / State	Fair Market Value
201-215 East 9th HWY 49 North	Rector, Arkansas	$232,905
HWY 49 & Maple	Marmaduke, Arkansas	$60,514
HWY 49 & Clay St.	Greenway, Arkansas	$26,303
State Line 412 & 139	Paragould, Arkansas	$19,476
HWY 49	Hickory Ridge, Arkansas	$39,776
366 South Division	Blytheville, Arkansas	$58,804
500 St. Francis	Kennett, Missouri	$95,867
2081 Kennett Street	Kennett, Missouri	$93,058
Rt. A & Broadway	Wardell, Missouri	$43,589
Main Street	Bragg City, Missouri	$3,333
HWY 139 & 49	Holly Island, Arkansas	$27,899
HWY 77	Leachville, Arkansas	$37,105
HWY 62	McDougal, Arkansas	$22,258
Exit I-55	New Madrid, Missouri	$406,785
Exit I-57	Bertrand, Missouri	$262,974
Exit 53 North	Holcomb, Missouri	$44,447
614 North Douglas	Malden, Missouri	$46,774
Air Base Rd. & Dorris	Gosnell, Arkansas	$51,818
307 East Washington	Hayti, Missouri	$34,945
Texas & Lindsay	Hoxie, Arkansas	$60,662
Total		$1,669,292

Table 1

Even though the 20 individual appraised values total $1.6 million, appraiser A certified that the properties had a combined fair market value of $1.5 million.

After obtaining appraisal 1, the lender knew these appraisals were not enough to collateralize the loan. The lender wrote the borrower on October 6, 1999, that the existing appraisal of $1.5 million did not meet the requirement of the conditional commitment. The lender went on to write that he had a conversation with another appraiser who did not agree with the original appraisal and was willing to perform another appraisal. The new appraiser said that he felt the properties were worth approximately $3 million. The lender engaged this appraiser to conduct the second appraisal. The effective date of the second appraisal was December 15, 1999. Once again, an individual appraisal was conducted on each of the 20 properties. However, this time the combined appraisal for each of the 20 properties totaled approximately $4.3 million.

Appraiser B did not give a fair market value for each of the properties; instead, he provided a "range of market value,"[5] based on the assumption that each property had been improved to meet EPA guidelines regarding site fuel storage.

In a sworn statement to OIG staff, appraiser B stated that the property values were based on the assumption that the proposed upgrades would be

[5] The appraiser's report to the lender stated that replacement cost, sales comparison, and income capitalization approaches were used to arrive at the range of market value of the subject properties.

completed, but he never verified that the upgrades had been completed. While under oath, the appraiser stated that it was assumed the lender was monitoring the upgrades and that the lender would ensure the upgrades were completed prior to loan closing.

Table 2 shows the appraised value of each of the 20 properties as certified in appraisal 2:

Address	City/State	Range of Market Value
201-215 East 9th Hwy 49 North	Rector, Arkansas	$408,000
Hwy 49 & Maple	Marmaduke, Arkansas	$116,000
Hwy 49 & Clay St.	Greenway, Arkansas	$76,000
State Line 412 & 139	Paragould, Arkansas	$74,000
Hwy 49	Hickory Ridge, Arkansas	$151,000
366 South Division	Blytheville, Arkansas	$88,000
500 St. Francis	Kennett, Missouri	$250,000
2081 Kennett Street	Kennett, Missouri	$340,000
Rt. A & Broadway	Wardell, Missouri	$163,000
Main Street	Bragg City, Missouri	$83,000
Hwy 139 & 49	Holly Island, Arkansas	$119,000
Hwy 77	Leachville, Arkansas	$100,000
Hwy 62	McDougal, Arkansas	$93,000
Exit I-55	New Madrid, Missouri	$687,000
Exit I-575	Bertrand, Missouri	$760,000
Exit 53 North	Holcomb, Missouri	$180,000
614 North Douglas	Malden, Missouri	$81,000
Air Base Rd. & Dorris	Gosnell, Arkansas	$375,000
307 East Washington	Hayti, Missouri	$133,000
Texas & Lindsay	Hoxie, Arkansas	$93,000
Total		$4,370,000

Table 2

Appraiser B certified that six properties had been upgraded to meet EPA guidelines for petroleum storage tanks and that a list of recent improvements was included in the addendum section of the appraisal reports. OIG's review of the appraisals showed that each individual appraisal's addendum had either a bid proposal or a handwritten list for proposed upgrades at the following six properties:

- Holly Island, Arkansas
- New Madrid, Missouri
- Paragould, Arkansas
- Gosnell, Arkansas
- Bertrand, Missouri
- Rector, Arkansas

Appraiser B stated that he felt his appraisals for a total value of $4.3 million were conservative, if all environmental upgrades were completed. The appraiser stated that he was provided proposals for the work to be done at each site and stated that during his visits to the 20 properties, work was being done

to install canopies on 1 or 2 of the properties. Appraiser B stated that he had seen a Phase I Environmental Site Assessment for each of the properties, and that the report was very small and did not contain any environmental concerns (subsoil contamination, monitoring, testing, etc.) of any kind at any of the 20 properties. Appraiser B was unable to locate any of his files for the year 1999 and recalled the information from memory.

Appraiser B stated that after his appraisals were completed, the EPA conducted inspections at some of the properties, which resulted in over 60 separate violations and penalties of over $300,000. (See appendix C for the EPA's summary of counts.) It should be noted that the EPA inspections were conducted April 25 and 26, 2000, approximately 4 months after the completion of appraisal 2 and 2 months before loan closing.

Appraiser B said that most lenders (banks) would advance loan proceeds as various stages of upgrades/construction were completed. He assumed the lender was monitoring the construction to ensure it was being completed. For his work on similar commercial projects, appraiser B said that lenders would contact him to visit those sites to ensure they were operational and the upgrades completed. He would then certify his observations to the lenders. He indicated he usually took photos and sent them along with his written report. Appraiser B said the lender never contacted him to confirm that 95 percent of the properties were open for business and that the environmental upgrades had been completed.

Appraiser B said that the lender did not monitor the progress of the upgrades and that the lender's actions were not the same as he had seen from other lenders.

When appraiser B was asked how, if the upgrades were not completed, that would affect his valuation of the real estate, he stated it would have a dramatic affect on the property's value. He stated that he would take the market value of the real estate and then deduct the cost of any cleanup or other costs to return the land to a clean marketable state or to meet EPA guidelines. Appraiser B stated that if the 20 properties did not have the completed upgrades, their value should be reduced to between $1.5 million and $1 million, or less. He indicated that would be a liberal estimate.

The third set of appraisals (appraisal 3) performed by appraiser C was dated June 28, 2002. Again, the set of appraisals consisted of individual appraisals on the 20 properties. The purpose of the appraisals was to estimate the market value of the fee simple estate.[6] The appraisals did not take into consideration any environmental issues involving the properties. The lender intended to use appraisal 3 for liquidating the 20 properties.

[6] Fee Simple Estate – Absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat.

Table 3 below shows the appraised value of each of the 20 properties as certified in appraisal 3:

Address	City / State	Fair Market Value
201-215 East 9th Hwy 49 North	Rector, Arkansas	$200,000
Hwy 49 & Maple	Marmaduke, Arkansas	$51,000
Hwy 49 & Clay St	Greenway, Arkansas	$6,000
State Line 412 & 139	Paragould, Arkansas	$17,000
Hwy 49	Hickory Ridge, Arkansas	$18,000
366 South Division	Blytheville, Arkansas	$60,000
500 St. Francis	Kennett, Missouri	$83,000
2081 Kennett Street	Kennett, Missouri	$70,000
Rt. A & Broadway	Wardell, Missouri	$13,000
Main Street	Bragg City, Missouri	$3,600
Hwy 139 & 49	Holly Island, Arkansas	$13,000
Hwy 77	Leachville, Arkansas	$25,000
Hwy 62	McDougal, Arkansas	$8,000
Exit I-55	New Madrid, Missouri	$145,000
Exit I-575	Bertrand, Missouri	$125,000
Exit 53 North	Holcomb, Missouri	$40,000
614 North Douglas	Malden, Missouri	$103,000
Air Base Rd & Dorris	Gosnell, Arkansas	$100,000
307 East Washington	Hayti, Missouri	$32,000
Texas & Lindsay	Hoxie, Arkansas	$57,000
Total		$1,169,600

Table 3

The June 2002 appraised fair market values agree more with the first appraisal completed in March 1999 than with the set of appraisals the lender presented to the State office. Neither of the appraisals, March 1999 nor June 2002, has enough value to collateralize the 80-percent B&I guaranteed loan.

The borrower signed and dated his B&I loan application on March 9, 1999. Appraisal 1, which valued the 20 properties at $1.5 million, was dated March 22, 1999. The borrower and lender had this first set of appraisals in hand 1 year before the loan closed on June 19, 2000. The borrower and lender knew from appraisal 1 that the properties did not have sufficient value to collateralize the loan.

The first appraisal was found in the lender's loan files during an annual review conducted by the Farm Credit Agency in 2002. In 2002, the Farm Credit Agency discussed this appraisal with the State office. State officials said they were not aware of the $1.5 million appraisal but would try to obtain a copy from the lender. The lender did not release the first appraisal for $1.5 million to the State office until December 2004, approximately 4 years after the loan was closed and the loan note guarantee was issued.

We concluded that the lender misrepresented the value of the 20 properties to the State office by concealing the March 1999 appraisal. State officials said they would not have guaranteed the loan if the March 1999 appraisal had been made available prior to issuing the loan note guarantee.

Finding 2 Lender Misrepresented That 95 Percent of Properties Were Upgraded and Operating

The lender misrepresented to the State office that 95 percent of the borrower's properties were upgraded and operating when, in fact, at most, only 75 percent were upgraded and operating before the loan was closed on June 19, 2000. This occurred because the lender neither personally verified that the upgrades were completed nor obtained verification from a third party.

Rural Development regulations[7] require that the lender must certify that all other requirements of the conditional commitment have been met prior to issuing the loan note guarantee.

The conditional commitment was signed and dated by the State office on October 27, 1999, and by the lender on October 30, 1999. The conditional commitment states that the lender will certify that 95 percent of the borrower's locations have been updated and are in operation before the loan is closed.

The borrower gave the lender a signed affidavit certifying that 95 percent of its properties were upgraded and operating on June 19, 2000. Without the lender conducting its own independent verification, it used this affidavit in order to certify to the State office that at least 95 percent of the stations owned by the borrower were open and operating on June 19, 2000.

OIG reviewed a copy of the lender's policy manual effective September 30, 2003. Even though the loan was closed in June 2000, the lender's chief executive officer (CEO) stated that these policies were in effect in June 2000 and applied to the loan. The section in the policy manual pertaining to site visits indicates a site visit to the borrower's place of business and the location of the primary collateral should be made prior to loan closing. An employee of the lender should perform the site visit. The site visit should include the following:

- Primary real estate collateral should be inspected with pictures taken with emphasis on condition of the property, location, and suitability for the intended purposes.

[7] 7 CFR 4279.181(j), dated January 1, 2000.

- Machinery, equipment, furniture, and fixtures taken as collateral should be inspected and verified.

- Personal contact with principal(s) of borrower and any key personnel to evaluate the borrower's management and overall operation of the business.

- The level of inventory, if applicable, and the level of activity should be observed and noted.

The lender did not follow its own policy manual when closing this loan and providing its lender's certification to the State office.

The borrower and lender were requested by OIG to provide some type of documentation (i.e., leases, rental agreements, etc.) to confirm that 95 percent of the properties were, in fact, updated and in operation when the loan was closed on June 19, 2000. Neither the lender nor the borrower has supplied documentation to certify that at least 95 percent of the properties were upgraded and operating prior to loan closing. The borrower has failed to return any telephone calls.

In February 2005, photographs of some of the 20 properties were shown to the CEO and two vice presidents. The CEO was not aware if anyone had actually visited these properties prior to making the loan. At the time of the review, one of the vice presidents had only been employed by the lender for 3 months and the other for 6 months. Neither of the vice presidents nor the CEO had any knowledge of the lender's actually making the loan. The vice president who had processed and closed the loan no longer works for the lender. OIG attempted to interview the vice president who processed the loan; however, the former vice president's attorney would not allow his client to attend the interview.

In fact, the lender knew that 95 percent (19 of 20) of the properties had not been upgraded and were not operating at loan closing. The lender's certified settlement sheet of loan proceeds lists that $158,000 was set aside in a real estate improvement and equipment escrow account. OIG concluded that if all equipment had been purchased, upgrades completed, and 95 percent of the properties were operating at loan closing, there would be no need for an escrow account to purchase equipment and upgrade real estate.

Our review of appraisal 3, dated June 28, 2002, found that at least 5 of the 20 were not open prior to loan closing. Therefore, only 75 percent of the properties were operating, not the required 95 percent. To date, the lender has not provided any reasonable form of verification of its certification to the State office that 95 percent of the properties were operating, much less upgraded.

Presented below are pictures of these five properties taken by OIG together with information contained in appraisal 3.

1. 606 East Broad Street, Wardell, Missouri. Appraisal 3, dated June 28, 2002, indicated the property had been improved with a service station. However, the improvements are now in a dilapidated condition because of tornado damage that reportedly occurred on May 24, 2000, almost a month prior to loan closing on June 19, 2000. There are currently no improvements that contribute value to the site.

View of vacant lot in Wardell, Missouri, February 23, 2005

2. 500 St. Francis Street, Kennett, Missouri. The City of Kennett posted the property as being unfit for human occupancy or use on June 12, 2000, 7 days prior to loan closing. Appraisal 3 reads that the improvements are in disrepair and are considered to be of no contributory value.

Frontal view of property located at 500 St. Francis Street, Kennett, Missouri, February 21, 2005

3. Highway 62, McDougal, Arkansas. Appraisal 3 reads that this facility has apparently not been in use for some time and is in poor condition. Neither the lender nor borrower has provided documentation that this site was leased/rented and operating at loan closing.

Frontal view of property on U.S. Hwy. 62, McDougal, Arkansas, February 21, 2005

4. 309 South Highway 49, Greenway, Arkansas. Appraisal 3 indicated that this property has apparently not been used for some time and is in poor condition. Neither the lender nor the borrower has provided documentation that this site was leased/rented and operating at loan closing on June 19, 2000.

Frontal view of property located at Hwy. 49 and Clay Street, Greenway, Arkansas, February 21, 2005

5. Main Street and Frisco Street, Bragg City, Missouri. Appraisal 3 noted that the improvements are in disrepair and are considered to be of no contributory value. Neither the lender nor the borrower has provided documentation that this site was leased/rented and operating at loan closing on June 19, 2000.

Frontal view of property located at Main Street and Frisco Street, Bragg City, Missouri, February 16, 2005

State officials were unaware that the properties had not been upgraded or improved prior to loan closing. Furthermore, State officials were not required to verify that the information the lender certified was correct. (See exhibit B for additional pictures of the borrower's properties.)

The borrower and lender knew that all properties suffered from functional obsolescence, such as inadequate restroom facilities. External factors included: competition among other oil and gas stations that were newer, larger, and offered a variety of customer conveniences; locality factors; and the fact that eight of the subject properties were closed, with one being used as a car wash. Appraisal 1 indicated that some properties appeared to have been closed for a considerable period. As of the date of the first appraisal, all properties were either closed or restricted in the sale of fuel under the authority of the EPA, which mandated that required environmental standards be in place on or before December 31, 1998.

Appraisal 1, dated May 10, 1999, listed the following properties as closed. The appraiser took the information from the borrower's depreciation records.

- Paragould, Arkansas
- Holly Island, Arkansas
- Greenway, Arkansas
- Bragg City, Missouri
- Hayti, Missouri
- McDougal, Arkansas
- Leachville, Arkansas
- Kennett, Missouri (assessor records)

Our review of the lender's appraisals and loan files concluded that the lender knew it misrepresented the number of properties upgraded and operational in its lender's certification to the State office. The lender accepted the borrower's signed affidavit as the only verification that 95 percent of the properties had been upgraded and were operational. The lender did not (1) confirm the facts by actually visiting the 20 properties, (2) get the appraiser of record in December 1999 to provide confirmation, or (3) obtain the corroboration from some other impartial third party. As a result of the lender's misrepresentation, the State office issued a loan note guarantee of 80 percent on its $3 million loan.

Finding 3 Lender Misrepresented That No Hazardous Environmental Conditions Existed

The lender did not comply with key provisions of the guaranteed loan documents. This occurred because the lender misrepresented to the State office that no hazardous environmental conditions existed at the borrower's 20 properties used as collateral for the loan.

In a letter dated June 21, 2000, the lender certified to the State office that all requirements of the conditional commitment had been met, and there had been no material change in the borrower's financial condition or any other area of the borrower's operation during the period of time from issuance of the conditional commitment to issuance of the loan note guarantee. The letter further certified that the lender must address all adverse changes of the borrower, including parent companies, affiliates, or subsidiaries of the borrower, and guarantors.

During our review of the loan records, we found two material adverse changes that occurred 2 months after the conditional commitment was issued on October 27, 1999, and 6 months prior to loan closing on June 19, 2000.

- On December 18, 1999, the Missouri Department of Revenue revoked the borrower's motor fuel license, and this action was still effective on a listing dated February 7, 2005.

- On April 25 and 26, 2000, the EPA conducted inspections on six properties owned by the borrower. Of these six, only four were pledged as collateral for the B&I guaranteed loan. (See exhibit C for a complete list of the EPA's summary of counts.)

These conditions greatly affected the borrower's operations to generate income and the value of the collateral. Without the license, the borrower could not sell gasoline, nor could the storage tanks be used until EPA violations were satisfied. The State office was not notified of these adverse conditions. Even though the EPA did not issue its administrative penalty order against the borrower until January 3, 2001 (6 months after the loan closed), the lender and borrower had knowledge of environmental problems with these properties more than a year before loan closing and should have been concerned enough to perform site visits to ensure the problems had been corrected.

The borrower presented an application to the lender for a B&I guaranteed loan on March 9, 1999. The lender, in turn, contracted with a service company to conduct a Phase I Environmental Site Assessment on the borrower's properties listed as collateral. This is a requirement by RBS to ensure that properties with petroleum storage tanks meet EPA standards. The service company performed the inspection on March 25, 1999, and found numerous violations and problems. (See exhibit D for a complete list of the findings.) The service company presented its written report to the lender on May 28, 1999 (a year before loan closing), and a followup report on January 10, 2000. The reports emphasized that there were compliance issues and recommended corrective actions to meet EPA standards. The report further stated that these issues were a risk to all properties contained in the report, and further testing was needed to assure storage tanks had been upgraded.

In addition, the problems were revealed to the borrower in a March 8, 1999 (over a year before loan closing), letter from appraiser 1. The appraiser stated that all 20 sites were currently closed to pumping gasoline and were to remain closed until brought into compliance with the EPA. Further, the lender sent the borrower a letter on October 13, 1999 (10 months before loan closing), discussing appraisal and EPA issues. The letter stated the borrower possibly would not receive interim financing based on the facts that were in place concerning the appraisals and the outstanding EPA issues, and that USDA would require that all contaminated sites be cleaned up prior to funding.

The lender did not perform further testing and did not visit the sites to ensure improvements had been made. From these facts, we conclude that the properties were not operational, at a minimum, from March 1999 (Phase I Environmental Site Assessment) to April 2005 (borrower still had not supplied the EPA with documentation that improvements had been made).

As a result of the EPA's inspection on April 25 and 26, 2000, the borrower was cited because the corrosion protection systems at the properties used as collateral in Marmaduke and Holly Island, Arkansas, were not in operation, since all electrical power was cut off.

The EPA also determined that the borrower failed to maintain the corrosion protection systems for the underground storage tanks (UST), while the UST systems were in temporary closure.

EPA regulations[8] required that all USTs be upgraded not later than December 22, 1998. In addition, for owners and operators of USTs that utilize corrosion protection systems,[9] the systems must be inspected every 60 days to ensure the equipment is running properly and that records of the last three inspections are maintained.[10] Further, EPA regulations[11] require that the UST owners and operators must have the corrosion protection systems examined by a qualified tester within 6 months of installation, then every 3 years thereafter.

During the EPA's inspection, it was observed that the borrower did not inspect to ensure that the corrosion protection systems were running properly, nor were any records produced to verify that the corrosion protection systems were running properly. The borrower could not provide proof that the corrosion protection systems were inspected within 6 months from installation, as well as every 3 years thereafter.

The borrower chose to use the vapor monitoring method or ground water monitoring method as allowed under EPA regulations.[12] The vapor monitoring method samples vapors in the soil surrounding the UST. There are several requirements for using this leak detection method. For example, this method requires using porous soils in the backfill and locating the monitoring devices in these porous soils near the UST system. Before installation, a site assessment is necessary to determine the soil type, groundwater depth and flow direction, and the general geology of the site. This can only be done by a trained professional. Vapor monitoring requires the installation of monitoring wells within the tank backfill.

[8] 40 CFR 280.21, dated January 1, 2000.
[9] Impressed current cathodic protection system - A technique to prevent corrosion of a metal surface by making it the cathode of an electrochemical cell.
[10] 40 CFR 280.31(c), dated January 1, 2000.
[11] 40 CFR 280.31(b)(1), dated January 1, 2000.
[12] 40 CFR 280.43(f), dated January 1, 2000.

The EPA cited the following violations of the vapor monitoring or ground water monitoring methods at properties the borrower used as collateral for the B&I guaranteed loan (see exhibit C):

- Not establishing the number and proper positioning of monitoring wells that would detect releases from any portion of the tank that routinely contained petroleum products and that would detect releases within the excavation zone from any portion of the tank that routinely contained product.

- Not installing proper well casing that would prevent migration of natural soils or filter pack into the well and to allow entry of regulated substances on the water table into the well under both high and low groundwater conditions, and failing to seal the monitoring wells from the ground surface to the top of the filter pack. The borrower also did not comply with the requirement to ensure an acceptable monthly release detection system for UST.

- Not conducting an annual testing of pressurized lines for tightness. The EPA inspectors said the borrower had not conducted an annual line tightness test for pressure lines, nor was the method of monthly leak detection for pressure lines in compliance with EPA regulations[13] on 12 UST systems. In addition, the borrower also was cited for not conducting an annual testing of the operation of automatic line-leak detectors at nine USTs.

The EPA inspection determined that the borrower failed to upgrade the bulk plant in Rector, Arkansas, with required overfill prevention equipment or to conduct closure requirements at four existing UST systems by December 22, 1998, in accordance with EPA regulations.[14]

On October 26, 2004, the Justice Department, acting on the request of the EPA, filed a complaint against the borrower in the District Court for the Eastern District of Arkansas. This complaint was to get the borrower to comply with a Consent Agreement and Final Order entered into with the EPA on June 25, 2001, concerning UST violations on April 25 and 26, 2000. The EPA stated in its complaint that the borrower did not comply with the Consent Agreement and Final Order because the borrower did not provide a written response or documentation to the complaint.

[13] 40 CFR 280.43(e) or (f), dated January 1, 2000.
[14] 40 CFR 280.21, dated January 1, 2000.

The Consent Agreement and Final Order required the borrower to provide, for all 18 USTs (13 of which were on properties used as collateral for the guaranteed loan), written verification that all metal tanks, metal piping, and metal components (e.g., flexjoints, pump manifold, connectors, etc.) that were in direct contact with soil/water and routinely contained petroleum products, had been tested by a corrosion tester to ensure that they were protected from corrosion in accordance to the National Association of Corrosion Engineers. The borrower was to provide written documentation verifying the corrosion prevention systems were in operation and was to provide the last two monthly readings that the system continued to be in operation.

According to the complaint, the EPA sent five requests[15] to the borrower to provide the EPA with written verification of testing by a corrosion tester, as well as written documentation verifying that the corrosion protection systems were in operation as required by the Consent Agreement and Final Order. The borrower did not answer the five requests.

On April 18, 2005, the District Court for the Eastern District of Arkansas granted a Summary Judgment against the borrower totaling $83 million.

The EPA's inspection was conducted 2 months prior to loan closing and 1 year after the initial Phase I Environmental Site Assessment. The borrower and lender knew that the properties did not comply with environmental laws when the loan was closed. Had it not been for the borrower and lender concealing from the State office that the environmental upgrades had not been properly completed and certified, as well as concealing that the properties were not in compliance with EPA guidelines, the State office would not have issued the loan note guarantee.

Recommendation 1

Take action to contest the guaranty.

Agency Response.

RBS concurs and will cancel the loan note guarantee upon receipt of repayment of the funds and accrued interest.

OIG Position.

We agree with the planned action. In order to reach management decision, we will need documentation showing the receipt of the repayment of funds and accrued interest, and the cancellation of the loan note guarantee.

[15] October 15, 2001; November 15, 2002; December 11, 2002; February 26, 2002; and April 30, 2002.

Recommendation 2

Take necessary legal action to recover the amount paid to repurchase the loan note guarantee, plus accrued interest and other fees.

Agency Response.

RBS concurs. The State office, in consultation with the Office of the General Counsel, is preparing a demand letter to present to the lender for repayment of the principal and interest accrued to the date of repayment.

OIG Position.

We agree with the planned action. In order to reach management decision, we will need a copy of the demand letter sent to the lender.

Recommendation 3

Take necessary action to debar the lender and its subsidiaries from the B&I Guaranteed Loan Program.

Agency Response.

RBS concurs and will pursue debarment if the lender does not repay the principal and accrued interest. If the lender repays all funds to the Government, the Government will not have sustained a loss, and RBS will not initiate debarment proceedings.

OIG Position.

We do not concur with this course of action. Before making any decision, consult with the RBS National Office to determine the lender's overall history of delinquent and foreclosed loans. RBS should use this information as the basis for a decision on debarment proceedings, regardless of the amount collected.

Finding 4 Lender Used Guaranteed Loan Funds From an Escrow Account for Unauthorized Purposes

We found that loan funds were used for unapproved purposes in the loan application or the conditional commitment. This occurred because the lender paid $75,000 from an escrow account to a debt reduction arbitrator without the approval of Rural Development or the knowledge of the borrower. As a result of the unauthorized use of loan funds, the borrower had to stop the environmental upgrades and real estate improvements. This $75,000 payment depleted loan funds set aside for equipment and real estate improvements and the viability of the business.

Rural Development regulations[16] require that a loan note guarantee will not be issued until a lender certifies that the loan proceeds have been or will be disbursed for purposes and in amounts consistent with the conditional commitment. A copy of the detailed loan settlement of the lender must be attached to support this certification.

The State office signed the conditional commitment on October 27, 1999. The lender and borrower signed the document on October 30, 1999, and November 2, 1999, respectively.

Section 4 of the conditional commitment authorized how the loan funds were to be used. The authorized use of the B&I guaranteed loan funds, in approximate amounts, is as follows:

Real Estate Improvements	$ 150,000
Working Capital	958,151
Equipment	200,000
Debt Refinancing	1,691,849
Total	$3,000,000

The lender's settlement statement shows loan funds were actually paid for the following:

Debt Restructure and Payoffs	$1,698,150
Real Estate Improvements	150,000
Equipment	200,000
Closing Costs/Fees	144,500
Working Capital	807,350
Total	$3,000,000

[16] 7 CFR 181(l), dated January 1, 1999.

All guaranteed loan funds were to be used in connection with the borrower's business, which had approximately 20 company owned gas station/convenient stores located throughout northeast Arkansas and southeast Missouri. The lender furnished a certified disbursement statement at loan closing showing the disbursement of all loan funds.

The lender introduced the borrower to an arbitrator to aid in reducing outstanding debt prior to loan closing. The arbitrator was to be paid 33 percent of the amount of the reduced debt. The agreement noted the fee was to be paid by the borrower from the proceeds of the B&I guaranteed loan. This agreement was never revealed to the State office. As such, the fee owed to the arbitrator was not an authorized use of guaranteed loan funds. The lender knew this was not an authorized use of loan funds, and, legally, should not have paid the arbitrator without the borrower's and the State office's approval.

The arbitrator's statement of professional services rendered shows the borrower owed him $150,159. The following is an itemization of services rendered:

Creditor	Amount per Claim
Creditor 1	$448,000
Creditor 2	90,038
Creditor 3	130,894
Creditor 4	165,092
Creditor 5	135,571
Total	$969,595

The arbitrator stated that the creditors would settle for payments totaling $519,070 as full and final settlement for the claims of $969,595.

Total Amount of Claims	$969,595
Less: Settlement Amounts	519,070
Amount of Agreed Reduction	$450,525
Fee: 33 percent x $450,525	$150,159

The lender knew that the borrower owed the fees to the arbitrator and that payment would come from guaranteed loan funds. The lender also knew this payment of fees was not an authorized use of loan funds listed in the conditional commitment or the loan application.

The lender mailed the arbitrator a letter dated June 2, 2000, advising him of the loan closing the week of June 19, 2000. The lender asked for updated settlement letters in order to arrange to pay the borrower's creditors. The

arbitrator provided the information in a document dated June 12, 2000, including the amount of his professional fees.

The arbitrator wrote the lender on August 21, 2000, requesting payment of at least $75,000 by August 25, 2000, from loan proceeds held in an escrow account. In a letter dated November 14, 2000, the borrower wrote to the lender that it was not happy about the payment. The borrower had to stop the upgrades and improvements being worked on because the last invoices submitted could not be paid, as the balance of the account had been used to pay the arbitrator. The lender's loan officer believed the borrower was not going to pay any of the arbitrator's fees and simply could not live with that scenario. The loan officer further indicated he felt a moral obligation to make the payment since he brought the borrower and arbitrator together.

The arbitrator wrote the lender again on December 15, 2000, seeking payment for services to the borrower. The arbitrator left the lender over 15 telephone messages that were not returned. The arbitrator then threatened to follow his attorney's recommendation to sue all parties, including USDA.

The lender paid the arbitrator $75,000 from an escrow account set aside for equipment and real estate improvements. In a fax to the arbitrator, dated December 20, 2000, the lender's loan officer wrote that he had stuck his neck out to pay him the initial $75,000.

This was a third-party debt between the borrower and the arbitrator and was not listed as an authorized use of loan funds in the conditional commitment. The lender knew the arbitrator and borrower wanted to use guaranteed loan funds, as evidenced in the power of attorney that the borrower gave the arbitrator. Even if the borrower wanted to use guaranteed loan funds, neither the lender nor the borrower revealed to the State office that guaranteed loan funds would be used to pay this debt. Even though the lender paid an initial $75,000 from an escrow account, the lender knew this was not an authorized use of loan funds. The lender stated it knew that it was not proper in the December 20, 2000, fax in which the lender stated that it simply could not pay a third party against the wishes of the borrower for obvious legal reasons.

Recommendation 4

If amount in Recommendation 2 is not collected, recover the $75,000 from the lender for unauthorized use of funds.

Agency Response.

RBS concurs, and will pursue recovering this amount if the lender does not repay the total funds expended by the Government and accrued interest.

OIG Position.

We agree with the planned action. To reach management decision, if the lender does not comply with the demand letter in Recommendation 2, we will need documentation showing recovery of the $75,000.

Scope and Methodology

At the request of RBS, OIG initiated an audit of B&I guaranteed loans made to a local oil and gasoline distributor in the State of Arkansas. The audit concentrated on the B&I guaranteed loan the lender made to the borrower in June 2000. Fieldwork was performed at the Arkansas Rural Development State Office and the lender's office in New York City. We conducted the fieldwork from January 2005 to August 2005.

To accomplish the audit objectives, we reviewed State office records, as well as the lender's records related to the borrower's B&I guaranteed loan, to determine if the lender properly closed and serviced the loan, and that loan proceeds were used as specified in the loan agreements. We interviewed and obtained records from the lender and the State office and interviewed one real estate appraiser. We also visited and took pictures of all 20 properties listed as collateral.

We conducted this audit in accordance with Government Auditing Standards issued by the Comptroller General of the United States. Accordingly, the audit included such tests of program and accounting records as considered necessary to meet the audit objectives.

However, the scope of the audit was limited. The borrower would not return telephone calls or requests for an interview or to have business records reviewed. Also, the attorney for the former vice president of the lender who handled the loan in question would not allow his client to be interviewed by OIG.

Exhibit A – Summary of Monetary Results

FINDING NUMBER	RECOMMENDATION NUMBER	DESCRIPTION	AMOUNT	CATEGORY
3	2	Lender's Misrepresentation Lead to Loan Note Guarantee Being Contested	$2,502,954	Questioned Costs and Loans, Recovery Recommended
4	4	Lender Used Guaranteed Loan Funds for Unauthorized Purposes	*75,000	Questioned Costs and Loans, Recovery Recommended
TOTAL			**$2,502,954**	

Loan Note Guarantee Repurchased:	$2,388,830
Accrued Interest:	114,124
Repurchase Amount	$2,502,954

* = The $75,000 is part of the $2,502,954 in Recommendation 1.

Exhibit B – Pictures of Properties

Bertrand, Missouri, Property

Blytheville, Arkansas, Property

Bragg City, Missouri, Property

Gosnell, Arkansas, Property

Greenway, Arkansas, Property

Hayti, Missouri, Property

Hickory Ridge, Arkansas, Property

Holcomb, Missouri, Property

Holly Island, Arkansas, Property

Hoxie, Arkansas, Property

Kennett, Missouri, Property

Leachville, Arkansas, Property

Malden, Missouri, Property

Marmaduke, Arkansas, Property

McDougal, Arkansas, Property

New Madrid, Missouri, Property

Paragould, Arkansas, Property

Rector, Arkansas, Property

Wardell, Missouri, Property

Exhibit C – EPA's Summary of Counts Against the Borrower's Properties Pledged as Collateral

SUMMARY OF COUNTS										
	FACILITY NUMBER	**LOCATION /TANK**	**COUNTS**							
			1A	**1B**	**2**	**3**	**4**	**5**	**6**	**7**
1	28001620	**HWY 49 Marmaduke, Arkansas**								
		GAS 4K	X							
		GAS 4K	X							
		GAS 1K	X							
		DIESEL 1K	X							
2	11000049	**215 E 9th Rector, Arkansas**								
		GAS 10K			X	X	X	X	X	X
		DIESEL 10K			X	X	X	X	X	X
		GAS 10K			X	X	X	X	X	X
		GAS 10K			X	X	X	X	X	X
3	11000006	**12505 HWY 90 Holly Island, Arkansas**								
		GAS 2K		X						
		GAS 2K		X						
		DIESEL 550 GAL		X			X			
4	28000006	**1211 Rector Rd. Paragould, Arkansas**								
		GAS 6K			X	X	X	X		
		GAS 6K			X	X	X	X		

Count 1A - Failure to continuously operate corrosion protection system for temporarily closed UST
Count 1B - Failure to continuously operate corrosion protection system for temporarily closed UST
Count 2 - Failure to test impressed current corrosion protection system every 60 days
Count 3 - Failure to test corrosion protection system within 6 months of installation, then every 3 years thereafter
Count 4 - Failure to provide adequate release detection for tanks
Count 5 - Failure to provide adequate release detection for piping
Count 6 - Failure to provide annual test of automatic line-leak detectors
Count 7 - Failure to install overfill prevention by the December 22, 1998, deadline

Exhibit D – Environmental Violations and Problems Found During Environmental Site Assessment on March 25, 1999

Some of the environmental violations and problems found during the service company's Phase I Environmental Site Assessment are as follows:

- Record keeping and compliance requirements were lacking. Information on testing that had been done was limited and unclear. An example was information on line testing. The testing company showed a test being done that indicated only one line was tested. A proper report should have indicated each product (unleaded, mid-grade, premium, diesel) being tested, pressure and time, along with a pass/fail report. The use of ground water monitoring and out-of-tank vapor monitoring were acceptable means of leak detection. They should have been accompanied with information of site evaluation and assessment of well placement and backfill suitability for this type of monitoring.

- Inventory was used as a source of leak detection. Inventory records with monthly evaluations should have been provided. The records should have shown a daily reading of inventory on hand, meter readings, and any deliveries that were made. A monthly reconciliation report should have accompanied these readings to determine product gain or loss. An inventory method was not an acceptable means of leak detection without being supplemented by statistical inventory reconciliation. The borrower should have purchased a third-party certified program or worked through a third-party certified company.

- Some locations were in operation without insurance certification. The State of Arkansas was a State insurance fund, and the State of Missouri was not; however, both States required current leak detection and compliance to be eligible for insurance coverage. The service company noted that locations that were pressurized-type systems should have had line-leak detectors tested annually.

- Locations that were closed did not have compliance requirements that were mandatory for December 1994; however, several pumps were certified in 1997. In the event these locations were not in operation, the borrower was required to file closure notices (temporary or permanent) with either the Department of Natural Resources in Missouri or the Department of Pollution Control and Ecology in Arkansas.

- In reference to upgrading, all tanks should have been tested prior to being treated for corrosion protection. The service company spoke with a company that tests USTs. The company said that all corrosion protection systems must have been tested 60 days prior to installation and again 3 to 6 months after installation. The borrower had no records to indicate that any testing had been done. Statistical inventory reconciliation, ground water monitoring, and vapor monitoring were not acceptable on locations that had been inactive.

- Some locations were in operation that did not meet the upgrades for December 1994, and some had just been installed. The service company said that spillage could have created a problem over time. Some of the locations were in populated areas and neighboring other petroleum storage tank locations. Due to lack of records and compliance, the service company recommended that all locations be tested for possible contamination.

- 215 East 9th Street, Rector, Arkansas – The service company was not provided a copy of registration. The borrower provided no leak detection records. No tank test data was available; however, a line test was performed in September 1998 but did not indicate if more than one line was tested. The waste oil tank and surrounding areas were contaminated from spillage. (See exhibit B, page 7.)

- 117 South State Street, Greenway, Arkansas – The service company was not provided a copy of tank registration. The service company reported that the property was not in compliance as required by law. Leak detection records, as provided by the borrower, were for ground water monitoring. There were no line or tank test records available. (See exhibit B, page 2.)

- Hwy 412 East State Line, Paragould, Arkansas – The service company reported that leak detections, as provided by the borrower, were for ground water monitoring. The lines appeared to have been tested, but records did not indicate if more than one line was tested. There were no records to indicate that the line-leak detectors were being tested. (See exhibit B, page 6.)

- 255 South Flore, Hickory Ridge, Arkansas – No certificate of tank registration was provided to the service company. Line test records, dated October 16, 1998, indicated that lines passed; however, records did not indicate if all lines were tested. (See exhibit B, page 3.)

- Hwy 49 and Hwy 139, Holly Island, Arkansas - No certificate of tank registration was provided to the service company. The property was not in compliance with EPA standards as required by law. Leak detection records, as provided by the borrower, were for ground water monitoring. No line or tank test records were available. (See exhibit B, page 4.)

- 204 South West Texas Street, Hoxie, Arkansas – Leak detection records, as provided by the borrower, were for ground water monitoring. The lines appeared to have been tested, but records did not indicate if more than one line was tested. The lines were a pressurized system, and the line-leak detectors should have been tested annually. No test was found. (See exhibit B, page 4.)

- North Main Street, Leachville, Arkansas - No certificate of tank registration was provided to the service company. The property was not in compliance with EPA standards as required by law. Leak detection records, as provided by the borrower, were for ground water monitoring. It should be noted that ground water monitoring was not acceptable if ground water did not exist. In the service company's review of the vapor monitoring readings, the month of June 1998 indicated a release or possible spillage. No line or tank test records were available. (See exhibit B, page 5.)

Exhibit E – Agency Response

UNITED STATES
DEPARTMENT OF
AGRICULTURE

Rural
Development

USDA Service Center
Federal Building, Room 3416
700 West Capitol Avenue
Little Rock, AR 72201-3225

September 26, 2005

Subject: Business and Industry Loan in Arkansas
34099-7-Te

TO: Tim R. Milliken
Regional Inspector General
for Audit
USDA
Temple, TX

Reference is made to the draft report of subject audit that was conducted at the request of Rural Business Cooperative Service.

The State office has reviewed the report and concurs with the findings and recommendations.

The State Office, in consultation with Office of General Counsel, is preparing a demand letter to be presented to the lender for repayment of the principle and interest to the date of repayment. The Loan Note Guarantee will be cancelled upon receipt of the repayment of the funds plus accrued interest is received. Recommendation number three will be used as a negotiating tool. If all funds are repaid to the government, the government will not have sustained a loss and debarment proceedings will not be initiated. Recommendation number four will be pursued if the lender does not repay the funds expended by government plus accrued interest.

If you have questions, please contact Shirley Tucker, RBS Director at 501-301-3280.

ROY G. SMITH
State Director