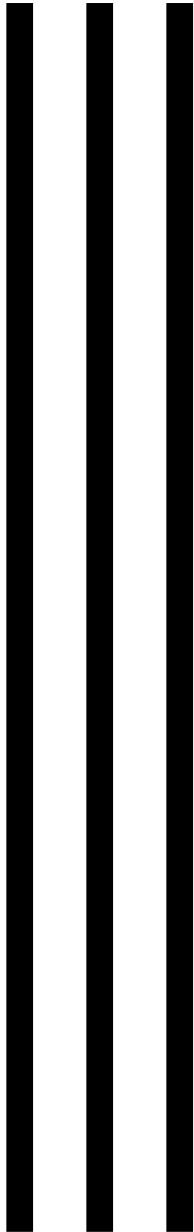


# USDA



U.S. Department of Agriculture  
Office of Inspector General  
Midwest Region  
Audit Report

**RURAL DEVELOPMENT  
BUSINESS AND INDUSTRY LOAN  
EXCELSIOR-HENDERSON MOTORCYCLE  
MANUFACTURING COMPANY  
BELLE PLAINE, MINNESOTA**



**Report No.  
34099-0004-CH  
DECEMBER 2002**



UNITED STATES DEPARTMENT OF AGRICULTURE  
OFFICE OF INSPECTOR GENERAL  
Midwest Region  
111 North Canal Street - Suite 1130  
Chicago, IL 60606-7295



DATE: December 19, 2002

REPLY TO

ATTN OF: 34099-0004-Ch

SUBJECT: Business and Industry Loan – Excelsior-Henderson Motorcycle  
Manufacturing Company

TO: Stephen G. Wenzel  
State Director  
Rural Development  
410 AgriBank Building  
375 Jackson Street  
St. Paul, MN 55101-1853

ATTN: John Melbo  
Program Director  
Rural Business-Cooperative Service

We have completed our audit of the Business and Industry (B&I) guaranteed loan made to Excelsior-Henderson Motorcycle Manufacturing Company in Belle Plaine, Minnesota. Our objectives were to determine whether the lender, Dakota Bank in Mendota Heights, Minnesota, properly serviced the loan guarantee; properly applied any payments received; and adhered to the requirements of the Lender's Agreement. This included a review of loan files at both Rural Development and the lender; discussions with all available parties; and a review of all applicable laws and regulations. This audit was requested by the Minnesota Rural Development State Office.

### **BACKGROUND**

The B&I Guaranteed Loan Program is administered by the United States Department of Agriculture's Rural Development (RD). RD is administered locally through a State Director who maintains oversight over lending institutions that request loan guarantees. Lending institutions must meet the requirements of Title 7 of the Code of Federal Regulations, Part 4279, subpart A – General, subpart B – Business and Industry Loans, and Part 4287, subpart B – Servicing Business and Industry Guaranteed Loans.

The purpose of the B&I Guaranteed Loan Program is to improve, develop, or finance business industry and employment, and improve the economic environmental climate in rural communities. This purpose is achieved through bolstering the existing private credit structure through the guarantee of quality loans, which will provide lasting community benefits. Regulations allow RD to guarantee loans made by private lenders (banks, savings and loan associates, etc.) for up to 80 percent of the approved loan amount to eligible borrowers. Guarantees are subject to negotiation between the applying lenders and RD, dependent on the dollar amount of the loan. The loan guarantee covers the outstanding loan principle, approved protective advances, and accrued interest. However, guaranteed payments are limited to the guarantee percentage times the loan principle advanced and unpaid accrued interest. The maximum time allowed for final maturity of guaranteed B&I loans is 30 years.

The regulations require lenders to service the B&I loans while the loans are current, in default status, or in liquidation. Lenders are responsible for notifying RD officials of any violations of lenders' loan agreements. The loan note guarantee will be unenforceable by the lender to the extent any loss is the result of usury law violations, use of loan funds for unauthorized purposes, negligent servicing, or failure to obtain the required security regardless of the time at which RD acquires knowledge of the foregoing.

In December 1998, the RD Minnesota State office approved a request by the Dakota Bank (the lender) for an 80 percent guarantee of a \$5 million loan for the Excelsior-Henderson Motorcycle Manufacturing Company (the borrower). Per the terms of the Lender's Agreement, the lender was to provide all loan servicing, including the obtaining of adequate loan security. In December 1999, the borrower filed for Chapter 11 Bankruptcy. In August 2000, a company called EH Partners (the buyer) offered \$12.5 million to purchase the borrowers' company out of its bankruptcy. The borrower's creditors, including the B&I lender, allowed the buyer to purchase the company for \$4 million in up-front cash, with the remaining \$8.5 million represented as a line of credit which was to be available if needed. However, the new owners of the borrower company defaulted on their first loan payment of \$1,033,000, which was due on January 2, 2001. At this point, the lender foreclosed on the debt and the borrower was forced into liquidation.

On September 25, 2001, the Minnesota RD State office requested that an independent audit be performed by OIG of the loan made to this borrower. RD officials were concerned that the lender had neither applied loan payments properly nor serviced the loan in accordance with regulations. The RD officials were also concerned that the new owners had engaged in activities, such as misappropriation of loan collateral, that may have contributed to the loss. Since RD's request mentioned possible fraud, OIG – Investigations made some initial inquiries. On October 12, 2001, OIG – Investigations declined to initiate an investigation.

On October 1, 2001, Rural Development estimated the loss to the government on the guarantee to be about \$3.2 million. Rural Development made an initial loss payment of approximately \$2 million. After all the collateral was liquidated, the lender proposed a final loss payment of approximately \$800,000. Rural Development officials withheld making a decision on whether to pay the final loss payment until OIG completed its review of the loan.

### **SCOPE AND METHODOLOGY**

We performed audit work at the Rural Development State office in St. Paul, Minnesota, and the offices of the Dakota Bank in Mendota Heights, Minnesota. We did not perform audit work at the borrower's offices, since by this time the borrower had ceased operations and the records were in storage. At the RD State office, we reviewed all regulations regarding B&I loan making and servicing, in particular those relating to eligibility requirements, the application process, loan guarantee requirements, responsibilities of the lending institution, and loan servicing requirements. We also reviewed the borrower's loan file and interviewed all RD officials involved in the B&I loan-making process. At the lender's office, we likewise reviewed the borrower's loan file and interviewed officials as appropriate to determine if the lender had met all responsibilities for loan making and servicing. Finally, we conducted interviews with a representative of the Office of the General Counsel (OGC) who worked with RD during the original borrower's bankruptcy proceedings and buyout by EH Partners. We performed fieldwork from November 2001 through July 2002.

### **SUMMARY OF CONDITIONS NOTED**

Rural Development made an 80 percent guarantee on a loan of \$5 million to the borrower for working capital to manufacture motorcycles in December 1998. At that time, the borrower had not yet begun the process of manufacturing motorcycles; thus, much of the needed working capital involved startup costs. The lender had no prior lending history with this borrower.

The borrower declared bankruptcy in December 1999. In August 2000, the bankruptcy court presented a plan to reorganize the company and bring it out of bankruptcy through a takeover by another entity called EH Partners which was able to provide needed working capital to allow the borrower to continue its manufacturing operations. In September 2000, the reorganization was completed and the new buyer assumed control of the company. However, the new owners failed to make their initial B&I loan payment and the lender called the loan in January 2001.

Through our interviews with RD, lender, and OGC officials involved in the original bankruptcy and reorganization process, we found that serious questions had come to light about the new buyer's offer to take over Excelsior-Henderson and provide new working capital. An individual who had an interest in EH Partners was found to have an extensive history of unpaid bills and legal entanglements in both Florida and Minnesota, including an unpaid \$1.58 million tax lien. This individual had also been previously convicted of fraud and had a history of acquiring firms and then liquidating their assets while leaving creditors unpaid.

The lender became aware of some of these facts during the bankruptcy process. It was because of concerns raised by this knowledge that the lender made the decision to require an initial loan payment of over \$1 million only 4 months after the reorganization. This would, according to lender officials, reveal the true intentions of the new owners of Excelsior-Henderson, i.e. whether they intended to keep the business a going concern as originally represented or whether their true reason for acquiring the company was to misappropriate its assets. We asked officials of the lender why the reorganization was approved when they had such doubts about the buyer's intentions, and were told that there were no other viable buyers besides EH Partners. Lender officials stated that had the reorganization not taken place, the only alternative would have been to begin immediate liquidation of the borrower's assets and division of the proceeds between the B&I lender and the firm's other creditors.

In addition, officials of both the lender and RD stated that the lender was not the sole decision-maker in the determination of whether the reorganization should or should not take place. Lender officials stated that other creditors, including the State of Minnesota (the largest single creditor) had already expressed their intent to vote for approval. We interviewed the State official who was involved in the bankruptcy process, who confirmed that the State had voted in favor of the reorganization despite their knowledge of the questionable past of one of the representatives of EH Partners. He stated that at the time, the reorganization was viewed as the best available option. A Dakota Bank official told us that they had believed that even if the reorganized company subsequently defaulted on the loan, the lender's losses would be less than had an immediate reorganization taken place. Thus, the secured creditors voted unanimously to approve the reorganization.

At the time of reorganization, using the best available information regarding the assets pledged as collateral for the B&I loan, we determined the lender would probably have recovered just over \$1.2 million as shown in the table below:

Value of Collateral on January 31, 2000	\$1,652,000.00
Less: Value of Collateral Sold from Time of Appraisal to Time of Reorganization with Proceeds not Applied to the Debt	(\$224,977.75)
Less: Estimated Cost to Liquidate the Collateral	(\$206,792.00)
Net Estimated Recovery	\$1,220,230.25

When presenting the details of the proposed reorganization to Rural Development, the lender did not inform the agency of the information it possessed regarding the prospective buyer's history of legal and credit difficulties. Thus, when Rural Development officials concurred with the reorganization, they did so without having knowledge of all pertinent facts. Rural Development officials have stated they probably would not have given this concurrence had they possessed this information.

When servicing a loan in bankruptcy, Rural Development Instructions require the lender to keep RD officials adequately and regularly informed in writing of all aspects of the proceedings.<sup>1</sup> In withholding the information it possessed regarding the past activities of the new buyer, the lender clearly failed to meet these requirements. Thus, the loan guarantee would be unenforceable by the lender to the extent that all or any part of the monetary loss had resulted from this failure.

However, following the reorganization, our audit showed that the lender serviced the loan in a reasonable and prudent manner. The lender's servicing actions included: Initiating a Notice of Default shortly after the borrower failed to make its initial payment; commencing foreclosure action; and entering a temporary restraining order after learning that the new owners were liquidating collateral. Although RD and lender officials both estimated that the borrower's new management improperly converted approximately \$219,000 in loan collateral without remitting any of this to the lender, we were unable to establish that this could be directly attributed to any failure on the lender's part to properly service the loan. In discussions with RD officials, they were unable to cite specific actions that the lender could have taken to further protect the collateral.

Had the reorganization been rejected, the lender could have liquidated its collateral for an estimated \$1.2 million as indicated above. However, with the reorganization, the lender received about \$1.5 million in liquidation proceeds; in addition, the lender had received upfront money of \$525,477.25 from EH Partners at the time of reorganization. Even when taking into account the additional accrued interest on the loan principal that had accrued since the reorganization, the value of collateral improperly converted by the buyer, and expenses associated with the bankruptcy and liquidation, the lender realized an amount comparable to what would have been expected had the reorganization not taken place, as indicated in the following table:

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<sup>1</sup> Rural Development Instruction 4287-B, Subsection 4287.170(a)(4), dated December 23, 1996.

Final Liquidation Proceeds	\$1,500,000.00
Plus: Up-Front Money from EH Partners	\$525,477.75
Less: Lost Collateral during EH Partners Control	(\$218,775.58)
Less: Additional Interest Accumulated from Reorganization to Initial Loss Payment	(\$407,315.60)
Less: Liquidation Costs and Bankruptcy Fees	(\$170,634.56)
Net Actual Recovery	\$1,228,752.01

In their response to our draft report, dated December 18, 2002, RD officials continued to express concerns regarding the lender's servicing of the B&I loan. The full text of the response is included as exhibit A of the report. Excerpts from the response, with OIG's comments, are noted below.

- The response notes that OIG was not able to make an appropriate comparison between the actual losses incurred by the lender and those that would have been incurred in a September 2000 liquidation, and cited problems with the appraisal of the borrower's assets performed in February 2001. In fact, we did not rely on this appraisal in performing our computations; instead, we used the most recent appraisal that was available at the time of the decision to reorganize, dated January 31, 2000. RD officials correctly noted that this appraisal was considerably outdated by the time of the reorganization, but had not at that time required the lender to obtain a more current and accurate appraisal.
- RD officials disagreed that the reorganization was a foregone conclusion, and expressed their belief that one creditor (i.e. the B&I lender) could have potentially prevented the reorganization from occurring. While this may or may not be true, the computations reflected in this report indicate that preventing the reorganization would not have reduced the lender's claim under the B&I loan guarantee.
- RD officials cited the lender's failure to make a proper analysis of the commitment of the \$8.5 million line of credit that EH Partners stated would be available to the company. It should be noted, however, that the only potential effect of such a discovery by the lender would have been to prevent the reorganization. As already stated, preventing the reorganization would not have reduced the losses that were incurred.

- RD's response cites the lender's failure to timely provide a liquidation plan, which cost the agency approximately \$104,000 in additional interest. However, RD and lender records both show that a "draft" liquidation plan was submitted to the agency by mid-March 2001. This draft was in the hands of RD officials for nearly 2 months before it was returned with comments to the lender. In RD's letter approving the final liquidation plan on July 17, 2001, the agency authorized an additional 90 days of interest accrual. RD's actions make this point questionable.
- Finally, RD officials stated that there is evidence of negligent servicing, and could constitute fraud or misrepresentation. Our audit did not disclose any evidence of fraud or negligence on the part of the lender that harmed the Government. RD discussed their concerns with OIG's investigators prior to the audit, and we did so after its completion. Neither effort resulted in investigative interest. Agency officials should take appropriate administrative action based on the evidence they have of fraud or negligence.

Thus, while our audit disclosed that the lender failed to provide RD with all relevant information regarding the reorganization under EH Partners, we are unable to establish that any monetary loss occurred as a result.

Since we are not making any recommendations, no written response is necessary. However, if you have any questions or wish to provide further information, please contact John W. Pepper, Assistant Regional Inspector General, at (312) 353-4910.

*/s/*

EDWARD R. KRIVUS  
Regional Inspector General



**USDA Rural Development**

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December 18, 2002

Edward R. Krivus  
Regional Inspector General  
USDA Office of Inspector General  
111 North Canal Street, Suite 1130  
Chicago, IL 60606

RE: Business and Industry Loan – Excelsior-Henderson Motorcycle Manufacturing  
Company: 34099-0004-Ch

Dear Mr. Krivus:

We have reviewed your final audit of our \$5 million guaranteed loan to Excelsior-Henderson Motorcycle Manufacturing Company. We have the following comments:

1. The final audit was not able to make an appropriate comparison between the loss the Agency would have incurred by liquidating the company at the time of the Chapter 11 bankruptcy plan and the liquidation as it occurred 18 months later. The reason for this is because the 2/5/01 appraisal failed to include collateral that was acquired under cash collateral stipulations that occurred after the 1/31/00 appraisal but prior to the Chapter 11 agreement. If Dakota Bank (now American Bank of St. Paul) had appraised all of the guaranteed loan collateral on 2/5/01, as it should have, we believe it would have shown that the loss to the government would have been far less with an early liquidation.
2. The bank failed to inform this Agency of EH Partner's principal's "extensive history of unpaid bills and legal entanglements in both Florida and Minnesota, including an unpaid \$1.58 million tax lien" prior to the Chapter 11 agreement. We do not agree with the bank's argument, presented in this audit, that approval of the Chapter 11 plan was a foregone conclusion; one creditor with conviction could have changed the outcome. In fact, the bank's failure to share significant facts on the principal with this Agency seems to indicate that it wanted to avoid second opinions. Further evidence of the bank's negligent servicing was its failure to make a proper analysis of the commitment of the \$8.5 million line of credit that EH Partners said was available to the company.
3. We do not think that the lender serviced the loan in a reasonable and prudent manner following the reorganization. The bank failed to provide a liquidation plan within 30 days of the 1/31/01 decision to liquidate, as our regulations require and which the lender knew, having gone through this process the year before. We believe this failure cost the Agency approximately \$104,000 in additional interest.

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The lender's failures cited above are evidence of negligent servicing. These failures also quite possibly also constitute "fraud or misrepresentation ... of which the lender participates in or condone" (Form 4279-4, Lender's Agreement, Section I., Paragraph B.), which could have voided the guarantee altogether.

We do appreciate the time and effort Mark Hight and Joel Wells spent on this case.

Sincerely,

A handwritten signature in black ink, appearing to read "John Melbo". The signature is written in a cursive, somewhat stylized font.

**John Melbo  
Program Director  
Rural Business-Cooperative Service**

**Mark Hight, OIG, St. Paul  
Jim Wood, OGC, St. Paul**

Informational copies of this report have been distributed to:

Agency Liaison Officer, RD	(4)
General Accounting Office	(1)
Office of the Chief Financial Officer	
Director, Planning and Accountability Division	(1)