

June 1989

# FAILED THRIFTS

## Allegations at FirstSouth Receivership in Little Rock, Arkansas



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United States  
General Accounting Office  
Washington, D.C. 20548

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General Government Division

B-235547

June 16, 1989

The Honorable David Pryor  
Chairman, Subcommittee on  
Federal Services,  
Post Office, and Civil Service  
Committee on Governmental Affairs  
United States Senate

Dear Mr. Chairman:

As agreed with the Subcommittee, we have made an assessment of four allegations of wrongdoing concerning the Federal Savings and Loan Insurance Corporation's (FSLIC) FirstSouth Receivership in Little Rock, Arkansas. These allegations are that: a former receivership employee improperly contracted with the receivership, an auction of receivership properties was restricted to employees only, the receivership gave an unsecured loan to a borrower who was in default on existing loans, and the receivership contracted with a borrower who had defaulted on existing loans.

Our objectives were to review the four allegations to determine whether improprieties occurred. However, as requested, we limited our work to some extent to meet the Subcommittee's time constraints. The appendix contains a detailed analysis of the allegations and more information concerning our objectives, scope, and methodology.

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## Results in Brief

The Managing Officer in charge of FirstSouth Receivership and a former employee did sign a contract that included work the former employee was responsible for while he was employed at the receivership. In addition, the receivership did hold a property auction that was limited to receivership employees. The contract and the auction were both improper, and federal criminal statutes may have been violated. After we discussed our findings with the Federal Home Loan Bank Board (FHLBB) and FSLIC officials, the Managing Officer was suspended pending FSLIC's further review.

The loan that was alleged to have been unsecured was secured by an escrow account; however, time did not permit us to fully evaluate all the circumstances surrounding the loan transaction. As to the fourth allegation, the receivership did do business with a debtor in default on loans, but we found no laws, regulations, or FHLBB policies that were violated.

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## Federal Management of FirstSouth Receivership

FirstSouth was a federally insured savings and loan association with its main office in Pine Bluff, Arkansas, and 35 branch offices located within the state. It was put into receivership on December 4, 1986, with assets of \$1.68 billion. FHLBB documentation shows it closed FirstSouth because it was insolvent, had substantially dissipated its assets and earnings, and was in an unsafe and unsound condition to transact business.

FHLBB, an independent federal regulatory agency, is responsible for regulating and supervising the savings and loan industry and overseeing the operations of its various organizations, including the 12 Federal Home Loan Banks, the Federal Home Loan Mortgage Corporation, and FSLIC. FSLIC, a government corporation, insures savings accounts to a maximum of \$100,000. The FHLBB also appoints FSLIC as receiver, a separate and distinct legal entity, for the purposes of liquidating a failed institution. Once the FHLBB decides to close a savings and loan and appoints FSLIC as receiver, FSLIC's duties as receiver include taking legal and physical possession, collecting obligations due, disposing of assets, and settling claims against the savings and loan association. As of April 30, 1989, there were 99 operating receiverships with total assets of \$8.6 billion.

The Federal Asset Disposition Association (FADA), a wholly-owned subsidiary of FSLIC, was created by the FHLBB to assist FSLIC in managing and disposing of receivership assets. FSLIC often contracts with FADA for receivership asset management and did so for the FirstSouth Receivership. FSLIC also sometimes hires former employees of an association to remain on as receivership employees. For example, at FirstSouth, the Property Manager was a former association employee. The receivership's Managing Officer, however, was a former FHLBB employee.

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## Consultant Contract With a Former Employee

In June 1988, FirstSouth's Managing Officer and the former Property Manager signed a contract under which the latter was to appeal 1988 property taxes on 26 properties that were in the receivership's asset portfolio. He was to be paid by the receivership on a percentage commission basis. As of early April 1989, receivership records showed one payment of about \$69,000 had been made to the former Property Manager for contract work on 1 property, and billings of approximately \$127,000 had been made on another 12 properties. The Managing Officer exceeded the monetary limitation on her authority in entering into this contract. Moreover, some of the work billed under the contract was done while the Property Manager was still an employee of the receivership.

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Appeals on property taxes apparently had been completed on at least two properties covered under the contract and had begun on at least three others before the former Property Manager resigned. Yet, bills were submitted for work on these properties, and one payment of about \$69,000 was made. Receivership employees who examined the contract arrangement said they believed that much of the work billed for had in fact been done by receivership employees, and they were not willing to approve any more payments.

We believe the circumstances concerning the contract and the payment for work done while the Property Manager was employed by the receivership constitute possible violations of criminal statutes.

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## Employee-Only Auction

The receivership held a property auction in March 1988 that was open only to employees. This violated a July 1986 FSLIC policy because the property had not first been offered for public sale for a reasonable period of time. In addition, contrary to FSLIC requirements, we found no evidence that fair market value had been determined for the property. Although the market value of the property was unavailable, the cost data for some of the items sold suggest that they may have been sold for substantially less than their value. We could not verify whether the Managing Officer acquired a number of expensive items or arranged for other employees to bid on her behalf or refrain from bidding on certain items, as alleged. In our opinion, the auction, in addition to violating FSLIC policy, may have violated criminal statutes.

Receivership employee standards of conduct issued May 11, 1989, now preclude employees from acquiring receivership assets.

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## Additional Loan and Contracting With Debtors in Default

We found that a loan was made to a debtor in default, as alleged. However, the loan was secured by an escrow account, contrary to the allegation that it was not. According to FSLIC officials, the additional loan was made in order to minimize the receivership's losses on the borrower's other outstanding loans in default.

Also, as alleged, the receivership was obtaining insurance from a debtor in default, but we found no law, regulation, or policy that precluded this. FSLIC officials agree that a policy covering such situations would be desirable.

## Office of Inspector General Investigations

The Bank Board's Office of Inspector General (OIG) had also received allegations concerning the contract with a former employee, the auction, and the loan to a borrower in default. It did not investigate the employee-only auction because, on the basis of discussions with the Bank Board's Office of General Counsel (OGC) and other officials, it did not believe any laws, regulations, or policies had been violated. FSLIC adopted a new policy on asset disposal after the OIG brought the employee-only auction to its attention. Also, the OIG plans to audit controls over receiverships' property disposition in the future.

The OIG investigated the contract with the former Property Manager but closed the investigation because, on the basis of discussions with the Bank Board's OGC and documents it reviewed, it did not believe federal conflict of interest statutes applied since receivership employees were not federal employees. Because FSLIC does not appoint receivership employees as federal employees, they are not subject to criminal conflict of interest statutes. In our opinion, however, they are subject to other criminal statutes. The OIG is currently investigating the allegation concerning the unsecured loan to the borrower in default.

## Receivership Employees Who Perform Federal Functions Should Be Appointed as Federal Employees

The Bank Board has in the past chosen not to appoint any receivership employees as federal employees under federal law and civil service regulations. We believe that all receivership employees who perform federal functions under the direct supervision of federal officials should be appointed as federal employees. In our view, FSLIC's failure to appoint them as federal employees constitutes a circumvention of federal civil service laws and regulations.

As a general rule, a federal agency may not obtain personal services on a contractual basis but must have such services performed by personnel employed in accordance with the civil service classification laws. Application of this rule hinges on the existence of an employee-employer relationship. It is clear to us that such a relationship exists in the case of some receivership employees.

Although the agreements between the employees and FSLIC as receiver contain a statement that they are not federal employees, the degree of control and supervision by FSLIC is much broader than usually exercised in an agency-independent contractor arrangement. In particular, the Managing Officer, who heads the receivership's operations, appears to be subject to close supervision by FSLIC federal employees and must obtain prior approval from FHLBB or FSLIC before performing various

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duties. We also noted that the Managing Officer's performance appraisal was signed by the FSLIC Regional Director.

Other receivership employees also seem to be subject to substantial FSLIC control. For example, they can be reassigned and transferred by FSLIC to work at other receiverships. Their initial salaries are determined by FSLIC on the basis of a general proposed range of salaries for the particular positions they hold. We also noted that certain receivership employee performance awards are subject to FSLIC approval. These are just some of the indications that some receivership employees are subject to government supervision and appear to be acting as federal employees. Given this, such receivership employees should be federal employees and, therefore, subject to the laws and regulations applicable to federal employees.

FSLIC officials told us that they have been restructuring receivership operations to move a number of responsibilities to FSLIC regional offices and place responsibility for key operations under regional federal officials' control. According to FSLIC, about 50 of the approximately 1,300 employees involved in receivership activities will be appointed as federal employees under FSLIC's current restructuring plan.

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## Conclusions

In our opinion, the contract signed by the Managing Officer and the former Property Manager was not valid because the Managing Officer did not have the authority to enter into such a contract.

We do not believe the former Property Manager should have been paid for any work that was performed while he was employed by the receivership. Additional billings, in our opinion, should not be paid until it can be shown that the work was not done while he was employed by the receivership and there is clear evidence of a benefit to the receivership.

The lack of fair market price determinations to support the seemingly low prices for some items sold at the auction indicates to us that maximum return on receivership properties sold may not have been obtained.

The award of the contract to the former Property Manager and the holding of the employee-only auction were indicative of overall weaknesses in controls, in effect at the time, for approving contracts awarded by receiverships and disposing of assets. Given the number of receiverships now under FHLBB's control, it is important that the Board ensure that the

necessary controls are in place and functioning to prevent similar occurrences in the future. Time constraints did not permit us to evaluate recent changes in policy and operations that FSLIC officials believe strengthen controls over contracting and property.

The evidence we gathered concerning the contract and the payment for work done while the Property Manager was employed with the receivership, and the auction, suggests that certain criminal statutes may have been violated.

Since FSLIC does not appoint most receivership employees as federal employees, criminal conflict of interest statutes do not apply to them. We think some of the employees should be federal employees and therefore subject to these statutes.

Lastly, a FSLIC policy on receiverships doing business with debtors in default would be useful to determine under what circumstances doing business with a debtor in default would be appropriate.

## Recommendations to the Chairman, Federal Home Loan Bank Board

We recommend that the Chairman instruct the Executive Director, FSLIC, to

- appoint as federal employees those receivership employees who carry out federal functions under direct federal supervision;
- make no further payments to the former FirstSouth Receivership Property Manager for any work billed absent additional information that the work was not substantially completed while he was employed by the receivership and absent clear evidence of a benefit to the receivership;
- take action to recover funds paid to the former FirstSouth Receivership Property Manager under the invalid contract for work he did or for which he was responsible as a receivership employee;
- take action to recover the property disposed of inappropriately at the employee auction; and
- adopt a policy on the circumstances and conditions under which receiverships can and cannot do business with debtors in default.

## Agency Views

As requested by the Subcommittee, we did not obtain written comments from FHLBB. We did, however, discuss the factual content of our report with FHLBB, FSLIC, and OIG officials who generally agreed with the facts presented. They also generally agreed with the recommendations we are

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making to FHLBB and said they have decided not to make further payments to the former Property Manager. They also said they would look into recovering the payment already made to him and recovering the property inappropriately disposed of at the auction and would consider appointing more employees involved in receivership activities as federal employees. They provided us with additional views and information, which we incorporated in the report as appropriate.

FSLIC told us that since mid-1987, FSLIC has recognized problems with receivership operations and has taken steps to gain management control of its receivership operations and to increase their efficiency, accountability, and responsiveness. These steps include appointment of a Deputy Executive Director for Asset Management and Liquidation, a reorganization of regional operations, and creation of 42 senior management positions in the regional offices to ensure more federal control over the receiverships. FHLBB and FSLIC officials added that receivership employee standards of conduct, issued May 11, 1989, make receivership employees subject to the same standards of conduct established for all federal employees. While we think this is a positive step, it is not a substitute for appointing as federal employees those employees who perform federal functions.

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As arranged with the Subcommittee, we plan no further distribution of this report until 5 days from the date of its issuance unless you publicly announce its contents earlier. At that time, we will send it to the Bank Board and other interested parties and make copies available to others upon request.

If you have any questions, please contact me on 275-5074.

Sincerely yours,



Bernard L. Ungar  
Director, Federal Human Resource  
Management Issues

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# Contents

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Letter	1
Appendix	10
Discussion of Allegations and Issues	10
Allegation Regarding a Consultant Contract With a Former Employee	10
Allegation Regarding Receivership Employees Purchasing Receivership Property at "Bargain" Prices Through "Employee-Only" Auction	15
Unsecured Loan to a Debtor in Default	16
Allegation Concerning the Purchase of Insurance From a Contractor in Default to the Receivership	18
The FHLBB/OIG Investigations of Allegations of Improprieties at Receiverships	19
Objectives, Scope, and Methodology	21

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## Abbreviations

FADA	Federal Asset Disposition Association
FHLBB	Federal Home Loan Bank Board
FSLIC	Federal Savings and Loan Insurance Corporation
OGC	Office of General Counsel
OIG	Office of Inspector General
OLD	Operations and Liquidation Division



# Discussion of Allegations and Issues

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## Allegation Regarding a Consultant Contract With a Former Employee

One of the allegations referred to us by the Subcommittee was that the Managing Officer of the FirstSouth Receivership and the former Property Manager signed at two different times improper consulting contracts. It was further alleged that acting as a consultant, the former Property Manager submitted, or had a receivership employee submit on his behalf, erroneous billings to the receivership for his services. On June 24, 1988, the FHLBB OIG received a hotline call regarding this allegation.

FirstSouth's Managing Officer and its former Property Manager signed a contract effective June 8, 1988, for the former Property Manager to attempt to obtain 1988 property tax reductions on real estate in which the receivership had an interest. Under the terms of the contract the former Property Manager's fee was to be 30 percent of any property tax reduction obtained. In our opinion, for reasons summarized below, the contract was improper, invalid, and a violation of FSLIC policy. In addition, the fee structure set forth in the contract does not appear to be reasonable, and billings and payment under the contract were either improper or questionable.

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## Propriety of the Contract

In our opinion the June 8th contract signed by the Managing Officer and the former Property Manager was improper. The Managing Officer did not have the authority to enter into the contract without FSLIC approval. FSLIC approval was not obtained, and an earlier proposed contract signed by the Managing Officer and former Property Manager, including tax appeal and other property management work, was disapproved by FSLIC because the Property Manager would be acting more as an employee than a contractor.

The FirstSouth Receivership Property Manager, who had also been an employee of the association, was employed by the receivership from January 20, 1987, until he resigned on June 6, 1988. In this capacity, he was in charge of the receivership's property department with several Assistant Property Managers under his supervision. His duties included property tax statement analysis to determine accurate tax assessments and to appeal property taxes where they appeared to be too high. Also, he was responsible for soliciting and reviewing bids from, and recommending the selection of, property tax contractors. He obtained bids for the 1988 tax year in March 1988 and narrowed his recommendation to one contractor. However, after reviewing the bids from prospective contractors, he told us that it occurred to him to resign and bid for the work himself. This decision, he said, was also influenced by the changing

nature of his receivership duties and the uncertain future of his job with the receivership because of the anticipated relocation of receivership operations.

In April 1988, the receivership's Managing Officer and the Property Manager, who was still employed with the receivership, signed a contract for the Property Manager to be a consultant, in his individual capacity, and to do property management and tax appeal work for the receivership. The Managing Officer said she had requested the former Property Manager to provide consulting services to the receivership until a suitable replacement could be found. The contract was submitted to FSLIC headquarters for approval by the Managing Officer, but it was not approved on the basis that the Property Manager would "be working more as an employee than as a consultant, eg. far too many hours and performing actual receivership duties normally performed by an employee."

On May 27, 1988, the Property Manager tendered his resignation effective June 6, 1988. After resigning he formed a corporation in the state of Arkansas. Then, the Managing Officer signed another contract with him on June 8, 1988, which he signed in a corporate rather than individual capacity, to appeal 1988 property taxes for 26 properties in the receivership's asset portfolio.

The June 8th contract to do tax appeal work, which was one of the same types of work covered under the April proposal, was never approved beyond the level of the receivership. The contract was not submitted for approval initially because the receivership's Managing Officer said she believed that since this was a contract to obtain savings, it was not a contract involving expenditures. As such, she believed it was outside of FHLBB "Chairman's Order 613," which limited the Managing Officer's contracting authority to \$20,000.

Under authority of the Chairman's order, in January 1986, the Director of FSLIC's Operations and Liquidation Division (OLD), without exception, limited a Managing Officer's contracting authority for general services, such as consulting, personal and professional-type services, to \$20,000. Accordingly, we believe the order applies to all contracts, regardless of their nature. Therefore, we believe that the Managing Officer acted outside of her authority when she failed to forward the June 8th contract to the appropriate authority for approval. Because the Managing Officer did not have the authority to enter into such a contract, and

because the contract was not approved at appropriate levels, it is our opinion that it was not a valid contract.

After concerns raised by the receivership Controller were addressed to FSLIC's regional office in June of 1988 and, ultimately, to FSLIC headquarters, the Director, OLD, ordered the receivership's Managing Officer on October 17, 1988, to terminate the contract in order to avoid even the appearance of compromised standards and to determine the fees owed.

### Contract Fee Structure Did Not Appear Reasonable

The fee structure called for under the contract between the receivership and the former Property Manager was unreasonable because there was no ceiling on the amount the former Property Manager could earn, and substantially lower bids for the work had been provided to the receivership.

The purpose of the contract was to reduce the assessed values of, and taxes on, the properties in the receivership's portfolio. Under the terms of the June 8th contract, the contingency fee for these services was 30 percent of whatever tax savings the former Property Manager could obtain. The contract did not provide for a maximum fee per property as did five other bids received by FADA and provided to the receivership's Managing Officer and former Property Manager in March of 1988. For contingency fee contracts, the bids FADA obtained and provided to the receivership contained fees ranging from 25 percent to 50 percent of tax savings, with maximum fee ceilings ranging from \$2,500 to \$20,000 per property. FADA recommended that the receivership select a contractor whose bid was 25 percent of tax savings with a fee ceiling of \$2,500 per property. Because there was no ceiling on fees per property, the former Property Manager's fee was substantially higher than these bids, which were rejected. For example, on one property, the former Property Manager was to receive a fee of almost \$31,000. Under the contract proposal FADA recommended, however, the fee would not have exceeded \$2,500.

According to the former Property Manager, the fee structure he proposed gave him the incentive to work for the highest possible reductions. We believe, however, the fee structure under the former Property Manager's contract was too high and was not necessary to acquire services desired. We also found that the Managing Officer had signed at least one other contract for property tax appeals based on the same fee structure, 30 percent of all tax reductions achieved with no maximum fee per property. Work for the receivership was done and billed for apparently without FSLIC approval of the contract.

## Improper and Questionable Billings and Payment

As of early April 1989, the receivership records showed billings under the contract totaling approximately \$127,000 on 12 properties. One payment of about \$69,000 to the contractor had been made for work on another single property. In our opinion, there was no evidence what the actual tax savings were to the receivership, and some of the work had been done while the Property Manager was an employee.

The detailed explanation is as follows:

- For two properties included in the contract, tax appeal work was apparently completed before the Property Manager resigned and before the contract was signed. Bills for these two properties were withdrawn by the Assistant Property Manager when the Controller found that the appeals for these two properties included in the contract signed on June 8, 1988, were scheduled on June 1, 1988, 5 days before the former Property Manager's June 6, 1988, resignation.
- On at least three properties, it appears that the Property Manager, while employed with the receivership, arranged for taxes to be appealed on June 9, 1988, the day after his contract was signed and 3 days after his resignation became effective. Billings were submitted for appeal work to reduce taxes for these three properties, one of which resulted in the \$69,000 payment to the former Property Manager. The Deputy Chief Appraiser in the county where these properties were located told us that the former Property Manager contacted him to set up an appointment to appeal the taxes for this property and two others in mid-May, after the district sent out appraisal notices dated May 11th.

The former Property Manager said he selected his resignation date to accommodate appeal dates. The former Property Manager, while an employee, was setting up appointments in mid-May for these three properties and apparently appealed the assessments near the date of his resignation. Thus, we conclude that he was influencing when appeals would officially take place and doing at least some work, while he was employed, on properties included in his contract for which he intended to claim fees as a contractor. After approving payment of about \$69,000 to the former Property Manager, which he received in November 1988 for an appeal that was heard on June 9, 1988, the Managing Officer rejected another billing because an assessment reduction was dated June 9th, and the work was very likely done before his June 6th resignation. We believe the propriety of the \$69,000 fee is also questionable, and grounds may exist for FSLIC to recover the fee paid to the former Property Manager.

- As of early April 1989, the receivership had billings totaling approximately \$127,000 on 12 properties. The receivership's Assistant Managing Officer and the Controller informed the Managing Officer that it was their belief that much of the work was done by receivership employees, and they were not willing to approve any of the disbursements. The Assistant Managing Officer added that appeal dates do not indicate when the preparatory work was done and that the appeal work was done by receivership employees under the former Property Manager's supervision. The Assistant Managing Officer stated that to pay a former department head under these circumstances was highly questionable and contrary to the way the receivership normally did business, and he recommended that the former Property Manager be paid only for expenses that could be properly documented. FSLIC officials told us they do not intend to pay the former Property Manager for these billings.
- Billings submitted under the contract prior to February 1989 were not properly documented and in those cases where documentation was available, they were based on reductions in assessed property values and estimated, rather than actual, reductions in property taxes. For example, the basis for billing and payment for the property for which the contractor was paid \$69,000 was savings based on estimated, not actual, tax rates.

FHLBB and FSLIC officials told us in June 1989 that the timing of their action on the termination of the contract with the former Property Manager was due to reorganization within FSLIC, personnel turnover, and the unavailability of contract information to appropriate officials. After our discussion with the officials, FSLIC suspended the Managing Officer at the FirstSouth Receivership for violations of FSLIC policies, instructions, and standards of conduct on the contract with the former Property Manager and the employee auction.

## **Allegation Regarding Receivership Employees Purchasing Receivership Property at "Bargain" Prices Through "Employee-Only" Auction**

Another allegation the Subcommittee referred to us was that the receivership's Managing Officer organized and held an employee-only auction to dispose of expensive furnishings and obtained a high-value item from the failed FirstSouth savings and loan at a fraction of its original cost, as well as other items. It was also alleged that the Managing Officer requested other employees to assist her in bidding on selected items and made it clear that other employees were to refrain from bidding on the items she wanted. The OIG received a hotline call on June 24, 1988, regarding this allegation.

We were unable to substantiate allegations regarding the Managing Officer's acquisition of expensive items or her request for other employees to assist her in acquiring them. However, we found that an auction of certain receivership property, held on March 21, 1988, was limited to receivership employees and netted \$7,453.50. Contrary to FSLIC policy and instructions contained in a July 7, 1986, memorandum to FSLIC Regional Directors, we found no evidence that fair market price had been established for the property, and the property had not been publicly offered for sale for a reasonable period of time prior to the auction.

Federal regulations require that an inventory of receivership property be provided by the receivership, as soon as practicable after FSLIC takeover of a failed institution, to both the Secretary to the Bank Board and FSLIC. The inventory was not available from these sources, and we were initially told that it was not available at the receivership. We asked for the inventory because we thought it might help us identify items auctioned. The inventory, showing fixed assets costing about \$28 million with a book value (cost less depreciation) of approximately \$22 million, was subsequently obtained from the receivership and provided to us. On the basis of our review of the inventory and the list of items auctioned, it appears that some items may have been sold for significantly less than they were worth.

The announcement for the March 21, 1988, auction listed such items as lamps, pictures, rugs, and miscellaneous items to be sold to the highest bidder. A handwritten list of items sold at the auction, provided to us by the receivership, does not show the original price paid by FirstSouth, a current appraised value, book value, or any other information from which we could reasonably estimate market values of the items sold.

We compared the takeover inventory with the list of auctioned items, but we were unable to match most of the items because the list of auctioned items did not include unique serial numbers or other specifically

identifying information. No effort was made to describe items on the auction list as they appeared on the takeover list.

We did find, however, two cases where items on the inventory appeared to match those on the auction list. In one case, the takeover inventory lists a category of eight rugs, most of which appeared to be Oriental, purchased by the institution during 1984 and 1985 for \$19,479.95 with a book value of \$14,796.32. From the auction list it appears that all eight of the rugs, plus two we could not identify, were auctioned for a total of \$2,245. In another case, two camera systems were auctioned for \$105 and \$75. The takeover inventory shows eight such items costing a total of \$10,500, or \$1,312.50 each, based on our calculations, with a book value of about \$740 each.

In response to our question regarding the allegation that the Managing Officer preselected items for herself and had other employees bid on them, she said there was no substance to the allegation. She said she had only purchased a couple of pictures and a small table for a total cost of about \$100. Our review of the auction's cash receipts register showed her purchases totaled \$120. However, because we could not continue our work long enough to determine whether the Managing Officer enlisted the services of other employees, we could neither refute nor support her claim.

An examination of the two examples and the two lists, plus the fact that receivership staff responsible for liquidating the inventory apparently did not provide it to appropriate FHLBB and FSLIC officials, contrary to federal regulations, indicates that previous controls over receivership property were not effective. Further, in the absence of appraisals or other outside estimates supporting the seemingly low prices for the two examples shown above, the Managing Officer failed to follow FHLBB policy and may have failed her fiduciary duty to obtain the maximum return to the receivership. FSLIC officials told us that the restructuring of their regional operations and a new policy and new procedures they have adopted strengthen controls considerably. FSLIC policy now prohibits employees from purchasing any receivership assets. Also, FSLIC officials said they were exploring the possibility of recovering the property inappropriately auctioned.

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## Unsecured Loan to a Debtor in Default

While we were working at the FirstSouth Receivership, an allegation was made to us that FSLIC breached its fiduciary responsibility by directing the receivership to grant an unsecured loan for \$200,000 to

pay attorneys' fees for services related to the sale of a major property owned by a debtor in default. A law firm in Little Rock was to be paid \$142,000, and a law firm in Fairfax, Va., was to be paid \$58,000. The same debtor, through the same attorneys, was seeking approval from FSLIC to reduce his total debt to the receivership from \$37 million to \$29 million.

Problems with this debtor existed when FirstSouth was an operating savings and loan. Documents obtained from the Federal Home Loan Bank of Dallas listed this debtor as one of the principal stockholders of the savings and loan who obtained loans in excess of the amounts permitted under 12 C.F.R. 563.9-3, "Excessive Loans to One Borrower," and the bank examiners considered the loans unsafe and unsound.

We found that FSLIC officially approved the \$200,000 loan at the national level after the legal services had been rendered and after the property, in which the receiver had an interest, had been sold. According to the minutes of the meeting of the FSLIC Committee that approved the loan, repayment of the \$200,000 was to become part of the overall negotiations that involved the \$8 million debt reduction on loans the borrower in default owed the receiver. The minutes did not state a justification for the loan or the reason for including it in the overall negotiations with the debtor, nor did the minutes indicate whether or not the loan was secured. FSLIC officials told us that minutes do not normally include justifications for loans.

In June 1989, a FSLIC official said the loan was approved unofficially before settlement on the property and that the sale of the property would not have gone through unless the loan were made because net proceeds from the sale were insufficient to pay the debtor's attorneys. According to FSLIC officials, the loan was made to minimize the receivership's losses against the borrower on other loans, many of which were in default. Further, documents provided to us by FSLIC showed that the loan was secured by a \$1 million escrow account established to pay off any creditors of the property.

Because of time constraints, we were unable to fully evaluate the propriety of the loan and its criticality to settlement on the property and the ultimate benefit to FSLIC. Negotiations with the debtor on his total debt to the receiver were still in process as of June 1989. FHLBB's OIG had received an anonymous call regarding this situation and has an investigation in process.

## Allegation Concerning the Purchase of Insurance From a Contractor in Default to the Receivership

The Subcommittee requested that we look into an allegation from an anonymous source that a debtor, while in default, contracted to sell insurance to the receivership. According to the allegation, the debtor, a personal friend of two receivership employees, received premium payments for 2 years while negotiating to write off his debt.

Termination of our work at FirstSouth precluded us from fully evaluating this allegation. However, vendor files show that between December 30, 1986, and March 24, 1989, the receivership disbursed \$535,845.50 for premium payments to the contractor who insured the receivership's property and the property of FirstSouth when it was an operating savings and loan. Documentation showed the contractor's debts to the receivership totalled \$2,570,903 on February 1, 1989, with only one loan with a balance of \$61,541 not in default. The remaining loans had apparently been in default since FSLIC's takeover of FirstSouth. A plan prepared by the receivership and approved by FSLIC's Eastern Regional Office in February 1989 outlined a settlement between \$960,000 and the contractor's offer of \$810,000. Not included in the settlement was \$98,334 to be pursued against a second guarantor on that specific loan.

According to the receivership's Managing Officer, the recommended settlement, while probably not a good one, was the best that could be obtained. The Managing Officer did not believe that doing business with a debtor was unusual, since selection of the contractor was based on competitive bids. The Managing Officer also said that one of two employees whose duty was to evaluate bids and recommend an insurance contractor was a personal friend of the debtor.

We were unable to review the selection process. Documentation provided to us by FSLIC in June 1989 showed that bids were obtained, but it was inconclusive as to whether the contract was approved at appropriate levels. Neither were we able to obtain details of the final settlement with the contractor or find any laws, regulations, or policies prohibiting a receivership from contracting with a debtor in default. We discussed this issue with FSLIC officials who agreed that a policy covering such situations would be desirable.

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## The FHLBB/OIG Investigations of Allegations of Improprieties at Receiverships

The FHLBB's OIG is responsible for doing investigations at FSLIC receiverships. In fiscal year 1988, the Inspector General started 4 investigations into receiverships, and in fiscal year 1989 (as of May 22, 1989) started an additional 18 investigations. The allegations included mismanagement of receivership property, theft of government funds and property, conflict of interest, preferential treatment, unauthorized use of position, fraudulent conduct, and disclosure of confidential information.

The outcome of many of these investigations is still not known. One of the four cases in fiscal year 1988 was referred to an Assistant U.S. Attorney for possible further action, and the remaining three were referred to other units within the Board. As of May 22, 1989, 13 of the 18 cases started in fiscal year 1989 were still under investigation or review, 4 were closed with no violations found, and 1 had been referred to the Federal Bureau of Investigation and the U.S. Secret Service.

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## Investigation of Allegations of Improprieties at FirstSouth

On June 24, 1988, the OIG received hotline allegations from an unidentified source regarding the employee-only auction at FirstSouth, the attempts by the FirstSouth Managing Officer and former Property Manager to enter into improper consulting contracts, and the submission by the contractor of erroneous billings. The OIG declined to investigate the auction because, on the basis of discussions with Bank Board OGC and other officials, the OIG determined that no laws, regulations, or policies would have been violated since receivership employees are not federal employees. The OIG did investigate the alleged improper contract and erroneous billings. But, according to its January 12, 1989, report, the OIG was unable to identify any laws that "would have been violated" as described in the anonymous allegations because, as with the auction, receivership employees are not federal employees. The OIG consulted with the FHLBB's OGC during the course of its investigation prior to issuing its report. As previously discussed, the OIG has an ongoing investigation of circumstances surrounding a loan to a debtor in default to the receivership.

On January 12, 1989, the OIG issued a report regarding ALLEGATIONS INVOLVING FIRSTSOUTH RECEIVERSHIP STAFF, which stated that the first contract was proposed to the former Property Manager by the Managing Officer but disapproved by FSLIC. The OIG report further stated that the Managing Officer and the former Property Manager did enter into a second contract after the first one was disapproved whereby the former Property Manager was to receive 30 percent of all tax reductions as his fee.

The report also stated that the OIG could not determine whether the former Property Manager had submitted a bill to the receivership for work on two properties that was accomplished in March 1988 while he was still employed by the receivership. Inconsistent statements from the Assistant Property Manager, the Managing Officer, and the former Property Manager as to whether the former Property Manager or the Assistant Property Manager submitted the billings prevented this determination, according to the report.

The OIG declined to investigate the auction because, according to the OIG documents, the Director of OLD told OIG staff that policies and procedures do not prohibit this practice, and since receivership employees were not federal employees, no laws or regulations would have been violated by such actions. The OIG further stated it would be difficult to determine the fair market value of the items and the loss to the government. According to OIG documentation of a meeting between OIG and FHLBB OGC officials, OGC officials said it is unclear whether there is anything improper with limiting access to an auction of the receivership's assets to employees. According to OIG documentation of the meeting, OGC officials further said it might be considered a breach of the Managing Officer's fiduciary duty if the assets were sold at significantly less than their fair market value, but the officials said this is a judgment call.

When we met with an OGC official who attended the meeting between OGC and OIG officials, he confirmed what was said at the meeting. During a meeting in June with FHLBB officials to discuss the facts presented in this report, the OGC official said that the auction was clearly improper, and he had been under the impression that the auction was to be a public auction. As discussed previously, FSLIC policy contained in a memorandum to FSLIC Regional Directors prohibited the sale of property to receivership employees unless a fair market price had been established and the property had been first offered for sale publicly for a reasonable period of time.

After consultation with the FHLBB OGC and review of available documentation, the OIG was unable to identify any laws that would have been violated as a result of the circumstances described in the allegations and requested that OGC review its report for violations of the agency's standards of conduct. OGC stated that because receivership employees are not FSLIC employees, they are not subject to the conduct standards mandated for FSLIC staff. The OIG, therefore, closed its investigation into these allegations.

The OIG's report on, and/or workpapers for, its FirstSouth investigation contained sufficient information to show us that the contract was improper, the billings and payment under the contract were improper or questionable, and an employee-only auction took place. On the basis of our review of the OIG's report and its workpapers, we believe the contract billings and the auction may have violated criminal statutes. We could not determine whether or not sufficient documentation was provided to, or requested by, the FHLBB's OGC for it to determine that violations of criminal statutes may have occurred.

In June 1989, an OIG official explained to us that, generally, investigations are not initiated unless laws or regulations appear to have been violated, and based on OIG discussions with OGC officials, no laws or regulations were violated. The OIG official explained that at the time of the OIG review, it appeared that the indications of problems were more appropriate for audit rather than investigation, and plans were underway to audit controls over receivership property. Investigation reports, the official explained, do not contain recommendations for corrective actions. Time constraints did not permit us to fully evaluate the OIG's involvement in the FirstSouth allegations.

## Objectives, Scope, and Methodology

As agreed with the Subcommittee, we assessed 3 of 16 allegations of wrongdoing the Subcommittee referred to us concerning FSLIC's FirstSouth Receivership in Little Rock, Arkansas, and 1 allegation we received while working at the receivership.

Our objectives were to review the four allegations discussed above to determine whether improprieties occurred. We could not fully explore all aspects of the allegations because of the Subcommittee's time constraints. We did our work at the FHLBB and FSLIC headquarters in Washington, D.C., and at the FirstSouth Receivership in Little Rock, Arkansas. To determine whether the OIG had addressed the allegations we received, or similar allegations, we reviewed the OIG's files on investigations done at receiverships, including FirstSouth. Because the status of receivership employees as nonfederal employees had an impact on the results of the OIG's investigation, we also addressed the issue of whether receivership employees should be appointed as federal employees.

In reviewing each allegation, we interviewed current and/or former FirstSouth Receivership employees, including the Managing Officer and former Property Manager, and reviewed records at the receivership. We

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interviewed FHLBB and FSLIC officials to obtain information on the operations of receiverships in general, and specifically FirstSouth. We also reviewed applicable laws, regulations, and internal orders and procedures. Our work was done between March and June 1989, in accordance with generally accepted government auditing standards.

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