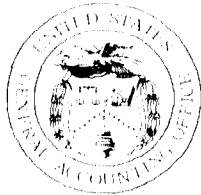


GAO

May 1989

COMMERCIAL FISHING VESSEL

Administration of the Colentino Rose II Loan Guarantee



Resources, Community, and
Economic Development Division

B-232617

May 3, 1989

The Honorable Douglas H. Bosco
The Honorable Peter A. DeFazio
House of Representatives

This report responds to your letter of March 24, 1988, in which you asked us to review the history of a commercial fishing vessel, the Colintino Rose II. This vessel was financed under the Fisheries Obligation Guarantee Program of the National Marine Fisheries Service (NMFS), an agency of the National Oceanic and Atmospheric Administration, Department of Commerce. After the owners of the Colintino Rose II had problems meeting payments, NMFS paid off the loan guarantee, took possession of the vessel, and arranged for its resale.

As agreed with your offices, we developed a chronological history of the Colintino Rose II and assessed NMFS' administrative and financial controls and procedures over actions involving NMFS' (1) approval of the original loan guarantee for the vessel, (2) efforts to resolve the loan default, (3) assurance that the vessel was fit for its intended purpose, and (4) disbursement of funds, including those for vessel repairs.

Results in Brief

In 1979 NMFS approved a loan guarantee for \$875,000 through its Fisheries Obligation Guarantee Program to finance the purchase of the Colintino Rose II. The owners encountered loan repayment problems immediately after the loan closed. From 1979 until 1985 NMFS assisted them by approving additional loan funds and refinancing the original loan. When the owners defaulted on the refinanced loan in 1985, NMFS took custody of the vessel. NMFS then reached an agreement to sell the vessel to a third party, Quest Export Trading Company. From 1985 until 1988 NMFS worked with the original owners and Quest to arrange the vessel's sale, and repaired and reconstructed the vessel. In June 1988 NMFS approved a loan guarantee for Quest to purchase the vessel from the original owners. Through October 1988 NMFS' net disbursements for the Colintino Rose II had totaled \$2.1 million. In October 1988 Quest defaulted on its loan. As of February 1989 NMFS was in the process of resolving the loan default with Quest, according to NMFS headquarters officials.

The loan history of the Colintino Rose II demonstrates that NMFS did not have effective internal control procedures in place and did not adequately oversee the vessel's loan guarantee. The loan history indicates

that, first, NMFS approved the original loan guarantee without ensuring that the original borrowers had the necessary qualifications for the guarantee program. Second, NMFS did not document its consideration of alternatives to resolve the default over the years, nor its reasons for the various steps it took to resolve the default. Third, because NMFS did not ensure that the vessel was originally constructed according to specifications, it subsequently had to expend funds to make the vessel fit for fishing off the Pacific coast. Finally, NMFS did not document its internal controls over disbursements for vessel repairs, modifications, and other expenses.

History of the Colintino Rose II

In 1979 Carl, Patsy, and Constantino Burlesci of Fort Bragg, California, purchased a newly constructed 77-foot trawler, which they named the Colintino Rose II, with a loan of \$875,000 obtained from a private lender. NMFS guaranteed the loan under its Fisheries Obligation Guarantee Program. (App. I describes this program in further detail.) Immediately after the loan closed in 1979, the Burlescis (the original owners) encountered loan repayment problems. In 1981, to help avoid a loan default, NMFS loaned them about \$286,000 from its emergency loan program. The purpose of the loan was to pay overdue principal and interest payments on the original loan and past due amounts owed to various suppliers, thereby avoiding loan default.

However, the original owners continued to have repayment problems, and in 1983 they filed for reorganization under Chapter 11 of the federal bankruptcy laws. In 1984 NMFS paid \$875,000 to the original lender in full payment of the loan guarantee and, as part of the bankruptcy proceedings, approved a new \$845,000 guaranteed loan to refinance the Colintino Rose II. The refinancing resolved the original loan default, according to NMFS headquarters officials.

The original owners' loan repayment problems continued under the new loan. In November 1985 NMFS notified the owners that they were in default and took custody of the Colintino Rose II. NMFS paid the lender \$908,000 in full payment of the loan guarantee on the vessel, including past due interest on the loan.

From 1985 to 1988 NMFS funded repairs and reconstruction of the Colintino Rose II. While undergoing repairs the vessel caught fire. Subsequent marine inspections showed that the vessel's stability for fishing was questionable because the vessel had not been built in accordance with design specifications and had been subsequently modified. According to

NMFS headquarters officials, the original owners had not, as required by the vessel mortgage agreement, obtained NMFS approval of the modifications, which had affected the vessel's stability. In early 1988 NMFS funded a reconstruction project to make the vessel fit for fishing off the coasts of Washington, Oregon, and California. NMFS spent about \$1.9 million in repairs, insurance premiums, custodial fees, reconstruction, and other work from April 1985 through October 1988.

In January 1986 NMFS reached an agreement to sell the vessel to Quest Export Trading Company of Coos Bay, Oregon, but the agreement was delayed, in part, by the fire and the need to reconstruct the vessel. In June 1988 NMFS provided to Quest a \$1,020,000 loan guarantee for purchase of the Colintino Rose II. In September 1988 the vessel, renamed the Sea Quest, was certified by a naval architect for fishing off the coasts of Washington, Oregon, and California.

Through October 1988 NMFS disbursed about \$4 million (see table II.1) for the Colintino Rose II and recouped approximately \$1.9 million in proceeds from loans it guaranteed to refinance the original loan and to finance the purchase of the ship by Quest. NMFS' net disbursements for the vessel through October 1988 totaled approximately \$2.1 million.

Loan payment problems are continuing for the vessel under its new owner. Quest did not make the loan payment due in October 1988. In November, the General Counsel of the Department of Commerce informed Quest that it had defaulted on the mortgage. Quest was also notified that it had not met several other provisions agreed upon at the loan closing, including providing the agency with a second mortgage on another vessel to serve as additional collateral for the loan. NMFS gave Quest until November 25, 1988, to remedy the defaulted position. In February 1989 the Senior Credit Officer at NMFS headquarters told us that it is very probable that NMFS will repossess the Sea Quest because the guaranteed loan is in default.

Appendix II provides a more detailed history of the Colintino Rose II.

Important Controls and Procedures Not Followed

We found several problems with the controls and procedures NMFS used with regard to the Colintino Rose II. These problems are summarized below and discussed in more detail in appendix III.

NMFS Did Not Ensure That Borrower Met Loan Guarantee Requirements

NMFS regulations require that each application be assessed to determine the applicant's eligibility—including financial condition and fishing experience—for a loan guarantee. Specifically, the regulations require that applicants be able to financially meet obligations, demonstrate successful fishing ability, and reasonably ensure adequate net earnings from the project. According to the Senior Credit Officer at NMFS headquarters, NMFS' Southwest Region reviewed and approved the loan guarantee for the Burlescis.

In reviewing the initial loan guarantee in 1979, the Southwest Region cited the applicants' past fishing experience (34 years of fishing for salmon, rockfish, blackcod, and other fish) and their demonstrated hard work and industriousness. While we found that the region obtained a summary of the applicants' fishing experience, we found no evidence of any assessment of the applicants' financial condition.

In 1983 the NMFS Senior Credit Officer reviewed the loan records for the Colentino Rose II. He stated that the original owners did not meet the minimum requirements of the obligation guarantee program for financial condition and fishing experience. He said that before the loan was closed, the original owners' working capital was a negative \$109,500 and their fishing record for the 4 years immediately preceding the 1979 loan did not demonstrate successful fishing experience—2 years showed a net loss and 2 years showed a small profit.

The Senior Credit Officer and the Chief, Financial Services Division, told us that, in their opinion, the loan guarantee should not have been approved. They stated that not all applicable program procedures were followed because of inexperienced field staff. The Senior Credit Officer told us that NMFS headquarters tried to stop the approval, but the region had already approved the guarantee.

NMFS Did Not Document Its Basis for Resolving Defaults

After the original owners defaulted their first loan, NMFS took a series of actions, including refinancing the loan and eventually selling the vessel to Quest, to resolve the default. We found that NMFS did not document its analysis of alternative actions, such as refinancing the loan, foreclosing on the vessel, or selling it, to resolve the original default. There was also no documentation of the later decision to resolve the default on the refinanced loan by repairing and selling the vessel to Quest. Documenting

alternatives and the rationale for specific courses of action is an important internal control to ensure that alternatives are properly analyzed and subsequent actions are reasonable.¹

NMFS program guidance indicates that the preferred methods of resolving problem loan cases are to arrange for the sale of the collateral or to foreclose on the vessel. The procedures state that refinancing should be used only under certain conditions, including the borrower's good past payment record. However, we found no documentation of NMFS' justification for refinancing the original loan. According to the Senior Credit Officer, NMFS did not conduct any eligibility determination for the loan guarantee for the loan refinancing that followed the 1983 bankruptcy filing. He stated that at the time the agency believed the best alternative was to refinance the loan. He added that the agency made a commitment at the time to refinance the loan with a new lender to allow the original owners to make a fresh start. Similarly, we did not find documentation explaining NMFS' basis for deciding to resolve the default on the refinanced loan through the repair and sale of the vessel to Quest.

According to the Senior Credit Officer, the sale of the Colentino Rose II to Quest was not subject to normal loan guarantee requirements because NMFS has wide discretion in approving loan guarantees following a loan default. NMFS regulations provide for "remedies which are deemed most appropriate to protect the Program's interest." We found that, in January 1986, the NMFS Southwest Regional Office reviewed Quest's financial condition and other normal qualifying factors. The review found that Quest's debt-to-net-worth ratio was "marginally acceptable."

We found no documentation after January 1986, when NMFS first evaluated Quest's qualifications, that NMFS reevaluated Quest's financial condition or the viability of the vessel's intended use prior to loan closure in June 1988. The vessel's intended use had changed since January 1986 because of stability problems that prevented it from participating in Alaska fisheries and reduced its revenue-generating capacity, according to the Senior Credit Officer. He said that NMFS evaluated these and other loan qualifying factors but did not document the analysis because of insufficient time and staff.

¹The Standards for Internal Controls in the Federal Government issued by the Comptroller General in 1983 requires that internal control systems and all transactions and other significant activities be clearly documented.

Vessel Not Constructed According to Specifications

The Colintino Rose II was not constructed in accordance with its plans and specifications, according to a marine surveyor who inspected the vessel for NMFS in 1986. As inspections of the vessel would later note, certain changes from the design specifications and later modifications to the vessel affected the vessel's stability. For example, when metal rails around the perimeter of the deck were filled with concrete to make them stronger, the added weight created stability problems.

NMFS program guidance in effect at the time of the original loan guarantee required that, for vessels 80 feet or more in length, a naval architect certify that the vessel was seaworthy. Certification by a naval architect was discretionary for vessels less than 80 feet; the Colintino Rose II was 77 feet.

NMFS records showed that a marine surveyor's examination of the vessel in August 1979 was the most recent inspection of the vessel prior to the November 1979 loan closing. NMFS did not have an architect certify the vessel, according to the Senior Credit Officer. He said that, unlike an architect, a marine surveyor does not have to meet professional or industry-wide certification standards. In this instance, the marine surveyor's examination did not disclose the problems that later inspections would find. A surveyor's inspection is also generally not as comprehensive as that of a certified architect, according to the Senior Credit Officer. In the case of the Colintino Rose II, the surveyor did not test any machinery or make any determination of the vessel's stability characteristics or inherent structural integrity.

Although the use of a naval architect was optional at the time of the loan, the Senior Credit Officer told us that, in his opinion, a certified architect or engineer should have inspected the Colintino Rose II because it was "one-of-a-kind," not a production-line vessel, and was built by a shipyard not well known to NMFS.

Current program regulations state that, where appropriate, inspection and approval by a certified architect or engineer is required for vessels involving a loan guarantee of more than \$500,000. Where an architect or engineer is not used, the required inspection and approval may, at the discretion of NMFS, be made by any competent authority acceptable to NMFS. The current regulations do not provide additional guidance about when it is appropriate to obtain certification such as in the case of the Colintino Rose II, which was a "one-of-a-kind" vessel built by a shipyard not well known to NMFS.

NMFS Disbursement Procedures Not Written

Internal control procedures, including those for disbursements, must be clearly written, in our opinion, so that employees understand appropriate procedures for disbursing funds and make only appropriate disbursements. The written procedures should be purposeful and useful to managers in controlling their operations and to others involved in analyzing operations. We found, however, that NMFS disbursed about \$1.9 million for repairs, insurance premiums, custodial fees, reconstruction work, and other services on the Colentino Rose II with little documentation of disbursement procedures. NMFS officials told us that, while their disbursement procedures are not written, the staff understands what information is needed to approve a disbursement and who has approval authority.

Changes Made by NMFS to Improve Controls

NMFS officials acknowledged the weaknesses we found in the agency's handling of the Colentino Rose II loans. The Senior Credit Officer, Financial Services Division, told us that NMFS has replaced the people in the Southwest Region who were responsible for the Burlesci loan. He also said that the problems with the original loan approval occurred, in part, because at the time the Chief, Financial Services Division, did not have direct personnel authority over the people in the region who were making the loan decisions. He told us that NMFS gave him direct personnel authority over the field staff in 1988 and this has improved program control. For example, the Senior Credit Officer told us that the Chief, Financial Services Division, has approved all decisions related to resolving the Colentino Rose II default. He said that to improve NMFS' documentation of disbursement procedures and in response to our audit findings, the Chief, Financial Services Division, in November 1988, started an effort to review and document the disbursement control process.

We conducted a limited review of five other loans in the NMFS Northwest Region to determine whether the problems we found with approving the Colentino Rose II loan guarantee may be occurring elsewhere. The controls and procedures we reviewed in these five instances were in general compliance with the program requirements for determining applicants' eligibility under the criteria for fishing experience, financial condition, and project feasibility.

Conclusions

The loan history of the Colentino Rose II demonstrates the need to ensure that effective internal control procedures are in place and that there is adequate program oversight for the loan guarantee program. NMFS' inadequate controls ranged from not ensuring that the original

owners qualified under the program to not documenting the analysis of alternatives to resolve the loan defaults, which is important to ensure that alternatives are properly analyzed and subsequent actions are reasonable.

NMFS has acted to improve internal controls by (1) providing the Chief, Financial Services Division, with additional authority over the program, including over regional personnel making loan decisions, and (2) starting an effort to document disbursement control procedures. However, NMFS' current program guidance does not clearly state under what conditions it is appropriate for a marine architect or engineer to survey the vessel to ensure that it is fit for its intended purpose.

Recommendations

We recommend that the Assistant Administrator for Fisheries, National Marine Fisheries Service, direct the Chief, Financial Services Division, to

- ensure that justifications of the actions selected to resolve default situations are documented and
- clarify the regulations by stipulating in program guidance the conditions under which it is appropriate to obtain a certified architect's or engineer's certification.

Scope and Methodology

Our review focused on developing a history of the Colintino Rose II and assessing NMFS controls and procedures in the obligation guarantee program as related to the history of the vessel. We also reviewed a sample of NMFS' disbursement transactions involving the Colintino Rose II to determine the extent to which they met agency requirements.

We interviewed officials and reviewed documents at the Financial Services Division at NMFS headquarters and at the Financial Services Branch offices at the NMFS Northwest regional office in Seattle and the Southwest regional office in Terminal Island, California. We reviewed NMFS records documenting key events in the vessel's history as well as applicable regulations, policies, and procedures relating to those events. We also interviewed and obtained documents from the vessel's original and current owners and their attorneys, the original lender, and a marine surveyor who inspected the vessel.

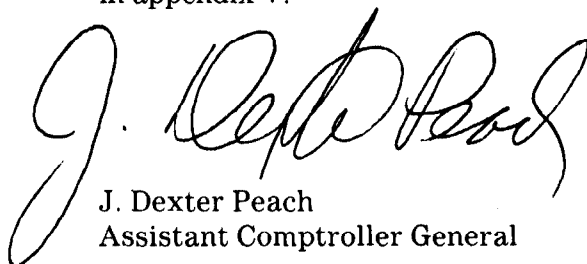
We also reviewed five other loan guarantees approved in 1988 by the Northwest Region in order to determine if weaknesses we found in the

approval of the guarantee for the Colentino Rose II existed in other cases.

We discussed the results of our work with officials at NMFS headquarters and incorporated their comments where appropriate. However, as you requested, we did not obtain official comments on this report from NMFS or the major affected private parties. We performed our work from June 1988 through December 1988 in accordance with generally accepted government auditing standards.

Copies of this report are being sent to the Secretary of Commerce; the vessel's original and current owners; the House Committee on Appropriations; the Subcommittee on Oversight and Investigations, House Committee on Merchant Marine and Fisheries; and other interested parties.

This report was prepared under the direction of Flora H. Milans, Associate Director, (202) 376-9715. Major contributors to this report are listed in appendix V.



J. Dexter Peach
Assistant Comptroller General

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Abbreviations

GAO General Accounting Office
NMFS National Marine Fisheries Service

Description of NMFS Loan Guarantee and Emergency Loan Programs

The purpose of the NMFS Fisheries Obligation Guarantee Program is to make long-term financing available to the U.S. fishing industry by providing a government guarantee of repayment of the debt portion of fishing vessel and shoreside facility construction, reconstruction, reconditioning, or purchasing costs. The program is governed by rules implementing Title XI of the Merchant Marine Act of 1936, as amended by the American Fisheries Promotion Act (P.L. 96-561). An application for a guaranteed loan is submitted by the applicant to NMFS. If the loan guarantee is approved, according to the Senior Credit Officer, Financial Services Division, NMFS, the agency guarantees the private lender's loan to the borrower. In the event of a loan default, such as a missed payment or noncompliance with a mortgage provision, he said the lender can recover the loan amount, plus interest, by submitting a claim to NMFS.

NMFS can resolve the default through a variety of actions, including selling the vessel to a third party, foreclosing on the vessel, and refinancing the original loan through a new loan guarantee, according to the Senior Credit Officer. He said that the borrower is liable to NMFS for any difference between the amount NMFS paid to the lender and the amount NMFS recovers through the sale to a third party or foreclosure on the vessel.

The program receives from the borrower a one-time filing and commitment fee of 1/2 of 1 percent of the amount guaranteed and an annual guarantee fee of 1 percent of the unpaid principal balance.

Effective October 1986 the program may guarantee financing up to 80 percent of a project's cost. To be eligible for the program an applicant must

- possess successful fishing industry ability and experience;
- demonstrate with reasonable assurance that the activity will generate adequate net earnings from the operation of the vessel; and
- meet certain financial requirements, including sufficient working capital to meet obligations, successfully operate the vessel or facility, and protect the program from undue risk.

The vessel or facility for which the financing is to be guaranteed serves as collateral for the program guarantee.

NMFS' Financial Services Division in Washington, D.C., and financial services branch offices in four NMFS regional offices carry out the program. In July 1988 NMFS reported it had approved about 2,200 loans, valued at

**Appendix I
Description of NMFS Loan Guarantee and
Emergency Loan Programs**

about \$840 million, since 1974. About 13 percent of these loans have defaulted, causing NMFS to refund about \$84 million in unpaid principal and interest payments to private lenders.

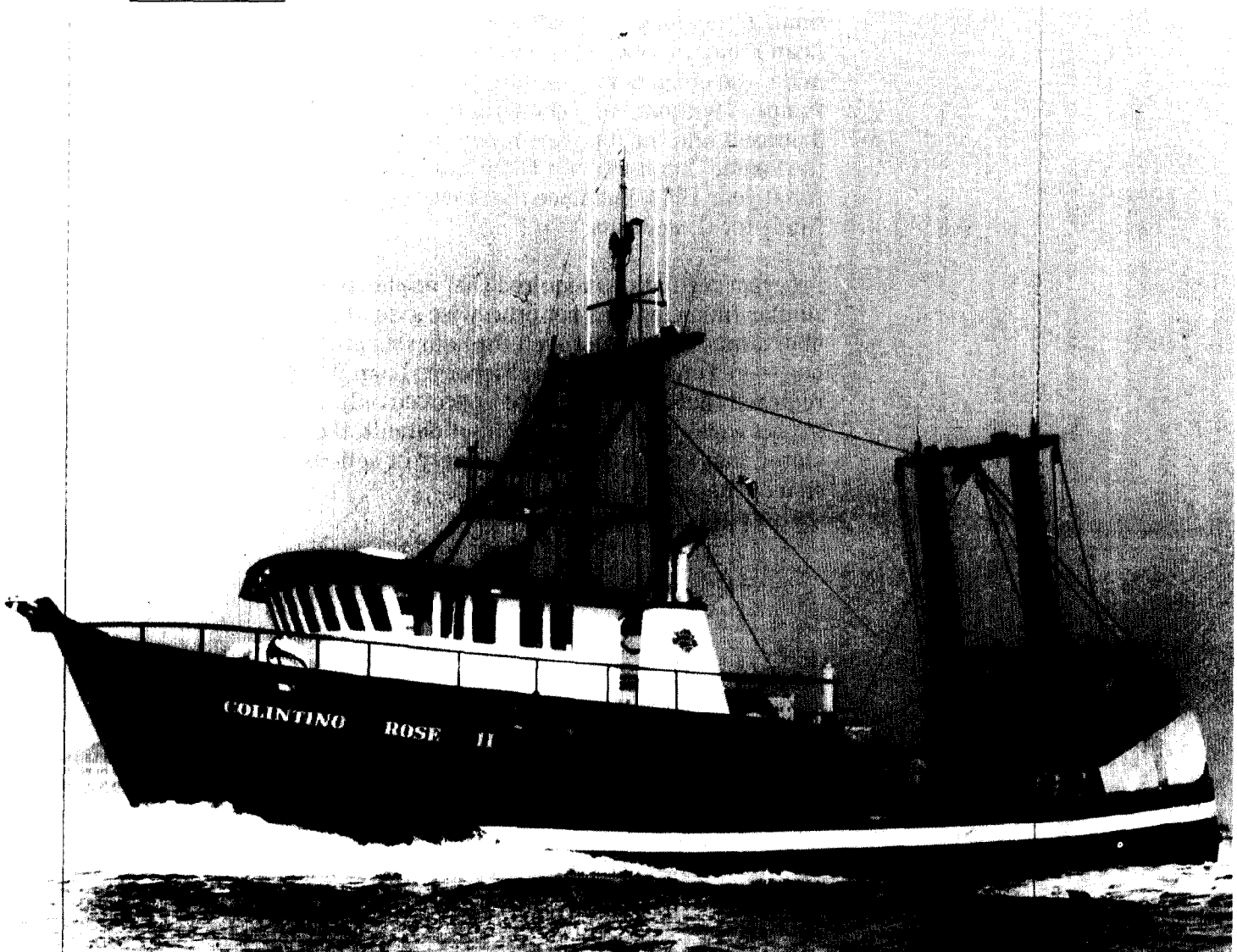
To help owners or operators of commercial fishing vessels avoid default on mortgages financing vessel construction, reconstruction, or reconditioning, the Congress made emergency loans available from the Fisheries Loan Fund. In total, NMFS reserved about \$4 million for vessels financed under the obligation guarantee program and about \$6 million for vessels financed without federal guarantees. The interest rate for the loans was 3 percent and the repayment period was up to 10 years. According to the Senior Credit Officer, these emergency loans were provided through fiscal year 1984, but since that time the Congress has not provided funds for these loans.

Program regulations required that applications be approved only where similar financing was not otherwise available to the applicant on reasonable terms. Loans approved through this program were direct from NMFS and were funded out of the Fisheries Loan Fund. The program also required that applications be approved only where it was reasonable to expect repayment. In the event of default, the program regulations stated that NMFS could take a variety of actions, including taking possession of the vessel and foreclosing.

History of the Colentino Rose II

The Colentino Rose II was completed in 1979 for its original owners by a boatyard in Fort Bragg, California. The owners, also from Fort Bragg, intended to use the 77-foot vessel as a trawler for hake, rockcod, and Pacific cod off the coasts of Alaska, Washington, Oregon, and California.

Fig. II.1: The Colentino Rose II in About 1979



Source: National Marine Fisheries Service.

1979 and 1981 Loans

In November 1979 NMFS approved a guarantee and a loan was made for \$875,000 under the Fisheries Obligation Guarantee Program, for purchase of the Colintino Rose II by the original owners. According to the Senior Credit Officer, NMFS headquarters, the owners initially applied for a loan guarantee under \$500,000, but they increased the amount as a result of increased construction costs. The owners selected the Redwood Empire Production Credit Association, located in Fort Bragg, as the lender.

In February 1980 the original owners failed to make the first quarterly loan payment, and in May 1980 the lender demanded payment on the loan in full as a result of the default. To prevent foreclosure, various actions were taken, including extending payments, to assist the owners with their repayment problems.

In November 1980 the original owners decided to apply for another loan, this one from the NMFS Fisheries Loan Fund. Eligibility for these loans was restricted to fishermen who were in jeopardy of defaulting on mortgages financing vessel construction, reconstruction, or reconditioning. In February 1981 the Director of the NMFS Southwest Region recommended that the owners receive a loan from this fund so that they could pay past due accounts payable and overdue loan payments. NMFS headquarters expressed concern about the owners' ability to service the additional debt but deferred the final loan decision to the Regional Director. In April 1981 NMFS disbursed a \$286,242 loan to the owners. The 3-percent, 10-year loan was secured by a second mortgage on the Colintino Rose II.

Refinancing the 1979 Loan

Difficulties with repayment of the 1979 loan continued after the owners received the emergency loan from the Fisheries Loan Fund. In May 1983 the lender demanded full payment on the loan. About the same time, the original owners filed for reorganization under Chapter 11 of the federal bankruptcy laws.

In May 1984, as part of the bankruptcy proceedings, NMFS arranged refinancing for the original owners' 1979 loan. The new lender, Western-Southern Company, loaned the owners \$845,000 for the Colintino Rose II under the Fisheries Obligation Guarantee Program. NMFS also paid \$875,000 to the 1979 lender in full payment of the loan guarantee. As part of the loan guarantee and refinancing arrangement, NMFS received the \$845,000 from the new loan. The arrangement also stated that the owners' \$286,242 loan from the Fisheries Loan Fund would remain as a

second mortgage on the Colentino Rose II. In July 1985, at the owners' request, the U.S. Bankruptcy Court dismissed the Chapter 11 proceedings.

Default on the 1984 Refinancing

Loan repayment problems continued under the refinanced loan. In June 1985 NMFS reviewed the original owners' financial condition and proposed several ways to make the note current by bringing payments up to date. The owners signed an agreement assigning a portion of the proceeds from their fishing ventures to the Department of Commerce, but the owners continued to be delinquent in their loan payments.

In November 1985 NMFS notified the original owners that their mortgage was in default and took custody of the Colentino Rose II in Alaska. Early in 1986 the lender demanded full payment from NMFS on the guaranteed loan. In April 1986 NMFS paid the lender about \$908,000 (principal and interest) in full settlement of the guaranteed loan.

Repair, Reconstruction, and Resale of the Colentino Rose II

After NMFS repossessed the vessel, a marine survey conducted in November 1985 found that the vessel was "sound and well built but lacking in general maintenance." NMFS began general repairs to the vessel in Kodiak.

In 1985 NMFS, the original owners, and Quest Export Trading Company exchanged correspondence about the possibility of Quest's managing or purchasing the Colentino Rose II. The Coos Bay, Oregon, company had in prior years contracted fishing efforts with various vessels and had also been involved with other international trade activities. Quest indicated that it was interested in the Colentino Rose II in its joint venture¹ fishing off Alaska as well as off the Washington, Oregon, and California coasts. In January 1986 NMFS officials informed Quest that they had approved in principle a \$1.1 million loan to purchase the Colentino Rose II. The loan covered the vessel's fair market value of \$975,000 and \$125,000 in funds for repair work on the vessel.

NMFS requested the original owners to agree to sell the vessel to Quest and sign a bill of sale. However, at that point, complications began to occur with the vessel's renovation. On January 30, 1986, the vessel

¹Joint venture fishing is a fishery operating in U.S. waters 3 to 200 nautical miles offshore in which U.S. fishing vessels deliver their catch to foreign processing vessels at sea.

caught fire while a welding company was working on the vessel. Subsequent inspections after the fire led to concerns about the vessel's stability. The vessel's construction and the original owners' subsequent modifications had added more weight than in the original design. The vessel's stability was of particular importance because of the rough waters of Alaska's fishing grounds, according to NMFS Northwest officials. NMFS paid for returning the vessel to Oregon and for repairs required because of the fire. The vessel arrived at Coos Bay, Oregon, in June 1986.

From June 1986 through November 1987, NMFS studied options and cost estimates to reconstruct the vessel, i.e., lengthening and widening the vessel to make it more stable for fishing off Alaska. The prior work done to repair the damage caused by the fire led NMFS to conclude that an extensive reconstruction was necessary to prepare the vessel for fishing off the coast of Alaska. One naval architect estimated reconstruction would cost \$1.2 million. According to the Senior Credit Officer, NMFS concluded that the estimates were too high. In November 1987 NMFS decided to make the vessel stable for operation off the coast of Washington, Oregon, and California at an estimated cost of \$826,000. NMFS appointed a marine surveyor to represent it during the reconstruction. Reconstruction began in April 1988 and was essentially completed in August 1988.

In May 1988, while reconstruction was under way, the original owners accepted an NMFS offer to settle their outstanding indebtedness on the note and mortgage on the Colintino Rose II and on other obligations from the vessel's operations. Under the agreement, NMFS would release the original owners from obligations involving the Colintino Rose II, including the note and mortgage on the vessel, outstanding liens on the vessel, and California and Oregon personal property taxes on the vessel. In consideration, NMFS requested that the original owners deliver a recordable bill of sale transferring title of the Colintino Rose II to Quest and assign to NMFS all other moneys, properties, rights, or other assets of any kind existing or accruing in connection with settlement negotiations about the Colintino Rose II. This included providing the government a first deed of trust on real property in California.

In June 1988 Quest agreed to meet NMFS' requirements for a \$1,020,000 loan guarantee for Quest's purchase of the Colintino Rose II. Among the agreement's conditions was a provision that NMFS would finance an additional \$100,000, if necessary, to correct stability problems identified by architectural and engineering estimates. The loan was to be secured by a first mortgage on the Colintino Rose II and a \$400,000 second mortgage

on another vessel owned by Quest. As additional security, NMFS required Quest and its owner to unconditionally guarantee the loan. The agreement specified that NMFS was to receive the loan funds (\$1,020,000) to repay prior disbursements for the vessel and to fund ongoing reconstruction work. In September 1988 the vessel, renamed the Sea Quest, was certified by a naval architect for fishing off the coasts of Washington, Oregon, and California, according to NMFS. That same month, Quest began to use it.

Current Status

As of February 1989 NMFS was continuing to work on completing the settlement signed in May 1988 with the original owners, according to the Senior Credit Officer. Under the terms of the agreement, NMFS agreed to release the original owners from their obligations under the note and mortgage on the Colintino Rose II and pay certain other past due debts they owed, including past due personal property taxes on the vessel. These disbursements may be as much as \$65,000. According to the Senior Credit Officer, the original owners conveyed to the government a first deed of trust on a California house and the proceeds from several bank accounts. He said these proceeds may be as much as \$157,000. NMFS is also pursuing an insurance settlement against the firm that was repairing the vessel when it caught fire in January 1986. NMFS officials said they expect to recover \$200,000 to \$350,000.

Payment problems are continuing for the vessel under its new owner. Quest did not make the loan payment due on October 1, 1988, and in November 1988 the General Counsel of the Department of Commerce, acting on behalf of NMFS, informed Quest that it had defaulted on the mortgage by failing to make the October payment. Quest was also notified that it had not met several other provisions agreed upon at the loan closing, including providing the agency with a second mortgage on another vessel to serve as additional collateral for the loan. NMFS gave Quest until November 25 to remedy the defaulted position. On December 12, 1988, an attorney from the General Counsel of the Department of Commerce said that NMFS was in the process of determining follow-on action after reviewing Quest's response.

On February 23, 1989, the Senior Credit Officer told us that it is very probable that NMFS will repossess the Sea Quest from Quest because the guaranteed loan is in default. He stated that NMFS will probably take the vessel, sell it as is, and incur the loss, which will be offset, in part, by insurance proceeds NMFS is anticipating as part of the fire claim that it has submitted to the insurance company. The Senior Credit Officer also

noted that the vessel is not properly insured, which is also a default under the terms of the vessel's mortgage, and that Quest has allowed a number of accounts payable to accumulate, indicating that Quest has a cash problem.

Summary of NMFS Disbursements

Through October 1988, NMFS disbursed about \$4 million for the Colintino Rose II. These disbursements are summarized in table II.1 The disbursements were offset by \$845,000 that NMFS received from the lender who participated in the 1984 refinancing of the vessel. According to the Senior Credit Officer, the agency used these funds to recover part of its disbursement to the original lender after the first loan default. NMFS also received \$1,020,000 from the lender who participated in the Quest loan. According to the Senior Credit Officer, the funds were used to pay prior disbursements for the vessel and to fund ongoing reconstruction work. NMFS' net disbursements for the vessel through October 1988 totaled \$2.1 million.

Table II.1: NMFS Disbursements for the Colintino Rose II Through October 1988

Rounded to the nearest \$1,000		
Year	Description	Amount
1981	NMFS Fisheries Loan Fund loan	\$286,000
1984	Payoff of owners' 1979 guaranteed loan	875,000
1986	Payoff of owners' 1984 guaranteed loan	908,000
1985-88	Direct payments to vendors (insurance, custodial fees, repairs, etc.)	481,000
1985-88	Reimbursement to Quest for repairs, etc.	520,000
1988	Vessel reconstruction	925,000
Total disbursements		\$3,995,000
Less:		
1984	Proceeds from refinancing	845,000
1988	Proceeds from sale of vessel to Quest	1,020,000
Net disbursements		\$2,130,000

Analysis of NMFS Loan Procedures

NMFS records show that for the *Colentino Rose II*, important administrative and financial controls and procedures were not followed. NMFS did not ensure that the vessel's original owners were qualified for loan guarantees, did not ensure that the vessel was stable enough to use for commercial fishing, and did not obtain adequate insurance coverage when it repossessed the vessel. In addition, NMFS files did not contain supporting documentation of its analysis of the new owner's financial condition and other factors before the loan was closed in 1988.

Loan Guarantee Requirements Not Met for Original Loan

Before NMFS approves a loan application, the regulations require it to assess each application to determine its eligibility for a loan guarantee. This assessment involves such factors as the applicant's financial condition, fishing ability, and the feasibility of the project. In reviewing the original owners' application, the NMFS Southwest Region cited the owners' past fishing experience (34 years of fishing for salmon, rockfish, blackcod, and other fish). The Chief of the Fisheries Development Division for NMFS' Southwest Region wrote that the owners

"... have of course demonstrated willingness to endure hard work and have demonstrated industriousness. These qualities according to our social system should be rewarded by financial gain and status."

However, the Senior Credit Officer at NMFS headquarters reviewed the loan records after the original owners encountered difficulties in repaying the loan and stated that, in retrospect, the owners did not meet the minimum program requirements for financial condition, fishing experience, and project feasibility, and as a result the loan guarantee should not have been approved.

Financial Qualifications

According to the Chief, Financial Services Division, and the Senior Credit Officer, the original loan should not have been made, in part because the applicants did not meet the financial qualifications for the program. Although the applicants submitted required financial information, we found no evidence that the region assessed the data during the loan application process to determine the applicants' financial qualification.

At the time of the original owners' 1979 loan, the program could guarantee financing up to 87-1/2 percent¹ of the actual cost of a vessel's construction costs with the remaining funds provided from the borrower's equity sources. In the case of the Colentino Rose II, the equity requirement for the vessel's construction was approximately \$128,000. According to the Senior Credit Officer, "As far as can be determined, the owners put absolutely nothing down."

Program regulations also required that the borrower provide minimum working capital (current assets minus current liabilities) equal to at least 8 percent of the total capitalized cost of the vessel from equity sources. For the Colentino Rose II, the minimum working capital requirement was about \$82,000. According to the Senior Credit Officer,

"A financial statement submitted with the application showed total working capital of \$50,000. Subsequent disclosures indicate the actual working capital available for the Project was \$15,000 in January of 1979 and a negative \$109,500 prior to [loan] closing."

In addition, at the time of loan closing, program regulations required the borrower to provide evidence of sufficient funds to pay the first year's loan guarantee fee and the first year's premium for all required insurance. According to NMFS records, the original owners paid the guarantee fee at closing with insufficient funds in their checking account and the fee was not received until years later. According to the Senior Credit Officer, part of the owners' 1981 Fisheries Loan Fund moneys was used to pay past due insurance premiums.

Fishing Experience

Program regulations require that applicants

"demonstrate a successful background of ability and experience in the fishing industry [italicized in the original] of an appropriate duration, degree, and nature considering the type and magnitude of the project for which financing is being sought . . ."

We found that the region, prior to the loan approval, summarized information provided by the applicants about their fishing experience. The Senior Credit Officer told us, however, that in his opinion available information in the regional files on the applicants' fishing ability indicated that the owners did not demonstrate successful fishing ability.

¹In 1986 the loan guarantee was reduced to 80 percent of a project's cost.

According to documentation in the NMFS files, provided by the original owners, at the time of the loan Carl Burlesci had 34 years of fishing experience in his own vessel and in other boats. According to the Senior Credit Officer, the Burlescis' fishing record for the 4 years immediately preceding the 1979 loan did not demonstrate successful fishing ability. Two years showed a net loss and 2 years showed a small net profit. The owner/captain's share ranged from \$0 to \$41,092 during the 4 years.

The regulations also state that owners of vessels that intend "to operate in the initial stages of an underutilized fishery must possess exceptional [italized in the original] fisheries ability and experience." NMFS records show that the original owners planned to fish for several fisheries, including hake and rockcod, both underutilized fisheries, according to NMFS. The Senior Credit Officer said that the owners did not demonstrate successful fishing ability, let alone exceptional ability.

Viability of Intended Use

Program regulations state as follows:

"Conservative income and expense projections must reasonably assure adequate net earnings from operation of the vessel . . . [and] allow the . . . accumulation of net retained earnings sufficient to provide for operational contingencies . . ."

The original owners' loan application showed projected income and expense data for 4 years. Annual sales were projected at \$600,000, and net profit after taxes ranged from \$18,000 to \$93,000. Included in the forecasted statement was an annual owners' share of \$180,000. In reviewing the financial forecast in retrospect, the Senior Credit Officer said

"There was no evidence that either office . . . [NMFS Southwest Region or NMFS headquarters] attempted to learn something about the underutilized species in the fishery the vessel was designed for. Apparently the Burlescis' pro forma projections were taken at face value."

Fisheries Loan Fund Requirements Not Met

In November 1980 the original owners decided to apply for a loan from the NMFS Fisheries Loan Fund, which provided loans to fishermen who were in jeopardy of defaulting on their mortgages. During review of the owners' eligibility, NMFS headquarters expressed concern about their ability to service the additional debt but deferred the final loan decision to the Director of the Southwest Region. In April 1981 NMFS disbursed a \$286,242 loan to the owners.

We found that the region did evaluate the original owners' capital needs in order to determine how much money they needed from the Fisheries Loan Fund. However, we found that certain other required procedures were not done for this loan. For example:

- NMFS files did not contain, as required, proof of loan refusal from the applicants' bank or other lending institution, as well as information that credit from sources other than banks was unavailable on reasonable terms.
- NMFS files did not show that repayment of the loan would be reasonably assured.

According to the Senior Credit Officer, the required loan provisions were not met because Southwest regional officials ignored them in approving the loan.

No Documentation of Review of Application for 1984 Loan

In April 1983 the original owners filed for reorganization under Chapter 11 of the Federal bankruptcy laws. About 1 year later, in April 1984, as part of the bankruptcy proceedings, NMFS agreed to locate and provide refinancing for two new guaranteed loans. The refinancing resulted in a new \$845,000 guaranteed loan for the Colintino Rose II and a \$200,000 guaranteed loan for another fishing vessel.

Program guidance at the time of the refinancing stated that the options for handling problem loan cases, in decreasing order of preference, included finding a purchaser for the vessel, foreclosing, deferring payments, refinancing, and making advances. The guidance also stated that the use of the last three options, including refinancing, should satisfy certain criteria, such as the borrower's good past repayment history. The guidance specifically stated that the case file should include a brief analysis of the criteria as a basis for the action taken.

The Senior Credit Officer for NMFS Financial Services Division said that the regulations provide the agency considerable discretion in attempting to resolve a defaulted loan. The regulations state, "At the Program's sole discretion, other remedies which are deemed most appropriate to protect the Program's interest may be pursued."

According to the Senior Credit Officer, NMFS did not receive and review a loan application from the original owners for the 1984 loan. He said that NMFS did not review the Burlescis' 1984 financial condition, fishing experience, or the viability of the vessel's intended use because the

review was not required as part of the process to resolve defaulted cases. Such items, however, generally provide a basis for determining the appropriateness of a loan and, in our opinion, would have provided the basis for the refinancing that the program guidance for handling problem cases required.

Vessel Not Constructed According to Specifications

The Colentino Rose II was not constructed in accordance with its plans and specifications, according to a marine surveyor who inspected the vessel in 1986. As inspections of the vessel would later note, certain modifications affected the vessel's stability. For example, when metal rails around the perimeter of the deck were filled with concrete to make them stronger, the added weight created stability problems.

Program guidance in effect at the time of the original loan guarantee required that, for vessels 80 feet or more in length, a naval architect certify that the vessel was seaworthy. Certification was discretionary for vessels less than 80 feet. The Colentino Rose II was 77 feet at the time of its construction.

NMFS records showed that a marine surveyor's examination of the vessel in August 1979 was the most recent inspection of the vessel prior to the November 1979 loan closing. NMFS did not have a naval architect certify the vessel, according to the Senior Credit Officer. He said that unlike an architect or engineer, a marine surveyor does not have to meet professional or industry-wide certification standards. In this instance, the surveyor's examination did not disclose the problems that later inspections would find. A surveyor's inspection is also generally not as comprehensive as that of a certified architect or engineer, according to the Senior Credit Officer. In the case of the Colentino Rose II, the surveyor did not test any machinery or make any determination of the vessel's stability characteristics or inherent structural integrity.

NMFS officials told us that, in their opinion, a certified architect or engineer should have inspected the Colentino Rose II because it was a "one-of-a-kind," not a production-line vessel, and was built by a shipyard not well known to NMFS. According to an NMFS headquarters official, the Southwest Region should have obtained but did not obtain such a certification, although the certification was optional under program regulations.

Current program regulations state that, where appropriate, inspection and approval by a certified architect or engineer is required for vessels

involving a loan guarantee of more than \$500,000. When an architect or engineer is not used, the required inspection and approval may, at the discretion of NMFS, be made by any competent authority acceptable to NMFS. The current regulations do not state when it is appropriate to obtain certification, such as in the case of the Colintino Rose II, which was a "one-of-a-kind" vessel built by a shipyard not well known to NMFS.

Vessel Not Properly Insured After NMFS Possession

When NMFS repossessed the Colintino Rose II in 1985, it did not obtain proper insurance for the vessel. The Senior Credit Officer stated that program procedures require NMFS to maintain insurance after a borrower defaults and the agency obtains possession.

Shortly after taking custody of the Colintino Rose II in 1985, NMFS began funding repairs on the vessel. While the vessel was being repaired, a fire broke out, causing damage estimated at \$300,000 to \$325,000. The Senior Credit Officer told us that the agency's insurance on the vessel did not cover repair work while in port. He said that proper and adequate insurance was not obtained prior to authorization of repair work because the Southwest regional officials failed to do so. NMFS claimed that the repair contractor was at fault for the fire and initiated a claim against the contractor's insurance company. As of February 1989 the claim was in the process of being settled, according to NMFS headquarters officials.

NMFS Disbursement Procedures Not Written

In 1983 the Comptroller General issued Standards for Internal Controls in the Federal Government. This document contains internal control standards to be followed by executive agency managers in establishing and maintaining systems of internal control as required by the Federal Managers' Financial Integrity Act. One of the internal control standards is documentation, which requires that internal control systems and all transactions and other significant activities be clearly documented. Documentation should be complete and accurate and also facilitate tracing the transaction after it has occurred.

We found that from April 1985 through October 1988, NMFS disbursed about \$1.9 million for work and other services for the Colintino Rose II with little documentation of disbursement procedures. According to the Senior Credit Officer, the disbursement procedures are not well documented. He told us that disbursements are made only with specific approval signatures, such as the Chief of the Financial Services Division, accompanied by supporting documentation such as invoices.

We reviewed 25 repair, reconstruction, and other disbursement transactions associated with the Colintino Rose II to determine to what extent they had the required approval signatures and were supported by documentation such as invoices. We found that in each case the Chief of the Financial Services Division had approved the disbursement. For 23 of the 25 transactions, we found an invoice or other documentation in NMFS files to support the transactions. For two transactions we could not locate an invoice or other supporting documentation. The first transaction, which was to reimburse Quest for relocating the vessel to Oregon and for vessel repairs, was for approximately \$73,000. The second transaction, totaling approximately \$8,700, also reimbursed Quest for expenses incurred.

In reviewing other NMFS disbursements for the Colintino Rose II, we also found a \$396 payment for services related to a stability test that had been paid twice. This double payment had not been found by NMFS or reported by the vendor. On December 7, 1988, an official told us that NMFS was attempting to collect the overpayment from the vendor.

NMFS Analysis of New Owner's Financial Condition Prior to Loan Closing Not Documented

We found no documentation after January 1986, when NMFS first evaluated Quest's qualifications, that NMFS reevaluated Quest's financial condition or the viability of the vessel's intended use prior to loan closure in June 1988. The vessel's intended use had changed since January 1986 because of stability problems that prevented it from participating in Alaska fisheries and reduced its revenue-generating capacity, according to the Senior Credit Officer. He told us that NMFS reviewed these and other loan-qualifying factors but did not document the analysis because of insufficient time and staff.

The sale of the Colintino Rose II to Quest was completed in June 1988, about 2-1/2 years after Quest agreed to purchase the vessel. The original bill of sale (signed in February 1986) transferring title to Quest was incorrectly dated. According to NMFS, the bill of sale had been overlooked when all other sale documents were signed. The bill of sale was not signed until 8 days following all other sale documents. Further, NMFS stated that the bill of sale would be "held in trust" until there was agreement on bills to be paid, assignment of a claim for damages, and other matters. In May 1988, several days before the loan to Quest was closed, the original owners signed a bill of sale transferring title to the vessel to Quest.

The regulations state, "At the Program's sole discretion, other remedies which are deemed most appropriate to protect the Program's interest may be pursued." Accordingly, the Senior Credit Officer stated that NMFS was not required to review Quest's financial condition, fishing experience, or the viability of the vessel's intended use, although such items generally provide a basis for determining the appropriateness of a loan.

We found that in January 1986 the NMFS Southwest regional office reviewed Quest's financial condition and other normal qualifying factors. The analysis performed by the Southwest regional office concluded that the loan was "excessive debt" for Quest. The regional analysis found that, on the basis of the vessel's cost to Quest, the company's debt-to-net-worth ratio was "marginally acceptable."

Because of the lengthy and costly loan history of the Colentino Rose II, we believe that NMFS should have documented its analysis of Quest's qualifications before the June 1988 loan closure. Such documentation would have provided a basis for NMFS' decision and allowed for subsequent review of the analysis and decision.

Limited Review of Recent Loans Shows Controls Over Loan Approvals Being Followed

In July 1988 NMFS reported it had approved guarantees for about 2,200 loans totaling about \$840 million since 1974. To gain some insight as to whether the problems we found with the Colentino Rose II might still be occurring, we examined five other guaranteed loans that were reviewed and approved during fiscal year 1988 by the Financial Services Branch of NMFS' Northwest Region. Our review was not intended as an analysis of the entire loan program. We limited our examination to the Northwest Region because, according to the Senior Credit Officer, loan guarantee review procedures are standardized in all NMFS regions and the Northwest Region has granted loan guarantees for vessels used for the same types of fisheries as the Colentino Rose II. While our sample was too limited in scope to allow us to draw conclusions about the adequacy of procedures in the entire loan guarantee program, we found that the controls and procedures we reviewed in these five instances were in general compliance with the program's requirements for determining applicants' eligibility under the criteria for fishing experience, financial condition, and project feasibility.

With regard to the regulatory requirement that vessels with loans in excess of \$500,000 be inspected by a certified architect or engineer

“where appropriate,” we found no evidence that two of the three vessels with loans above that amount had received such an inspection, but NMFS provided reasons why it was not appropriate in these cases to use a marine architect or engineer. Before approving these two loan guarantees, NMFS had marine surveyors examine the vessels. According to the Chief, Financial Services Branch, Northwest Region, certified architects or engineers were not used to assess the vessels’ fitness and sufficiency because, unlike the Colentino Rose II, the vessels were constructed by well-known and high-quality shipyards having their own staff of architects and engineers. Along with NMFS’ Senior Credit Officer, he stated that because the Colentino Rose II was a “one-of-a-kind” vessel, a certified architect or engineer should have inspected and approved the vessel after it was constructed.

Objectives, Scope, and Methodology

In their letter dated March 24, 1988, Congressmen Douglas H. Bosco and Peter A. DeFazio asked us to review the history of a commercial fishing vessel, the Colintino Rose II. They expressed concern about the potential breakdown of NMFS administrative and financial controls in this case. As agreed with their offices, we focused our work on developing a history of the vessel and assessing administrative and financial controls and procedures NMFS used in its handling of the Colintino Rose II. In particular, we examined NMFS' approval of the original loan guarantee, efforts to resolve the loan default, assurance that the vessel was fit for its intended purpose, and disbursement of funds including those for vessel repair.

To review the history of the Colintino Rose II and evaluate the existence and use of key administrative and financial controls, we reviewed documents and interviewed NMFS officials at the following locations:

Office	Location
Financial Services Division	NMFS headquarters Washington, D.C.
Financial Services Branch	NMFS Northwest Region Seattle, Washington
Financial Services Branch	NMFS Southwest Region Terminal Island, California

At these locations we reviewed NMFS correspondence and other records relating to key events in the vessel's history. We also reviewed applicable regulations and NMFS policies and procedures relating to those events.

To supplement our understanding of the history of the Colintino Rose II, we interviewed and obtained records from the family that originally owned the vessel. We did the same for officers of the Quest Export Trading Company, the present owner of the vessel. We also met with attorneys that had represented the original owners and Quest, reviewed loan records supplied by the original lender, and interviewed a marine surveyor who had inspected the vessel.

We discussed the results of our work with officials at NMFS headquarters and incorporated their comments where appropriate.

Our field work was conducted from June 1988 through December 1988. We performed our review in accordance with generally accepted government auditing standards.

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