**IN THE UNITED STATES DISTRICT COURT**
**FOR THE DISTRICT OF NEBRASKA**

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| UNITED STATES OF AMERICA, *ex rel*, JOHN P. RAYNOR, Relator, v. NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION, SHELDON C. PETERSEN, JOHN J. LIST, STEVEN L. LILLY, GLENN L. ENGLISH, DELOITTE TOUCHE USA, LLP, RANDALL B. JOHNSTON, ERNST & YOUNG LLP, MOODY'S CORP.; MOODY'S INVESTORS SERVICE, INC.; THE MCGRAW HILL COMPANIES, INC.; FITCH, INC.; FITCH RATINGS, LTD. Defendants. | ) | CASE NO. 8:08-CV-48<br><br>THIRD AMENDED COMPLAINT FOR DAMAGES UNDER THE FALSE CLAIMS ACT<br><br>JURY TRIAL DEMANDED |

Relator seeks to recover damages and civil penalties on behalf of the United States of America against the Defendants for False Claims made in violation of the False Claims Act, 31 U.S.C. § 3729 et. seq. (the "ACT"), arising out of (1) $3.0 Billion in loans from the Federal Financing Bank ("FFB") to Defendant, National Rural Utilities Cooperative Finance Corporation ("CFC"), under the Rural Economic Development Loan and Grant ("REDLG") program, 7 U.S.C. § 940c-1; (2) "non-program" investments in CFC, as described in 12 C.F.R. § 652.25, made by Federal Agricultural Mortgage Corporation ("Farmer Mac") by virtue of Farmer Mac's purchase of $435.6 Million in electric distribution systems loans; and (3) "program investments" in CFC made by Farmer Mac by virtue of Farmer Mac's line of credit loans to CFC of $1.675 Billion which are ultra vires because Farmer Mac has no express or incidental authority to provide lines of credit loans when there is no intent by Farmer Mac to acquire[1] "… a loan, or an interest in a loan, for an electric or telephone facility by a cooperative lender …" as is required by Farmer Mac's enabling statutory charter.

**JURISDICTION AND VENUE**

1. This Court has jurisdiction over this action pursuant to 28 U.S.C. § 133 and 31 U.S.C. 3729 et seq.

2. Venue is proper in the United States District Court for the District of Nebraska pursuant to 28 U.S.C. 1391(b) and (c). Section 3729(a) of the ACT provides that "[a]ny action under section 3730 may be brought in any judicial district in which any Defendant may be found to reside, or transact business, or in any district in which any proscribed act has occurred". Defendant, National Rural Utilities Cooperative Finance Corporation ("CFC") has forty (40) members in Nebraska with loans in excess of $15 Million. Defendant Deloitte Touché USA LLP has two offices in Nebraska: (i) 1601 Dodge Street First National Tower, Suite 3100, Omaha, Nebraska and (ii) 1248 O St., Suite 1040, Lincoln, Nebraska. Defendant Ernst & Young has an office at Suite 305 11605 Miracle Hills Drive, Omaha, NE.

3. Earlier versions of this Complaint have been filed in camera and have remained under seal for a period of at least sixty (60) days. The Government has filed a Notice of Election to Decline Intervention.

**PARTIES TO THE ACTION**

4. Qui tam Relator, John P. Raynor ("Relator"), is and was, at all times material herein, a citizen of the United States of America residing in Omaha, Nebraska and brings this action on behalf of the United States of America. Raynor personally developed the information

[1] Like Fannie Mae and Freddie Mac, Farmer Mac provides liquidity to the market by buying qualified loans, pooling those loans, and selling Farmer Mac guarantee mortgaged-backed securities.

about the activities of Defendants that led Raynor to believe that the Defendants have perpetrated a fraud upon the United States of America.

5. (a) Defendant National Rural Utilities Cooperative Finance Corporation ("CFC") is a tax-exempt (not-for-profit) financing cooperative formed pursuant to the laws of the District of Columbia and operates out of its offices at 2201 Cooperative Way, Herndon, VA 20171. CFC is controlled by (i) the Electric utilities that are members of the National Rural Electric Cooperative Association ("NRECA") and (ii) by the Board of NRECA. CFC lends funds directly to rural electric utilities and indirectly lends to rural telephone companies through Rural Telephone Finance Corporation ("RTFC"), a taxable cooperative, which is under the dominion and control of CFC.

(b) CFC is an unregulated, non-governmental sponsored entity that exists due to the desire of Defendant, National Rural Electric Cooperative Association ("NRECA") and NRECA members to have a financing cooperative that is under their control. As set forth below, CFC acknowledges that CFC's primary competitor is a government sponsored entity:

> CFC is primarily in competition with other banks for the business of its members. The **primary bank competitor is CoBank, ACB ("CoBank"), a government sponsored enterprise** and member of the Farm Credit System whose status as such gives it the ability to offer lower interest rates in select situations. SEE: 2007 10K, page 9. (Emphasis Added)

(c) CFC is a private entity which was formed because of the support of the U.S. Department of Agriculture ("USDA") Rural Electric Administration (predecessor to the Rural Utilities Service or "RUS") or REA in that:

(i) REA had to approve[2] investments by REA borrowers in CFC's Capital

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[2] PATRICIA LLOYD WILLIAMS, THE CFC STORY: HOW AMERICA'S RURAL ELECTRIC CO-OPERATIVES INTRODUCED WALL STREET TO MAIN STREET 16 (CFC Press, 1995), p. 67.

Term Certificates ("CTC") or CFC's hybrid debt/equity equities; and

(ii) REA further supported CFC's formation allowing "… systems [Electric Cooperatives] could delay payments to REA in order to invest in [CFC issued] CTCs." *See* PATRICIA LLOYD WILLIAMS, THE CFC STORY: HOW AMERICA'S RURAL ELECTRIC CO-OPERATIVES INTRODUCED WALL STREET TO MAIN STREET 16 (CFC Press, 1995), p. 69.

CFC was formed with the support of the USDA in order to facilitate Rural Electric Cooperatives access to private funds (not Government funds) by marketing debt instruments – mortgage backed securities.

6. (a) Defendant National Rural Electric Cooperative Association ("NRECA"), founded in 1942, is a cooperative organization representing the interests of cooperative electric utilities with a special emphasis on seeking Federal government economic support for rural electric utilities. NRECA has more than 900 member cooperatives that serve 40 million people in 47 states. NRECA was formed pursuant to the laws of the District of Columbia and is located at 4301 Wilson Blvd., Arlington, VA 22203.

(b) NRECA sponsored[3] the formation of CFC which is owned by NRECA members.

(c) NRECA is the District 11 Representative with permanent membership on CFC's Board.

(d) CFC "… participates in a multiple employer pension plan managed by NRECA." *See* CFC's 2009 10K, "Benefits", p. 72.

7. Defendant Sheldon C. Petersen ("Petersen") is and has been the Governor and Chief Executive Officer of CFC and RTFC since 1995. Petersen resides at 510 Fortress Circle.

[3] NRECA's annual meeting approved the formation of CFC on March 17, 1969.

SE, Leesburg, Virginia.

8. Defendant John J. List ("List") is and has been the Senior Vice President of Member Services and General Counsel of CFC and RTFC since 1995. Upon information and belief, List resides at 3919 Aspen Street, Baltimore, Maryland.

9. Defendant Steven L. Lilly ("Lilly") is and has been the Senior Vice President and Chief Financial Officer of CFC and RTFC since 1995. Lilly resides at 4285 Phoenix Road, Bealeton, Virginia.

10. Defendant Glenn L. English ("English") has been Chief Executive Officer of NRECA since March 1994. English served on CFC's Board from 1994 through fiscal year 2005. English previously served in the United States House of Representatives from 1975 to 1994. English served on the House Agriculture Committee from 1975 to 1994, and was Chairman of the House Agricultural Subcommittee on Environment, Credit and Rural Development in 1989. Upon information and belief, English resides at 3500 Clarks Crossing Road, Vienna, Virginia.

11. Defendant Deloitte Touché USA LLP ("Deloitte") is an international public accounting firm that has performed the individual audits of CFC, RTFC, and the National Cooperative Services Corporation ("NCSC") as well as the Consolidated Audit for CFC, RTFC, and NCSC - the Consolidated Audit for CFC, RTFC, and NCSC for the fiscal years ended May 31st 2005 thru 2009 and are hereinafter referred to as the "Deloitte Audits". The Deloitte office which provided the audit is located at Suite 800, 1750 Tysons Boulevard, McLean, Virginia.

12. Defendant Randall B. Johnston ("Johnston") is a partner at Deloitte Touché USA LLP, an international accounting firm, and a former partner at Arthur Andersen LLP. Johnston offices in Mclean, Virginia and resides at 7707 W. Huntmaster Lane, McLean, Virginia.

13. Defendant ERNST & YOUNG LLP (Ernst) is an international public accounting

firm that has performed the audits of CFC, RTFC, and the National Cooperative Services Corporation ("NCSC"). Ernst issued Audit Reports with respect to the Combined Audits of CFC and RTFC for fiscal years 2002 and 2003 as well as the Consolidated Audit for CFC, RTFC, and NCSC for fiscal year 2004. Defendant Ernst also issued Audit Reports for the Audits of RTFC for fiscal years 2002, 2003, and 2004. The Combined Audits for the fiscal years ended May 31st 2002 and 2003 and the Consolidated Audit for fiscal year ended May 31, 2004 is hereinafter referred to as the "Ernst Audits". The Ernst office which was responsible for the audit services is located at McLean, Virginia.

14. The following Defendants are hereinafter referred to as the "**Credit Rating Agencies**", which include:

i. Defendant MOODY'S INVESTORS SERVICE, INC. is a division of MOODY'S CORP., a Delaware corporation (collectively "Moody's'). Defendant Moody's provides credit ratings, research and risk analysis to investors. Moody's also maintains offices located at 250 Greenwich Street, New York, New York 10007. Defendant Moody's is a citizen of a state other than the U.S. Virgin Islands.

ii. Defendant, THE MCGRAW-HILL COMPANIES, INC. ("McGraw Hill") is a New York corporation. Standard & Poor's ("S&P") is a division of McGraw-Hill providing credit ratings, risk evaluation, investment research and data to investors. Defendant S&P is located at 55 Water Street New York, New York 10041. Defendant S&P is a citizen of a state other than the U.S. Virgin Islands.

iii. Defendant FITCH, INC. ("Fitch"), and its affiliate, Defendant FITCH RATINGS, LTD. ("Fitch Ratings") (collectively, "Fitch"), is a credit rating agency that has dual headquarters in New York and London. Defendant Fitch Ratings is a part of

Fitch Group, Inc. a subsidiary of a French company, Fimalac, S.A. Defendant Fitch has offices located at One State Street Plaza, New York, NY 10004. Defendant S&P is a citizen of a state other than the U.S. Virgin Islands.

**RELEVANT NON-PARTIES TO THE ACTION**

15. The U.S. Senate's Judiciary Committee in adopting False Claims Reform Act, fully set forth in S. REP. 99-345, 1986 U.S.C.C.A.N. 5266, at 5275, broadly defined the Act's object of protection by defining U.S. Government[4] to include "any Government agency or instrumentability [instrumentality], quasi-governmental corporation, or nonappropriated fund activity".

16. Rural Telephone Finance Corporation ("RTFC") is a taxable cooperative legally domiciled in the District of Columbia, created by CFC in 1987 purportedly to serve the financial needs of the rural telecommunications industry. RTFC's Headquarters is co-located with CFC at 2201 Cooperative Way, Herndon, Virginia 20171. RTFC is under the dominion and control of CFC as more fully described hereinafter.

17. The United States Department of Agriculture (the "USDA") is a Department of the United States Government. USDA's mission statement states that the USDA "provide[s] leadership on food, agriculture, natural resources, and related issues based on sound public policy, the best available science, and efficient management". The USDA, through RUS, administers the Rural Economic Development Loan and Grant ("REDLG") program - a program that provides funding to rural projects through local utility organizations. In this case, the USDA approved and also guaranteed the $3.0 Billion in bonds issued by CFC and purchased by the

[4] The House Judiciary Committee defined the term 'claim' stating, "A claim upon any Government agency or instrumentality, quasigovernmental corporation, or nonappropriated fund activity is a claim upon the United States under the Act". SEE: A&P H.R. REP. 99-660, p. 21. (Emphasis Added).

Federal Financing Bank ("FFB"), an instrumentality[5] of the United States, pursuant to the REDLG program.

18. The Federal Financing Bank ("FFB") is a government corporation created by Congress in 1973 under the general supervision of the Secretary of the Treasury and is designated as an instrumentality of the United States by 12 U.S.C. § 2283. The FFB was established to centralize and reduce the cost of federal borrowing. FFB is a "Government agency or instrumentability [instrumentality], quasi-governmental corporation, or nonappropriated fund activity" referred to in the Senate Judiciary Committee when adopting the False Claims Reform Act. SEE: S. REP. 99-345, 1986 U.S.C.C.A.N. 5266, at page 5275. In this case, in a series of transactions, the FFB purchased $3.0 Billion in bonds issued by CFC under the REDLG program.

19. The Federal Agricultural Mortgage Corporation, commonly known as "Farmer Mac", is a stockholder-owned, federally chartered instrumentality of the United States and is designated as an instrumentality of the United States by 12 U.S.C. § 2279aa-1(a)(1). Farmer Mac was created by Congress in 1988 by the Agricultural Credit Act of 1987, which added a new Title VIII to the Farm Credit Act of 1971 (12 U.S.C. 2279aa et seq.) to establish a secondary market for agricultural real estate and rural housing mortgage loans and to increase the availability of long-term credit at stable interest rates to American farmers, ranchers and rural homeowners. Farmer Mac is a "Government agency or instrumentability [instrumentality], quasi-governmental corporation, or nonappropriated fund activity" as referred to in the Senate Committee of Judiciary when adopting the False Claims Reform Act. SEE: S. REP. 99-345, 1986 U.S.C.C.A.N. 5266, at page 5275.

[5] *See* 12 USC § 2283.

20. a. The National Cooperative Services Corporation ("NCSC") was incorporated in 1981 in the District of Columbia as a private cooperative association. The principal purpose of NCSC is to provide financing to the for-profit or non-profit entities that are owned, operated or controlled by, or provide substantial benefit to, members of CFC. NCSC also markets, through its cooperative members, a consumer loan program for home improvements and an affinity credit card program. NCSC's results of operations and financial condition are consolidated with those of CFC in the accompanying financial statements. NCSC is headquartered with CFC in Herndon, Virginia. NCSC is a taxable corporation.

b. NCSC's membership (owners) consists of CFC and distribution systems that are members of CFC or are eligible for such membership. Thus, unlike RTFC, CFC and NCSC have common ownership.

21. James M. Andrews was and is, during the applicable period, a Government employee and the Administrator of USDA's Rural Utilities, and former NRECA and CFC Board member. During his nomination as Administrator of USDA's Rural Utilities program, Mr. Andrews stated:

> I served 16 years on the NRECA board. Six of those years I served as an officer, including two as the president. As president of NRECA, I served on the board of the National Rural Electric Cooperative Finance Corporation (CFC), a supplemental finance cooperative owned by the members. SEE: Mr. Andrews' speech as nominee before the Hearings of the Agriculture, Nutrition and Forestry Committee on Thursday, November 10, 2005.

Upon information and belief, Mr. Andrews was instrumental in helping to orchestrate the False Claims made by CFC, to Farmer Mac, USDA and FFB.

**THE DOLLAR AMOUNT OF THE FALSE CLAIMS**

22. This portion of the complaint sets forth the dollar amount of the Federal funds

accessed by CFC.

23. CFC was formed so that Electric Cooperatives can access private funds through the capital markets. CFC's formation[6] and functionality is: "[to act] as a conduit [for electric cooperatives] to the domestic and international capital markets." As illustrated below, CFC is now functioning as a conduit for Electric cooperative to Federal funds.

<u>*Farmer Mac*</u>.

24. As of February 28, 2010, per CFC's publicly filed reports (quarterly 10Qs and annual 10Ks), Farmer Mac has loaned CFC or provided CFC funds through purchasing loans from CFC of TWO BILLION, ONE HUNDRED FOURTEEN MILLION, SIX HUNDRED THOUSAND DOLLARS ($2,114,600,000) ("Farmer Mac Funding[7]").

25. FOUR HUNDRED THIRTY NINE MILLION, SIX HUNDRED THOUSAND DOLLARS ($439,600,000) of the Farmer Mac Funding consists of loans sold to Farmer Mac in a loan securitization transaction ("FM Loan Securitization Sale") which was accounted by CFC as a sale[8]. The FM Loan Securitization Sale consists of the following:

a. THREE HUNDRED SIXTY-FIVE MILLION, SIX HUNDRED THOUSAND DOLLARS ($365,600,000) reported in CFC's 2007 10K, FN 3, p. 98;

b. FORTY MILLION DOLLARS ($40,000,000) reported in CFC's 8/31/2007 10Q, FN 3, p. 14; and

c. THIRTY FOUR MILLION DOLLARS ($34,000,000) reported in CFC's

[6] *See* http://web.archive.org/web/20040825073008/www.nrucfc.coop/aboutcfc/whatWeDo.htm.

[7] Farmer Mac as of 12/31/2009 had only $6.1 Billion of total assets.

[8] For instance with respect to the largest transaction CFC's 2007 10K, FN 3, p.98, stated: "On February 15, 2007, the Company sold CFC distribution loans with outstanding principal balances totaling $366 million in a loan securitization transaction. The transaction qualified for sale treatment under SFAS 140." CFC does not report the transaction as occurring with Farmer Mac; however, Farmer Mac was the purchaser.

2/29/2008 10Q, FN 3, p. 15-16.

26. Additionally, as of February 28, 2010, Farmer Mac has loaned CFC on a secured basis, ONE BILLION, SIX HUNDRED SEVENTY-FIVE MILLION DOLLARS ($1,675,000,000) ("Farmer Mac Loans").

27. Since the 2008 Farm Bill, the Farmer Mac Loans are premised upon the new found statutory authority making CFC loans to "*electric or telephone facility by a cooperative lender*" qualified loans[9] within the meaning of 12 USC § 2279aa(9)(C).

*Federal Financing Bank*.

28. As of February 28, 2010, per CFC's publicly filed reports (quarterly 10Qs and annual 10Ks), under the authority of the Rural Economic Development Loan and Grant program (the "REDLG Program"), CFC has borrowed from the Federal Financing Bank ("FFB") THREE BILLION DOLLARS ($3,000,000,000) ("REDLG Loans").

*Farmer Mac and FFB Funding*.

29. The following table integrates the Farmer Mac Funding and from the REDLG Loans through CFC's 2/28/2009 10Q –

**Government Funds Invested in CFC**
(as of 2/28/2010)

| Date | Outstanding 10K | Farmer Mac | USDA | Cumulative Total |
|---|---|---|---|---|
| July 2005 | 2004 | 500,000,000 | - | 500,000,000 |
| Nov. 2005 | 2005 | - | 500,000,000 | 1,000,000,000 |
| Feb. 2006 | 2005 | - | 500,000,000 | 1,500,000,000 |
| May 2006 | 2005 | - | 1,000,000 ,000 | 2,500,000,000 |
| May 2007 | 2006 | 365,600,000 | - | 2,865,600,000 |
| Aug. 2007 | 2006 | 40,000,000 | 500,000,000 | 3,405,600,000 |
| Jan. 2008 | 2007 | 34,000,000 | - | 3,439,600,000 |
| March 2008 | 2007 | 400,000,000 | - | 3,839,600,000 |

[9] As set forth later, Farmer Mac has NO authority because a loan is a 'qualified loan' and such loan pledged as collateral to function in competition with private banks by providing line of credit for loans which Farmer Mac has no intention to purchase, pool, and market through the sale of Farmer Mac guaranteed mortgage backed securities.

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|---|---|---|---|---|
| July 2008 | 2007 | (500,000,000) | - | 3,339,600,000 |
| Sept. 2008 | 2008 | - | 500,000,000 | 3,839,600,000 |
| Dec. 2008 | 2008 | 230,000,000 | - | 4,069,600,000 |
| Jan./Feb. 2009 | 2008 | 270,000,000 | - | 4,339,600,000 |
| Mar./May 2009 | 2008 | 300,000,000 | - | 4,639,600,000 |
| March 2008 | 2008 | (400,000,000) | - | 4,239,600,000 |
| March 2008 | 2008 | 400,000,000 | - | 4,639,600,000 |
| June 2009 | 2008 | 200,000,000 | - | 4,839,600,000 |
| Aug. 2009 | 2008 | 425,000,000 | - | 5,264,600,000 |
| 2/28/2010 | 3Qtr. 10Q | (150,000,000) | - | 5,114,600,000 |
| | | 2,114,600,000 | 3,000,000,000 | 5,114,600,000 |

## EQUAL PROTECTION[10] & THE POLITICS OF INFLUENCE

30. Citing the Government's Notice of Election to Decline Intervention (DE 26, Order unsealing certain pleadings) filed in this case, CFC used the foregoing notice and inactivity of the Securities and Exchange Commission to, in oral arguments, casts aspersions as to Relator's averments made in this complaint. *See* Virgin Islands Bankruptcy Court, Case 3:07-bk-30012-JKF, Doc 1850, Filed 07/18/10, page 21, ¶ 43 & FN 32 (which set up character assassination that took place in oral arguments.)

31. Under information and belief, CFC and NRECA had been able to thwart or forestall investigations[11,12] because of the *politics of influence*[13] ("Politics of Influence").

[10] Selective enforcement of laws is an equal protection issue.

[11] The SEC Office of Inspector General has issued reports regarding Bernie Madoff, Allied Capital, and Allen Stanford that have demonstrated the SEC's reluctance to pursue known deviant activity.

[12] Department of Justice whistleblower who resigned over the "corrupt nature of the dismissal" of the New Black Panther case testified before the U.S. Commission on Civil Rights on July 6. 2010, *See* U. S. Commission on Civil Rights, New Black Panther Investigation. Under information and belief, political influence has been used to quash enforcement of laws within the beltway for a long time.

[13]NRECA uses money, the bedrock support for rural America (even NRECA and CFC do not operate in accord with rural values), and votes (NRECA claims to influence 35 to 40 Million coop patrons) to influence and/or corrupt our Government and undermine the laws of the United States.

NRECA's Politics of Influence rests firmly upon two forms of political currency: money[14] and votes[15].

32. Evidence of CFC's and NRECA's success with Politics of Influence includes, but is not limited to -

a. Special Purpose Legislation: The Farm Security and Rural Investment Act of 2002 implemented *7 U.S.C. § 940c-1* which is the statutory basis that allows CFC access to the REDLG program. CFC is the only company to qualify pursuant to that amendment.

b. Special Purpose Legislation: The 2008 Farm Bill, "Food, Conservation, and Energy Act of 2008", Sec. 5406, "Rural utility loans" amended Farmer Mac's statutory charter by

(i) Amending 12 U.S.C. 2279aa-9 making CFC loans and CoBank's[16] loans eligible loans for Farmer Mac's guarantee; and

(ii) Amending 12 U.S.C. 2279aa-9 to insure CFC loans are not subject to the $2.5 Million investment cap presently contained in 12 U.S.C. 2279aa-8(c)(1).

CFC is the only privately-owned company which is qualified by this legislation to **sell[17] loans to Farmer Mac.**

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[14] NRECA made political contributions of over $5.5 Million in 2009; $5.5 Million in 2008; $4.1 Million in 2007, etc. (see Open Secrets.com).

[15] NRECA claims to represent the interest of some 30 to 40 million rural residents. It sponsors the *Take Action Network*. *See* https://ssl.capwiz.com/nreca/home/ NRECA is an entity that represents rural interest but operates devoid of Rural Values.

[16] CoBank is a Farm Credit Bank institution, which has no need for Farmer Mac. CFC is the only privately owned entity eligible under these amendments to Farmer Mac's statutory charter.

[17] However, the only time CFC sold loans to Farmer Mac was before Farmer Mac had this authority was in the FM Loan Securitization Sale transactions described in paragraph 25 above.

c. CFC corrupted and perverted the administration of Farmer Mac into advancing CFC over $1.3 Billion before passage of the 2008 Farm Bill and Farmer Mac loans to CFC were classified as 'non-program investments[18], when –

(i) non-program investments were restricted in total to a sum of $60 Million or less pursuant to Federal regulations[19,20]; and

(ii) The CFC-Farmer Mac transactions, as private transactions, violated the marketability liquidity requirements (dealing with Farmer Mac's safety and soundness) for non-program[21] investments of 12 C.F.R. § 652.35(c).

d. After the 2008 Farm Bill, CFC corrupted and perverted the administration of Farmer Mac into investments that are *ultra vires*: Farmer Mac functions contrary to its statutory charter[22]; that is, Farmer Mac functions as a bank providing lines of credit to CFC.

e. House of Representatives, Committee on Oversight and Government Reform, held a hearing on June 26, 2008, regarding the GOVERNANCE AND FINANCIAL ACCOUNTABILITY OF RURAL ELECTRIC COOPERATIVES: THE PEDERNALES EXPERIENCE and –

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[18] Farmer Mac classified the investments as non-program.

[19] 12 C.F.R. § 652.35(d)(1) states that Farmer Mac "not invest more than 25 percent of your regulatory capital in eligible investments issued by **any single entity, issuer or obligor**".

[20] Mortgage investments that are program investments are subject to a $2.5 Million investment cap before the 2008 Farm Bill Amendments.

[21] If the investments were program investments, Farmer Mac was restricted by statute to mortgage investment cap of $2.5 Million.

[22] Ironically, when Farmer Mac's charter is altered to authorize the FM Loan Securitization Sale transactions and those transactions become legal, there are no more FM Loan Securitization Sale transactions. The amendment does not work because it would require CFC to sell its loan portfolio and thus contract (become smaller) until CFC became irrelevant.

(i) NRECA's CEO, the CEO, testimony was utterly disrespectful[23] to the Committee as a whole and specifically, to Representative Cooper;

(ii) Mr. English, at the hearing, publicly announced[24] that Representative Cooper was under investigation by the F.B.I. for accessing NRECA's web site; and

(iii) After showing complete disdain for the Committee and publicly accusing a sitting member of Congress of committing a crime, NRECA and CFC have **stymied** further hearings.

Representative Cooper[25] mistakenly presumed NRECA/CFC was independent of the targets of the investigations, aberrant cooperatives such as Pedernales.

f. Neutralizing any and all investigations into the business affairs of CFC.

33. Even though CFC's CEO's own words[26], describes CFC "function as a bridge between electrical co-ops and financial markets" to supplement Agriculture Department's Rural

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[23] e.g., COOPER. Mr. English, so there is co-op misbehavior that would be so bad that would prevent them from being members of NRECA as long as a loca1 vote ratified the decision?
Mr. ENGISH. I will go back again. We have the same situation here. I don't know if the behavior of Members of Congress that prohibit them from being members of this body. *SEE* HT, p. 123-124.

[24] ENGLISH: The people that could give you authorization is myself or others at NRECA, a limited number. Like I said, this is a matter under investigation by the FBI. You can take it up with them. *SEE* HT, p. 154.

[25] Representative Cooper committed two errors: (i) he published an article in the Harvard Legislative Journal critical of coop governance (Electric Co-operatives: From New Deal to Bad Deal?); and (ii) He failed to realize the relationship between the former management of PEDERNALES and CFC. CFC had proposed Bennie Fuelberg, the CEO and General Manager of Pedernales Electric Cooperative, Inc., to serve as Receiver for CoServ. Mr. Fuelberg was indicted in June of 2009 for misapplication of fiduciary property, theft and money laundering.

[26] *SEE* Steven Mufson, *Defaults Plague Little-Known Lender*, WASHINGTON POST, April 30, 2007.

Utilities Service loans, CFC would have financially collapsed had not CFC unlawfully[27] accessed Farmer Mac Funding before the 2008 Farm Bill.

34. NRECA's and CFC's capability to bend those parties charged with enforcing the law to their will as well as their ability to corrupt accountants and ratings agencies represents the worst state of government[28].

## DEFINITIONS

35. In addition to the terms defined in the foregoing paragraphs, for purposes of this pleading, the following terms shall be ascribed the following meanings:

"Coop" means a cooperative association.

"GAAP" means generally accepted accounting principles.

"MD&A" means "Management's Discussion and Analysis of Financial Condition and Results of Operations", an SEC mandated disclosure to inform investors of the reporting companies financial condition and important financial trends.

"SEC Filings" means CFC's annual reports, form 10K; CFC's quarterly reports, form 10Q; and CFC's other information filed with the Securities and Exchange Commission ("SEC") pursuant to law.

"Segment Information" is a required disclosure (primarily financial) about business segments of an enterprise and is required to provide information about the different types of business activities in which an enterprise engages and the different economic environments in which the enterprise operates. This is done in order to help users of financial statements: (i)

[27] There can be no better example of the Politics of Influence than to turn a blind eye to the blatantly unlawful access of Farmer Mac giving effect to the 2008 Farm Bill beginning in July 2005, nearly 3 years before Farmer Mac's charter was amended.

[28] "Society in every state is a blessing, but government, even in its best state, is but a necessary evil; in its worst state, an intolerable one." *See* Thomas Pain, Common Sense, 1776.

better understand the enterprise's performance; (ii) better assess its prospects for future net cash flows; and (iii) make more informed judgments about the enterprise as a whole.

"Electric Loan Portfolio" means the loans made by CFC to Electric Members as defined herein.

"Electric Members" or "CFC's Electric Members" mean the electric utilities that are members of CFC.

"Patron" in this context means a CFC borrower or RTFC borrower.

"Telephone Loan Portfolio" means the CFC loans to RTFC members through RTFC.

"Total Loan Portfolio" means CFC's total loans to members which include the Electric Loan Portfolio, the Telephone Loan Portfolio, and a small loan portfolio (less than 3% of the Total Loan Portfolio) to NCSC.

## GENERAL STATEMENT OF THE CASE

36. Regarding the False Claims Act, the Fourth Circuit in its opinion in *Harrison v. Westinghouse Savannah River Co.,* 176 F.3d 776, C.A. 4 (S.C.), 1999, held:

> According to Congress, after the 1986 amendments the False Claims Act should be broadly construed:
>
> > each and every claim submitted under a contract, loan guarantee, or other agreement *which was originally obtained* by means of false statements or other corrupt or fraudulent conduct, *or in violation of any statute or applicable regulation,* constitutes a false claim.
>
> S. Rep. No. 99-345, at 9, *reprinted in* 1986 U.S.C.C.A.N. at 5274 (emphases added). The courts have implemented the principles embodied in the above-quoted passage in a variety of ways. *See* 176 F.3d at 786.

The Fourth Circuit decision is not the only Circuit Court[29] decision that relies upon the foregoing Senate Report to define a false claim. *See Bettis v. Odebrecht Contrs. of Cal., Inc.*, 393 F.3d

[29] As cited seven circuits have specifically adopted the definition in the Senate Finance Committee Report of a False Claim.

1321, 1326 (D.C. Cir. 2005) (When Congress amended the False Claims Act in 1986, its legislative history recognized fraud-in-the-inducement liability under the Act. Specifically, Congress noted that, under False Claims Act case law, "each and every claim submitted under a contract, loan guarantee, or other agreement which was originally obtained by means of false statements or other corrupt or fraudulent conduct, or in violation of any statute or applicable regulation, constitutes a false claim." S. REP. NO. 99-345, at 9 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5266, 5274.); *United States ex. rel. Mikes v. Straus*, 274 F.3d 687, 697 (2d Cir. N.Y. 2001) (The False Claims Act … was intended to embrace at least some claims that suffer from legal falsehood. Thus, "a false claim may take many forms, the most common being a claim for goods or services not provided, or *provided in violation of contract terms, specification, statute, or regulation*." S. Rep. No. 99-345, at 9, *reprinted in* 1986 U.S.C.C.A.N. 5266, 5274.); *United States ex rel. Quinn v. Omnicare Inc.*, 382 F.3d 432, 439 (3d Cir. N.J. 2004) (Citing the Senate Report, the Court found that False Claims Act aims to impose liability for a broad range of conduct.); *American Textile Mfrs. Inst., Inc. v. Limited, Inc.*, 190 F.3d 729, 737 (6th Cir. Ohio 1999) (The 1986 Senate Report uses similar language to describe the reach of the pre-1986 False Claims Act. **See** S. Rep. No. 99-345, at 9, **reprinted in** 1986 U.S.C.C.A.N. 5266, 5274.); *United States v. Univ. of Phoenix*, 461 F.3d 1166, 1170-1171 (9th Cir. Cal. 2006) (More specifically, in amending the False Claims Act in 1986, Congress emphasized that the scope of false or fraudulent claims should be broadly construed: [E]ach and every claim submitted under a contract, loan guarantee, or other agreement which was originally obtained by means of false statements or other corrupt or fraudulent conduct, or in violation of any statute or applicable regulation, constitutes a false claim. S. Rep. No. 99-345, at 9 (1986), *reprinted in* 1986 U.S.C.C.A.N. 5266, 5274.); *Shaw v. AAA Eng'g & Drafting, Inc.*, 213 F.3d 519, 531 (10th Cir.

Okla. 2000) (The Senate Committee on the Judiciary noted a false claim under the False Claims Act "may take many forms, the most common being a claim for goods or services not provided, *or provided in violation of contract terms, specification, statute, or regulation*." S. Rep. No. 99-345 at 9, *reprinted in* 1986 U.S.C.C.A.N. at 5274.)

37. There are three separate and distinct types of prohibited conduct under the Act when accessing the Government fisc:

a. by means of false statements;

b. by means of other corrupt or fraudulent conduct; or

c. in violation of any … applicable statute or regulation.

This case involves CFC's (an unregulated entity) access of the Government fisc to the sum of over $5 Billion implicating all three of the above forms of prohibited conduct: false statements; corrupt or fraudulent conduct; and conduct in violation of Federal regulations.

38. CFC competes[30] against an instrumentality of the U.S. Government, CoBank, ACB ("CoBank").

39. In a material departure from GAAP, CFC has failed to recognize a catastrophic loan loss on a $1 Billion loan made to Denton County Electric Cooperative, Inc. ("CoServ") which makes every CFC financial statement issued beginning with the November 30, 2002 Financial Statement materially misleading.

40. In a material departure from GAAP, CFC has failed to recognize a catastrophic loan loss on a $600 Million loan made to Innovative Communication Corporation ('ICC") which makes every CFC financial statement issued beginning with the May 31, 2008 Financial

[30] "The primary bank competitor is CoBank, ACB ("CoBank"), a government sponsored enterprise and member of the Farm Credit System whose status as such gives it the ability to offer lower interest rates in select situations." SEE: 2007 10K, page 9.

Statement materially misleading.

41. Upon information and belief, in order to compete against CoBank[31], in 1987, CFC became a predatory lender in the rural market preying upon rural telephone companies and formed, for this purpose, RTFC, a coop through which CFC funded rural telephone loans. Due to CFC's illegal control over RTFC, income earned from loans made to rural telephone companies was unlawfully distributed to CFC's Electric Members. As a tax-exempt coop, CFC is legally required to allocate earned income to the Patron whose business created the earnings. As a Patron of CFC, RTFC is entitled[32] to be allocated RTFC's contribution to CFC's earnings. This conduit concept (CFC operates as a conduit for its patrons) which is embedded within Article XI of CFC's bylaws which provide:

> *Section 1*: **All net savings [net income] …** shall be received by the Association with the understanding that they **are furnished by its patrons as capital** and that the Association is obligated to pay by credits to a capital account … for each patron ….
> …
> *Section 4*: … **net savings [net income] so furnished by *each* patron** is clearly reflected and credited in an appropriate record **to the capital account of each patron** …
> (Emphasis Added)

The above are not gratuitous provisions but is inherent in the very nature of the coop form of business and is a legal requirement[33] (operation as a conduit) for coop tax treatment whether the coop is tax-exempt (as CFC) or taxable (as RTFC and NCSC).

42. CFC failed to allocate income that CFC earned from RTFC's loans to members of RTFC. Instead, patronage income due RTFC was allocated and distributed to CFC's Electric

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[31] CoBank borrows at government agency rates, is better capitalized and operates as a coop. CoBank's primary funding is derived from the sale of Farm Credit System securities (a government agency) to investors in the national and international money markets.

[32] Either through a dividend or credit to RTFC's capital account.

[33] General Counsel Memorandum on Cooperative Netting, GCM 38061, 1979 WL 52855.

Members: members that did not furnish the net savings or net income. The systematic defalcation of RTFC, the "Embezzlement Scheme," is a patently illegal scheme. In furtherance of the Embezzlement Scheme, CFC:

a. Provided long-term, fixed-rate financing to Electric Members at rates subsidized with the profits from the Embezzlement Scheme;

b. Prepared financial information to mask the Embezzlement Scheme and mislead the investing public and the Government as to the profitability of the Electric Loan Portfolio;

c. Submitted the SEC Filings which contained financial information that (i) was materially misleading and (ii) did not comply with generally accepted accounting principles, GAAP; and

d. As the Embezzlement Scheme profits decreased, due to a decrease in the Telephone Loan Portfolio, CFC accessed the Government fisc in violation of Federal regulations for a sum of approximately $5 Billion in lieu of seeking increases in the financing rates paid on funds provided to CFC's Electric Members.

Ernst was the only auditor of CFC that provided transparent financial information. Ernst was sandwiched between Arthur Andersen LLP ("AA") (which went out of business) and Deloitte, whose lead auditor was a former member of AA. By comparing RTFC's[34] financial information to the audits[35] in CFC's SEC Filings, Relator deduced that the PCMS in a five year period resulted in the defalcation of over $262 Million from RTFC by CFC: an un-booked and un-

[34] PCMS scheme can not be deduced without access to RTFC's financial information which is not available to the investing public or the Government.

[35] Ernst audits of CFC for fiscal years 2002, 2003 and 2004 were the only audits that provided transparent financial information.

disclosed claim against CFC's equity.

43. The CFC-RTFC relationship is imbued with illegality and fraud which provided CFC and the other Defendants the necessity to produce materially misleading SEC Filings so that they could continue the Embezzlement Scheme.

44. This complaint is organized relying principally upon the loan losses and Embezzlement Scheme as follows:

a. Part One addresses the unrecognized CoServ Loan loss;

b. Part Two addresses the unrecognized ICC loan Loss;

c. Part Three addresses CoServ and ICC as of May 31, 2009;

d. Part Four addresses the Embezzlement Scheme;

e. Part Five addresses CFC's access to Farmer Mac Funds;

f. Part Six addresses CFC's access to the REDLG Loan program funded by the Federal Financing Bank;

g. Part Seven addresses the Culpability of the Defendants; and

h. Part Eight addresses Relator's knowledge.

## GENERAL ALLEGATIONS

## PART ONE: CoServ Loan Accounting Fraud

***CoServ Loan Loss: General***.

45. Overview: CFC experienced a catastrophic loan loss (the "CoServ Loan Loss") that should have been recognized NO later than December 31, 2002 (CFC's fiscal year 2003) involving a large loan[36] to Denton County Electric Cooperative, Inc. d/b/a CoServ Electric ("CoServ"). CFC's financial statements from November 30, 2002 through the present are

[36] CFC's 5/31/2002 10K (annual report), p. 37, states: "Total loans to CoServ at May 31, 2002 and 2001 represented 4.6% and 4.2%, respectively, of CFC's total loans and guarantees outstanding."

fraudulent and materially misleading because of CFC's accounting for CoServ loan upon its emergence from bankruptcy reorganization and CFC's accounting for the receipt of CoServ's interest payments since November 30, 2002 through the present.

46. In a Bankruptcy reorganization, CoServ reorganized on December 13, 2002 pursuant to a reorganization plan (the "Reorganization Plan") sponsored by both CoServ and CFC. It is CFC's subsequent reporting of the CoServ restructured loan and the reporting of foreclosed assets received in the CoServ restructuring that is gravamen of this count.

47. Upon information and belief, if the CoServ loan loss was recognized as required by GAAP (Generally Accepted Accounting Principles), the resulting loss would then have caused a cascading effect that would have led to the financial collapse of CFC.

48. CFC is required to apply GAAP in CFC's financial reporting including the reporting revolving around the CoServ Loan because:

a. As a Registrant[37] (an issuer) Federal Regulations require[38] CFC to apply GAAP;

b. CFC's Financial Statements contain an attestation from CPA firm stating CFC's Financial Statements are presented "…in conformity with accounting principles generally accepted in the United States" (2003, 10K, p. 72) or words of similar import; and

c. Pursuant to the requirements of Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Sections 1350(a) and (b)), all 10Ks (annual reports) and 10Qs (quarterly

[37] CFC is a registrant within the meaning of *17 C.F.R. 210.1-02(t)*, the Securities Exchange Act of 1934, as amended, because CFC issues debt instruments listed on the New York Stock Exchange, debt instruments through an extensive broker/dealer network, and debt instruments to its members.

[38] Financial Statements are legally presumed to be misleading when there is a departure from GAAP. *17 C.F.R. § 210.4-01(a)(1)* provides that "Financial statements filed with the Commission which are not prepared in accordance with GAAP will be presumed to be misleading or inaccurate …".

reports) filed for fiscal years 2003 and later are certified by CFC's CEO and CFC's CFO as (i) fully complying with the Exchange Act; and (ii) as fairly presenting the financial condition and results of operations of CFC.

CFC affirmatively misrepresents its compliance with GAAP stating: "CFC calculates impairment on certain loans in accordance with SFAS 114 and SFAS 118." *See* CFC's 2003 10K, p. 26.

49. In a material departure from GAAP, CFC materially overstated the carrying amount of the CoServ loan on CFC's Financial Statements (the "CoServ Loan Balance") for CFC's fiscal year 2003 (May 31, 2003 and/or "FY 2003").

50. As FY 2003, the CoServ Loan Balance was overstated by a material sum (over $260 Million) which sum should have been charge-off as a bad debt expense.

51. The material overstatement of the CoServ Loan Balance continues in all of CFC's 10Qs and 10Ks filed through the last published CFC financial statement of February 28, 2010

52. In another material departure from GAAP, CFC proceeded to amortize the CoServ loan loss (the "CoServ Loan Loss") attributed to CoServ by recording all principal and interest received by CFC from CoServ through the last published CFC financial statement of February 28, 2010 as recovery of principal – *no interest income* has been reported by CFC related to payments of the CoServ Loan by CoServ.

53. The effect of CFC's departure from GAAP was to:

a. Spread (amortize) CoServ Loan Loss over a period in excess of ten (10) years or more in order to smooth out[39] CFC's reported income ("Income Smoothing") – earnings management;

[39] Federal National Mortgage Association, commonly known as Fannie Mae, involved Income Smoothing. Income smoothing involves smoothing out earnings so that year-to-year and quarter-to-quarter earnings target are met.

b. Materially understate interest income for all fiscal quarters after November 30, 2002; and

c. Materially overstate its equity by reporting a bloated CoServ Loan Balance that included the sum of (i) the correct amount outstanding to CoServ and (ii) the unamortized CoServ Loan Loss for all fiscal quarters after November 30, 2002.

54. CFC's material departure from GAAP related to the CoServ Loan Loss and the CoServ Loan Balance makes every financial statement since November 31, 2002 fraudulent.

55. Upon information and belief, in another material departure from GAAP, CFC has overstated the value of foreclosed assets received in the CoServ Reorganization.

***Pre-Restructuring CFC-CoServ Loan History***.

56. The CoServ Loan was not reported as impaired by CFC as of November 30, 2000. Per CFC's 11/30/2000 10Q, which was filed 1/16/2001, the CoServ Loan was reflected for the first time in the 'Contingencies' footnote[40] to the financial statements ("FN"), FN 11(d); however, FN exclaimed "*loans have not been classified as impaired*."

57. Pursuant to CFC's 11/30/2000 10Q, the CoServ Loan was $808 Million or 3.8% of CFC's total loans and guarantees outstanding as of November 30, 2000 and then was unquestionably material.

58. By the time of the filing of CFC's 11/30/2000 10Q, the CoServ loan had been placed on non-accrual status and CFC's CoServ Loan Balance was $856 Million.

59. The CoServ Loan was placed on non-accrual status by CFC as of January 1, 2001.

60. As of November 30, 2000, CFC reported 'Members' Equity' in CFC's 10Q of $366 Million. The CoServ Loan Balance was more than 2.2 times the Members' Equity.

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[40] This separate reporting of the CoServ Loan is a CFC admission of the materiality.

61. CFC's 2/28/2001 10Q reported that CFC and CoServ had entered into a 'Master Restructuring Agreement' ("MRA") effective March 16, 2001.

62. During the negotiation of the MRA, CoServ's cash obligations **exceeded** CoServ's cash flow making the continued funding by CFC a necessity in order

a. for CoServ to avoid bankruptcy; and

b. for CFC to avoid recognizing a large CoServ loan loss.

63. The CoServ Loan Balance per CFC's February 28, 2001 10Q was $889 Million per 11(d), p. 15 of the 10Q. CFC had loaned CoServ an additional $81Million in this second quarter including $43 Million since the filing of the 2nd quarter 10Q (11/30/2000) or nearly a $1 Million a day[41] during the period CoServ and CFC were negotiating the MRA.

64. CFC's 2/28/2001 10Q, FN 11(d) did not report any breakdown or detail on the CoServ Loan Balance violating the principle of completeness –

> The principle of completeness, which means that nothing is left out of the information that may be necessary to ensure that it validly represents underlying events and conditions. (FASB Statement of Concepts No. 2, ¶ 80)

65. FASB Concepts No. 2 expression of completeness mirrors the securities law concept of material omissions. *See TSC Industries, Inc. v. Northway, Inc.,* 426 U.S. 438 (1976) (an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important [in context to a proxy] in deciding how to vote.); and 15 U.S.C. § 78u-4(b)(1)(B) as well as 17 C.F.R. § 240.10b-5(b) (… omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading.)

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[41] The 2/28/02 10Q, FN 11(d), p. 16, reports $17 Million in accrued interest that is not included in the above balances.

66. A document not readily available to investors, the Bankruptcy 'Joint Disclosure Statement' (the "JDS") filed as part of CoServ's subsequent bankruptcy reorganization, in the "Loan History with CFC" subsection provided the following information: notes signed as part of the MRA agreement include:

a. $396 Million as Realty Note[42,43] ($296 Million then advanced);

b. **$262 Million of Telecom Notes[44]** ($220 Million then advanced);

c. $389 Million for the Electric Note (all advanced[45]);

d. CapEx note for future investments of $46 Million; and

e. Future commitments for **Telecom of $42 Million** through September of 2001.

The above Notes total is a sum nearly $215 Million higher than the $888 Million that was then

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[42] CoServ Investments included Realty which had NO gross income in 2001 per p. 20 of JDS. The Realty Note included future funding commitments in a back-to-back loan arrangement where CFC would loan to CoServ and CoServ would loan to developers.

[43] ¶ 37 of CFC's January 9, 2002 suit against CoServ stated: "The debt attributable to CoServ's utility [Realty] business, amounting to $296 million at the time of the Restructuring, was restructured under the Utility Credit Agreement. In addition to restructuring this outstanding debt, CFC extended Realty an additional $100 million in financing. The total Realty debt to CFC was represented by a promissory note in the amount of $396 million (the "Realty Note," attached hereto as Exhibit D)." *See* Case 3:02-cv-00067-G Document 1 Filed 01/09/02 Page 7 of 17

[44] CFC's January 9, 2002 suit against CoServ stated: "42. The debt attributable to CoServ's telecommunications business, amounting to $220 million at the time of the Restructuring, was restructured under the Telecom Credit Agreement, and represented by two promissory notes executed by Telecom for $110 million each ("Telecom Note 2" and "Telecom Note 3"). 43. The Telecom Credit Agreement provided for an additional advance facility of up to $42 million ("Telecom Note 1"). As of January 9, 2002, approximately $27 million has been advanced to Telecom and its subsidiaries under Telecom Note 1." *See* Case 3:02-cv-00067-G Document 1 Filed 01/09/02 Page 8 of 17 $242 was advance as of January 9, 2002.

[45] Pursuant to ¶ 31 of CFC's January 9, 2002 suit against CoServ: "The debt attributable to Utility, amounting to $389,070,941.20 at the time of the Restructuring, was restructured under the Utility Credit Agreement, and represented by a promissory note in that amount (the "Electric Note," attached hereto as Exhibit B)." *See* Case 3:02-cv-00067-G Document 1 Filed 01/09/02 Page 6 of 17.

reported by CFC as due and outstanding.

67. While CFC mentioned that CoServ provided telecommunications services, CFC failed to disclose in CFC's SEC Filings that nearly 27% of the CoServ Loan Balance, $242 Million as of January 9, 2002, represented investments in failed CoServ telecommunication ventures. This nondisclosure violated the principle of completeness set forth in FASB Statement of Concepts No. 2, ¶ 80 and is a material omission as defined by Security law.

68. In the JDS CFC and CoServ agreed that the Master Restructuring Agreement fell apart over the telecommunication business of CoServ, stating:

> The March Restructure Documents also required that the telecommunication assets of Affiliates of the Debtors be marketed and sold by September 30, 2001. If the telecommunication assets were not sold by that date, CoServ Telecom was obligated to repay its loans or exercise a "put" option which would require CFC to buy the telecommunications assets of CoServ Telecom for an agreed credit on the outstanding debt. Despite CoServ Electric's efforts to sell the telecommunications businesses during the spring and summer of 2001, no closing occurred or appeared eminent prior to September 30, 2001. **After CFC was advised that CoServ Telecom would exercise its put option, CFC refused to accept the put and ultimately ceased funding the Debtors and/or their Affiliates under the claim of alleged defaults in the Restructure Documents**.
> *See* AMENDED JOINT DISCLOSURE STATEMENT PURSUANT TO 11 U.S.C. § 1125 IN SUPPORT OF THE JOINT PLAN OF REORGANIZATION OF THE COSERV UTILITY DEBTORS, pgs. 18-19, Chapter 11, Case No. 02-40665-DML, file in the Northern Texas Bankruptcy Court. (Emphasis added)

69. On September 26, 2001, CFC filed a Complaint and Emergency Application for Injunctive Relief in the Northern District of Texas, styled, *National Rural Utilities Cooperative Finance Corporation vs. Denton County Electric Cooperative, Inc., CoServ Investments, L.P., CoServ Realty Holdings, L.P., CoServ Utility Holdings, L.P., CoServ Telecom Holdings, L.P.*, Civil Action No. 301-CV1930-L (the "First CFC CoServ Lawsuit").

70. As a result of the First CFC CoServ Lawsuit, on November 30, 2001, the CoServ

Telecom Debtors filed for Chapter 11 bankruptcy protection in the United States Bankruptcy Court for the Northern District of Texas, Fort Worth Division.

71. Following the bankruptcy filing of CoServ Telecom Debtors, CFC accelerated the entire debt of CoServ Electric and its Affiliates and on January 9, 2002, CFC filed another lawsuit against the Debtors and CoServ Realty styled *National Rural Utilities Cooperative Finance Corporation v. CoServ Electric, CoServ Investments, L.P., CoServ Realty Holdings, L.P. and CoServ Utility Holdings, L.P.* in the United States District Court for the Northern District of Texas, Dallas Division, Civil Action No. 3:02-CV0067-G, seeking the appointment of a receiver and judicial foreclosure on the defendants' assets (the "Second CFC CoServ Lawsuit").

72. Following the Second CFC CoServ Lawsuit, **on February 1, 2002**, CoServ and CoServ Realty filed for Chapter 11 bankruptcy protection in the United States Bankruptcy Court for the Northern District of Texas, Fort Worth Division.

***The Bankruptcy Restructuring Agreement***.

73. On 6/26/2002 CFC filed an 8K that announced that on June 17, 2002 CFC (the "6/17/2002 8K") and CoServ executed a Settlement Agreement (the "CFC/CoServ Settlement"); the terms of which provided how the current CoServ Loan was to be restructured in a bankruptcy reorganization and the foreclosed assets CFC would receive in lieu of the payment of the CoServ Loan.

74. CFC's 6/17/2002 8K provided that, after proceeds of a CoBank loan to CoServ are applied, the CoServ Loan on CFC's books would have a $591 Million balance and be amortized as a 35-year loan yielding an average rate of 3.06%.

75. CFC's 6/17/2002 8K provided that CRH Realty Holdings, L.P. ("CRH") and CFC

file the **Real Estate Plan**[46] which provided that:

> "all equity interests, cash, notes and accounts receivable, mortgage notes, properties, licensee rights and other assets of CRH and CRH entities engaged in realty investment and lending to an entity designated by CFC, in full satisfaction of the indebtedness owed by CRH under the amended, restated and consolidated promissory note dated March 15, 2001, **in the original principal amount of $396 million, which was not fully drawn**." (Emphasis added)

At the time of the Master Restructuring Agreement, March 16, 2001, CFC had loaned $296 Million (see ¶ 66 to this petition) and as of the date of the CFC/CoServ Settlement, CFC had advanced over $364 Million[47]. Furthermore, CFC assumed a continuing commitment to provide additional funding[48] to developers borrowing from CoServ. CFC's disclosure in its SEC Filings violated the principle of completeness set forth in FASB Statement of Concepts No. 2, ¶ 80 and is a material omission as defined by Security law.

76. CFC's 6/17/2002 8K disclosed that the **Telecom Plan** provided if the Telecom assets were not sold, the Debtors "will transfer all of the Telecom Debtors' assets to an entity designated by CFC on the later of the effective date of the Telecom Plan or September 30, 2002; … and Unsecured creditors will be paid up to a maximum of $7 million." At that time, CFC had assumed the obligation to provide at least $7 Million[49] with respect to the Telecom Plan.

***The Bankruptcy Joint Disclosure Statement***.

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[46] CFC and CoServ had three plans of reorganization: one which involved the Real Estate business (funding developers); one which involved the telecommunications business; and the plan which involved the utility businesses.

[47] Pursuant to CRH and CFC, as stated in the Realty Plan Disclosure Statement, CFC's claim (advances) was: "The Debtor estimates the Allowed CFC Secured Claim is $364,224,059.00."

[48] The Realty Plan's disclosure statement stated: "As the Debtor's Assets are largely comprised of the Developer Loans, the transfer of the Assets will ensure the future funding by CFC of unfunded advances under the Developer Loans."

[49] The assumed obligations do not add any value to the asset; rather the payment merely free-up the assets from the claim of unsecured creditors.

77. Exhibit C to CoServ's and CFC's JDS for CoServ (the "Utility Plan") was *Debtors' 2002 Post-Bankruptcy Financial Projections* ("CFC/CoServ Financial Forecast"). This document was to reflect the forecasted performance of CoServ for the nine years following the CoServ reorganization including CoServ's indebtedness to CFC.

78. The CFC/CoServ Financial Forecast reflects on page two thereof CFC's Loan Balance as of December 31, 2002 at a balance of $362 Million and not $591 Million as CFC disclosed in CFC's 6/17/2002 8K.

79. For the exact same stream of payments, CoServ and CFC were reporting the loan at approximately $362 Million in the Reorganization Plan and CFC was reporting the CoServ Loan Balance to be $591 Million in CFC's SEC Filings.

80. The CFC/CoServ Financial Forecast set forth the following payments for calendar years 2003 through 2009 pursuant to the Restructured CoServ Loan –

a. A total payment in 2003 of $24,443,300 with $24,429,157 allocated to interest using a 6.75% interest rate and with principal payment of $14,143;

b. A total payment in 2004 of $24,443,299 with $24,428,202 allocated to interest using a 6.75% interest rate and with principal payment of $15,097;

c. A total payment in 2005 of $24,443,299 with $24,427,183 allocated to interest using a 6.75% interest rate and with principal payment of $16,116;

d. A total payment in 2006 of $24,443,299 with $24,426,095 allocated to interest using a 6.75% interest rate and with principal payment of $17,204;

e. A total payment in 2007 of $24,443,300 with $24,424,934 allocated to interest using a 6.75% interest rate and with principal payment of $18,366;

f. A total payment in 2008 of $28,429,960 with $24,423,694 allocated to interest using a 6.75% interest rate and with principal payment of $4,006,266; and

g. A total payment in 2009 of $28,429,960 with $24,153,271 allocated to interest using a 6.75% interest rate and with principal payment of $4,276,689.

Through calendar year 2011, CoServ was to pay CFC nearly $ 236 Million in total payments with $ 218 Million of interest and nearly $ 18 Million of principal. Of the principal payments of $18 Million less than $100,000 was to be paid through calendar year 2007.

81. The CFC/CoServ Financial Forecast did have a notation in the top right hand corner of "$591 Mil – Blended Yield - 3.06%" or the CoServ Loan Balance that CFC was reporting in its SEC Filings[50] for exactly the same stream of cash flow.

***Proper Interest Rate To Determine the CoServ Loan Balance***.

82. With CFC and CoServ reporting the loan at $362 Million based upon a 6.75% interest rate in the Reorganization Plan and CFC purporting to report the same loan at $591 Million using a blended rate of 3.06%[51] raises a material issue: A critical issue is what interest rate should be used to discount the stream of payments to be made by CoServ for CFC to be GAAP compliant.

83. GAAP[52], FAS 114 as modified by FAS 118, requires that CFC record the CoServ

[50] Since CFC is a sponsor of the CoServ Plan, CFC, under penalties of perjury is accounting for the CoServ Loan differently by reporting two materially different loan balances.

[51] When a loan is restructured, the loan balance is a matter of discounting future payments by an interest rate. The lower the interest rate the larger the loan balance is, e.g., if there was no interest rate then the loan balance would be the sum total of all the future payments to be made by the debtor and received by the lender.

[52] FAS 15, Trouble Debt Restructurings, directs parties to FAS 114 stating –
In ¶ 30: "A creditor [CFC] in a troubled debt restructuring involving only a modification of terms of a receivable—that is, not involving receipt of assets (including an equity interest in the debtor)—shall account for the troubled debt restructuring in accordance with the provisions of Statement 114."

loan at the net present value of all future payments **using the historical lending rate** -

> FAS 114, ¶ 42, states that "The Board concluded that a loan that becomes impaired should continue to be carried at an amount that considers **the present value of all expected future cash flows** …." (Emphasis added)
>
> FAS 114, ¶ 14, states that the "**effective interest rate** for a loan restructured in a troubled debt restructuring **is based on the original contractual rate** [53], not the rate specified in the restructuring agreement." (Emphasis and footnote added)
>
> FAS 118, ¶ 6, states that "For a loan that has been restructured in a troubled debt restructuring, ***the contractual terms of the loan agreement*** refers to the contractual terms specified by **the original loan agreement**, not the contractual terms specified by the restructuring agreement. (Emphasis added)

The 'original loan agreement' is a reference to the interest rates applicable when the loan or loans were fully compliant with the CFC/CoServ Loan Agreement(s).

84. GAAP permits CFC to use the interest rates that existed before the MRA[54] (the Master Restructuring Agreement) which are the contractual terms of the original loan agreement or stated differently, the interest rates before the loan became impaired.

85. CoServ's interest rate before the MRA is NOT disclosed by CFC notwithstanding CFC's obligation of transparency. Given the materiality of the CoServ Loan Balance, failure to disclose the history CoServ loan rates violated the principle of completeness set forth in FASB

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In ¶ 33: "A troubled debt restructuring may involve receipt of assets (including an equity interest in the debtor) in partial satisfaction of a receivable and a modification of terms of the remaining receivable. A creditor shall account for a troubled debt restructuring involving a partial satisfaction and modification of terms as prescribed in Statement 114 except that, first, the assets received shall be accounted for as prescribed in paragraph 28 and the recorded investment in the receivable shall be reduced by the fair value less cost to sell of the assets received."

[53] It must be stressed that FAS 114 is not fair value accounting because (i) it applies only to impaired loans and (ii) the lender is entitled to use original interest rate (rather than market rates) to discount the payments and not the market rate. FAS 114 was issued in 1993.

[54] This is distinguishable from Fair Value accounting which would require the use of present interest rates; that is market interest rates. Under information and belief, Fair Value Accounting would have required CFC to report the CoServ Loan Balance at less than $300 Million.

Statement of Concepts No. 2, ¶ 80 and is a material omission as defined by Security law.

86. Nevertheless, the interest rate on CoServ's loan prior to the MRA can be extrapolated from CFC's statements made in public filings and it **was indeed 6.75%**. The information necessary for this extrapolation was only available in one publicly filed document.

87. This interest rate is determined by dividing $60 Million by $889 Million which is 6.75% or coincidentally, the exact interest rate used by CFC and CoServ in the Reorganization Plan. The disclosure required for this extrapolation is found as follows -

a. CFC's 2/28/2001 10Q, on page 29, proved the $60 Million per year stating "*Maintaining CoServ on non-accrual status results in a reduction to interest income of approximately $5 [Million] per month, based on current interest rates*."

b. The same 10Q on page 15, FN 11(d), stated: "*At February 28, 2001, CFC had a total of $889 million in loans outstanding to Denton County Electric Cooperative, Inc., (d/b/a CoServ Electric), a large electric distribution cooperative representing 4.1% of CFC's total loans and guarantees outstanding*."

$60 Million (annual interest) over $889 Million (principal balance as of the date of the statement) **equals 6.75%**.

88. CFC's statement made in public filings and submitted under penalties of perjury support a 6.75% interest rate and impeaches or discredits CFC's use of a 3.06% interest rate[55].

89. An examination of CFC's lending rates disclosed in CFC's annual reports, which are weighted average rates for segments of the loan portfolio, lends no support whatsoever to a 3.06% interest rate, to wit:

[55] The use of 3.06% interest rate is both a material and undisclosed departure from GAAP and further, conflicts with CFC's representations that (i) the Financial Records comply with GAAP and (ii) more specifically, comply with FAS 114.

**The Electric Loan Portfolio as reported in FN 2 to the Financial Statements**

| | 2001 | 2000 | 1999 | 1998 | 1997 | 1996 |
|---|---|---|---|---|---|---|
| Long-term fixed rate secured loans: | 6.85% | 6.74% | 6.69% | 7.02% | 7.20% | 7.29% |
| | | | | | 7.54% | 7.71% |
| Long-term variable rate secured loans: | 7.05% | 7.45% | 5.85% | 6.55% | 6.55% | 6.45% |
| Loans guaranteed by RUS: | 6.31% | 6.53% | 5.87% | 6.36% | 6.49% | 6.47% |
| Intermediate-term secured loans: | 7.08% | 7.41% | 6.62% | 7.39% | 6.70% | 6.60% |
| Intermediate-term unsecured loans: | 7.24% | 7.35% | 6.26% | 6.70% | 6.70% | 6.45% |
| Line of credit loans/short term loans: | 7.35% | 7.59% | 5.99% | 6.70% | 6.70% | 6.60% |

90. Given the coop mutuality requirement, it is incomprehensible to assume that CFC extended credit to CoServ before the loan became impaired at a 3.06% interest rate.

91. Even CFC interest rate on loans to members that are guaranteed by the Rural Utilities Services ("RUS") of the Department of Agriculture which have little or no risk of loss due to a guarantee **do not support** the use of a 3.06% interest rate by CFC to determine the value of the CoServ Loan Balance.

92. The closest RUS Guaranteed Loan Rate to the 3.06% rate in the above table representing May 31, 1996 through May 31, 2001 is 5.87% or 281 basis points more than the rate CFC used, which is a material difference.

93. A $229 Million difference between $591 Million and $362 Million **is material**.

94. The misreporting of the CoServ Loan Balance after the Bankruptcy restructuring is an **intentional**[56] **misstatement** of a material item.

95. The misreporting of the CoServ Loan Balance using a 3.06% interest rate is an **intentional and material departure from GAAP.**

[56] Much of the blame for the Financial Crisis has been attributed to Fair Value accounting. *See* *http://www.cnbc.com/id/27100454* where former FDIC Chair William Isaac blames such policies. FAS 114, **issued in 1993, is not Fair Value accounting**, and has been long applied to banks by the F.D.I.C. CFC has merely booked what loan balance was left and when dealing with the $591 Million balance, CFC backed into an unsupportable interest rate to avoid a charge-off. Using the terms of CoBank loan to CoServ as a benchmark, Fair Value accounting would require an interest rate higher than CoBank's 8.5% rate for a 5-year note with a priority interest in all collateral.

***CFC Did Not Report the CoServ Loan At $591 Million Balance***.

96. CFC reported the CoServ Loan Balance at $652 Million when the CoServ restructuring was implemented. CFC's 11/30/2002 10Q, FN 11(d), p. 20, stated:

> **At November 30, 2002 and May 31, 2002, CFC had a total of $652 million and $1,003 million, respectively, of loans outstanding to CoServ**, a large electric distribution cooperative that provides retail electric service to residential and business customers in an area where there has been significant residential and commercial growth in and adjacent to its current service territory over the last few years. Total loans to CoServ at November 30, 2002 and May 31, 2002 represented 3.0% and 4.5%, respectively, of CFC's total loans and guarantees outstanding. (Emphasis added)

97. An intentional overstatement by CFC of the CoServ Loan Balance of $229 Million (from $362 Million to $591 Million) transmuted to an intentional overstatement of $290 Million when compared to the CoServ Loan Balance of $362 Million applying a 6.75% interest rate to discount the CoServ payments.

98. CFC has never proffered any explanation of why the CoServ Loan Balance grew or expanded from $591 Million as set forth in the settlement agreement announced in CFC's 6/17/2002 8K to $652 Million, a $61 Million difference. This nondisclosure violated the principle of completeness set forth in FASB Statement of Concepts No. 2, ¶ 80 and is a material omission as defined by Security law.

99. It is impossible for the exact same stream of cash flows using the same interest rate (3.06%) to have two materially different discounted values: $591 Million and $652 Million – a $61 Million difference which is material.

100. The payments made between the date of December 31, 2003 and February 28, 2010 comport to the payments as set forth in Exhibit C to CoServ's and CFC's JDS for CoServ - *Debtors' 2002 Post-Bankruptcy Financial Projections* ("CFC/CoServ Financial Forecast").

101. CFC's Adjusted Net Margin[57] (income) for FY 2003 was $138 Million. *See* 2003 10K, p. 30. Thus, -

a. A $61 Million charge to earnings would have reduced CFC's Adjusted Net Margin by 44%, a material sum; and

b. A $290 Million charge to earnings is more than twice the sum of CFC's Adjusted Net Margin and thus, a material sum.

102. CFC's Adjusted Members' Equity[58] for FY 2003 was $454 Million. *See* CFC's 2003 10K, p. 33. Thus, -

a. A $61 Million charge to Adjusted Members' Equity would have reduced Adjusted Members' Equity by more than 13%, a material sum; and

b. A $290 Million charge to Adjusted Members' Equity would have reduced Adjusted Members' Equity by more than 63%, a material sum.

103. A $61 Million difference in the CoServ Loan Balance between $591 Million and $652 Million is **material**.

104. Furthermore, A $229 Million difference in the CoServ Loan Balance between $591 Million and $362 Million is **material**.

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[57] CFC ignores the effect fluctuations in the value of derivatives for purposes of allocating margins to members and measuring performance, stating in the 2003 10K, p. 30, that: "For the purpose of making operating decisions, CFC subtracts the derivative forward value and foreign currency adjustments from its net margin when calculating TIER and for other net margin presentation purposes. … In addition, since the derivative forward value and foreign currency adjustments do not represent current period cashflow, CFC does not allocate such funds to its members and thus excludes the derivative forward value and foreign currency adjustments from net margin when making certain presentations to its members and in calculating the amount of net margins to be allocated to its members."

[58] CFC's 2002 10K gave this explanation for adjustments related to fluctuations in the Fair Value of derivatives: "As long as CFC holds its derivative instruments to maturity and CFC and its counter parties perform in accordance with the terms of the instruments, there will be no impact on earnings or cash flow over the life of the derivative as a result of adopting SFAS 133. It is CFC's policy to hold derivatives to maturity." *See* 2002 10K , p. 32

105. The misstatement of the CoServ Loan Balance constitutes an **intentional misstatement**.

***<u>CFC Did Not Reflect Any Loss Due to the CoServ Restructuring</u>***.

106. CFC recognized NO loan loss as a result of CFC's departure from GAAP in reporting the CoServ Bankruptcy Restructuring.

107. In fact, CFC violated GAAP by recording more value (assets) upon the completion of the CoServ restructuring than CFC had reflected on the books before the CoServ restructuring.

108. As of May 31, 2002, CFC reported the CoServ Loan Balance at $1,003 Million. *See* 2002 10K, FN 12(d), p. 94.

109. Because of difficulties delaying the closing of the CoServ and CFC Telecom Plan, CFC did not fully report (Telecom Assets were not reported in CFC's 11/30/2002 10Q) the CoServ Restructuring until filing CFC's 2/28/2003 10Q – the quarter following the effectiveness of the CoServ utility reorganization.

110. CFC's 2/28/2003 10Q reflected $1,030 Million in total assets related to the former CoServ Loan Balance, a $27 Million **increase** from the FY 2002 year-end balance (when the CoServ loan was on non-accrual) of $1,003 Million.

111. Based upon CFC's 2/28/2003 10Q, the $1,030 Million is reflected as follows:

| | | |
|---|---|---|
| Foreclosed Assets | $369 Million | 2/28/03 10Q, FN 4, p. 13. |
| CoServ Loan Balance | $634 Million | 2/28/03 10Q, FN 11(d), p. 22. |
| Cash Received[59] | <u>$27 Million</u> | 2/28/03 10Q, FN 11(d), p. 23. |

[59] CFC received cash from the Real Estate Plan which was not included in either the loan value or Foreclosed Asset value, stating in the 10Q at page 23, that: "CFC received approximately $27 million in cash from the lock box that was established to collect all payments on notes receivable from the developers. CFC reduced the outstanding loan balance to CoServ by the cash received and the fair value of the notes receivable and properties."

Total CoServ Assets as of 2/28/03 1,030 Million

112. While CFC's 2/28/2003 10Q disclosed the information to compute the value of CoServ assets carried on CFC's books, nowhere did CFC disclose that assets reflected more than the CoServ Loan Balance reported in CFC's 2002 10K.

113. Upon information and belief, CFC received another $10 Million in cash from a CoBank Loan[60] to CoServ which proceeds (pursuant to CoServ and CFC JDS filed in the CoServ Reorganization) were to be paid to CFC.

114. Upon information and belief, CFC recorded directly or indirectly a post-reorganization value of $1,040 Million for a loan which had a pre-reorganization balance of $1,003 Million.

115. GAAP, FAS 15, ¶ 38, in the accounting by creditors' portion [CFC is the creditor], requires: "Legal fees and other direct costs incurred by a creditor to effect a troubled debt restructuring shall be included in expense when incurred."

116. CFC's statements in disclosures statements submitted under penalties of perjury to Realty plan and the CoServ Utility plan impeach[61] CFC's accounting, to wit:

a. On page 20 of the JDS for the Realty Plan, CFC's secured claim (Class 2 Claim) is listed as impaired; and

b. On page 28 of the JDS for CoServ Utility, CFC's secured claims (Class 2 Claims) is listed as impaired.

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[60] CFC subordinated its collateral interest in the CoServ assets and cash flow to CoBank in order to receive the $10 Million. CoBank was to make a 5-year loan to CoServ at an 8.5% interest rate. CoBank's interest rate makes CFC's 3.06% interest rate more offensive and unrealistic.

[61] While the Telecom Plan is not available it is obvious that CFC's loan was impaired given that $262 Million in loans resulted in assets with an Agreed Value of $28 Million.

CFC intentionally lied to either its investors or the CoServ creditors.

117. Upon information and belief, CFC overstated FY 2003 earnings by at least $27 Million or nearly 20% of CFC's Adjusted Net Margin (adjusted income) for FY 2003 by rolling CoServ Reorganization fees and expenses into the value of foreclosed assets received and/or the CoServ Loan Balance.

118. Under information and belief, if the CoBank $10 Million loan was funded, CFC overstated FY 2003 earnings by at least $37 Million or nearly 27% of CFC's Adjusted Net Margin (adjusted income) for FY 2003 by rolling CoServ Reorganization fees and expenses into the value of foreclosed assets received and/or the CoServ Loan Balance.

119. Whether CFC's adjusted net margin was overstated by $27 Million or $37 Million, such sums are **material**.

120. Furthermore, the departure from GAAP constitutes an **intentional misstatement**.

***Material Omission – Disclosure in re investment in CoServ Telecom***.

121. The First CFC CoServ Lawsuit was filed September 26, 2001 over a dispute over CoServ's Telecom business as set above.

122. The subsequent filings of CoServ's affiliates, the Telecom Debtors, resulted in the acceleration of CoServ's indebtedness and the Second CFC CoServ Lawsuit filed January 9, 2002.

123. The Second CFC CoServ Lawsuit resulted in CoServ's February 1, 2002 Bankruptcy filing.

124. CoServ's Telecom business was the reason that CoServ ended up in bankruptcy; nevertheless, CFC's investors know virtually nothing about CoServ's Telecom business.

125. As of January 9, 2002, CFC had loaned CoServ nearly $262 Million related to CoServ's Telecom Business. The Second CFC CoServ Lawsuit, filed by CFC, stated -

a. "42. The debt attributable to CoServ's telecommunications business, amounting to $220 million at the time of the Restructuring, was restructured under the Telecom Credit Agreement, and represented by two promissory notes executed by Telecom for $110 million each ("Telecom Note 2" and "Telecom Note 3");" and

b. "43. The Telecom Credit Agreement provided for an additional advance facility of up to $42 million ("Telecom Note 1"). As of January 9, 2002, approximately $27 million has been advanced to Telecom and its subsidiaries under Telecom Note 1."

*See CFC v. Denton County Electric Cooperative, Inc., District Court for the Northern District of Texas*, Case 3:02-cv-00067-G Document 1 Filed 01/09/02 Page 8 of 17.

126. In a November 27, 2002 *Motion To Enforce The TeleCom Plan*, CFC stated:

"16. Debtors could not sell the Telecom Assets. Therefore, CFC incorporated DTP as the entity to whom the Telecom Assets would be transferred. In addition to taking over the business, CFC committed to **paying up to $6.5 million** of Telecom's outstanding unsecured indebtedness to creditors. While Telecom is directly indebted to CFC in excess of $262 million, **the parties agree that the Telecom Assets are valued at only $28 million ["Agreed Value"]**. These are substantial financial commitments and they are the only financial commitments to which CFC agreed regarding Telecom." (Emphasis added)

127. Based upon the above Motion, CFC knew that CoServ and CFC lost at least $240 Million in CoServ Telecom business, which is calculated by subtracting from the total of $262 Million and $6.5 Million or $268.5 Million, the Agreed Value of the Telecom Assets of $28 Million.

128. This Agreed Value was also confirmed by the subsequent sale of the Telecom business. In the 2/29/2004 10Q, FN 4, p. 13, CFC stated: "On October 27, 2003, CFC sold the Denton Telecom Partners d/b/a Advantex (telecommunication assets received as part of the

CoServ bankruptcy settlement) for $31 million in cash." CFC's investment in CoServ's Telecom business after receiving the business as a foreclosed asset is not discernable.

129. CFC had a substantial and material loss due to lending to CoServ's Telecom business, however, -

a. did not recognize any loss with respect to CoServ bankruptcy reorganization; and

b. did not disclose this fact, the loss on CoServ's Telecom Business, to any investors.

This nondisclosure of the loss on lending to CoServ's telecom business violated the principle of completeness set forth in FASB Statement of Concepts No. 2, ¶ 80 and is a material omission as defined by Security law.

130. The loss in the CoServ Telecom business was allocated to either the post-reorganization CoServ Loan Balance and/or the value of foreclosed assets.

131. The failure of CFC to disclose the loss incurred in the Telecom business in light of CFC reporting the CoServ Loan Balance at $652 Million per the 11/30/2002 10Q, and reporting foreclosed assets at $369 Million per the 2/28/2003 10Q, make such a material omission within the meaning of 15 USC § 77k(a), of 15 U.S.C. § 78u-4(b)(1)(B), and 17 C.F.R. § 240.10b-5(b) , e.g. "… omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading …."

***CFC's Accounting for the CoServ Loan is an Admission or Proof that the Loan is Overstated*.**

132. Overview: If CoServ's payments were allocated between principal and interest, through calendar year 2009, CFC would have reported:

a. Over $170 Million in interest income if a 6.75% rate was applied; and

b. Over $103 Million in interest income if the embedded 3.06% (actually 2.25% interest rate through 2007) interest rate was applied.

CFC has NOT reported any interest income from the CoServ payments through February 28, 2010. Undeniably, the only cogent explanation for CFC's treatment of the CoServ Loan and the application of CoServ Loan payments is the fact that CFC is amortizing the CoServ Loan Loss.

133. From November 30, 2002 through February 28, 2010, CFC has reported the CoServ Loan on a non-accrual basis, to wit:

a. CFC's 11/30/2002 10Q, FN 11(d)[62], p. 21, states: "All [CoServ] loans have been on non-accrual status since January 1, 2001;" and

b. CFC's 2/28/2010 10Q, FN 13(c), p. 26, states: "All restructured loans have been on non-accrual status since January 1, 2001."

134. To date, the CoServ Loan has been on non-accrual status for **7 years, 3 months**.

135. CFC amortizes the CoServ Loan Loss by charging all the payments received from CoServ for the past 7 years, 3 months against the CoServ Loan Balance, a practice which -

a. For all quarters after November 30, 2002 materially understates CFC's adjusted net margin (income) by not reflecting interest income as interest; and

b. CFC is amortizing the CoServ Loan Loss by offsetting the CoServ Loan Balance with a portion of the CoServ payments which constitute interest income[63].

136. CFC effects the amortization through a general misunderstanding of many people regarding the significance of non-accrual status.

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[62] This Footnote, on p. 21, also stated "On December 13, 2002, CoServ emerged from bankruptcy and the Electric Plan and Telecom Plan became effective."

[63] For the first 5 years, CoServ's largest principal payment was under $20,000 so the payments constitute nearly all interest.

137. Non-accrual status is only relevant **as to the timing** of the reporting of the receipt of interest income and principal payments and means only that the CoServ Loan payments are being reported on a cash basis.

138. Non-accrual status does NOT transmute interest income into principal.

139. The Farm Credit Administration has enacted Federal regulations **applying GAAP**[64] that address the recognition or non-recognition on income when a loan is on non-accrual status and payments are being received, stating:

> 12 C.F.R. § 621.8 Application of payments and income recognition on nonaccrual loans.
>
> Each institution shall employ the following practices with respect to application of cash payments on nonaccrual loans:
>
> (a) If the ultimate collectibility of the recorded investment, in whole or in part, is in doubt, any payment received on such loan shall be applied to reduce the recorded investment to the extent necessary to eliminate such doubt.
>
> (b) Once the ultimate collectibility of the recorded investment is no longer in doubt, payments received in cash on such loan may qualify for recognition as interest income if all of the following characteristics are met at the time the payment is received:
>
> (1) The loan does not have a remaining unrecovered prior chargeoff associated with it, except in cases where the prior chargeoff was taken as part of a formal restructuring of the loan;
>
> (2) The payment received has come from a source of repayment detailed in the plan of collection;
>
> (3) The loan, after considering the payment, is not contractually past due more than 90 days and is not expected to become 90 days past due, or a repayment pattern has been established that reasonably demonstrates future repayment capacity.
>
> (c) … (not applicable).

140. 12 C.F.R. §621.8(a) is generally a pre-restructuring (when loans deteriorate enough that the loan moves from performing to non-performing) and NOT post-restructuring

[64] The Farm Credit Administration institutions lend to the same segment, rural lending, as CFC and one Farm Credit Administration institution, CoBank, is considered by CFC to be CFC's chief competitor.

methodology – a 'cost recovery methodology'. The debtor's ability to pay principal *must be in doubt*[65] and then, subpart (a) requires all payments to be credited against loan principal.

141. The cost recovery methodology is NOT applicable to the CoServ Loan because of the bankruptcy restructuring which was a successful restructuring. CFC's 2009 10K, p. 38, CFC stated: "To date, CoServ has made all payments required under the restructure agreement and capital expenditure loan facility."

142. The so called 'cost recovery methodology' is a major step beyond placing a loan on non-accrual basis. The methodology focuses upon the ability of the debtor to make payments that enable the lender to recoup 'loan principal' when there is an expectation that not all principal will be collected.

143. On the other hand, non-accrual status focuses on the ability of the debtor to make interest payments[66]. If the ability to pay interest is in doubt a loan should be placed on non-accrual basis.

144. Absent circumstances contemplated in 12 C.F.R. §621.8(a), when the lender is secured and has expectation to receive payments of both principal and interest from the debtor, GAAP expects a lender to report interest. The Federal Regulations capture this GAAP concept in 12 C.F.R. §621.8(b).

145. Post-bankruptcy, CoServ had the capacity[67] to make the payments of both principal and interest to CFC. In fact, as disclosed in CoServ's JDS, CoServ's pre-reorganization

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[65] Obviously, if the collection of principal is in doubt, it is probable that interest will NOT be collected.

[66] Principal vs. interest is a major difference; that is, the difference between earning money on a loan in contrast to having a loss of principal.

[67] CoServ's problems did not arise from failed utility operations but rather from a failed telecommunications venture and failed investments. The Bankruptcy Restructuring moved ALL of these toxic assets to CFC leaving CoServ with its otherwise successful utility businesses.

indebtedness related to the utility business to CFC exceeded[68] the post-reorganization indebtedness of $362 Million. CoServ only filed bankruptcy when CFC accelerated indebtedness of CoServ Utility as a result of the Telecom businesses bankruptcy.

146. Applying the standards explicitly set forth in 12 C.F.R. §621.8(b), CFC should recognize interest income, for the component of CoServ's payment which is interest, when received because:

a. Pursuant to Subpart 1 of §621.8(b), the CoServ loan was formally restructured;

b. Pursuant to Subpart 2 of §621.8(b), the payment has come from the operation of CoServ's utility businesses (the only businesses CoServ operates); and

c. Pursuant to Subpart 3 of §621.8(b), the CoServ Loan is not contractually past due more than 90 days and is not expected to become 90 days past due.

CFC's 2003 10K, FN 13(d), p. 104 stated: "Payments by CoServ to CFC are current as agreed to in the bankruptcy plan."

147. The facts do not support CFC's use of the 'cost recovery methodology' after the emergence of CoServ from formal bankruptcy reorganization with CoServ <u>stripped of its unprofitable investments and unprofitable telecom business</u>[69] and **left only[70] operating** CoServ's profitable utility businesses. Further, CoServ's post-reorganization loan of $362 Million, using a

[68] Pursuant to ¶ 31 of CFC's January 9, 2002 suit against CoServ: "The debt attributable to Utility, amounting to $389,070,941.20 at the time of the Restructuring, was restructured under the Utility Credit Agreement, and represented by a promissory note in that amount (the "Electric Note," attached hereto as Exhibit B)." *See* Case 3:02-cv-00067-G Document 1 Filed 01/09/02 Page 6 of 17.

[69] CoServ was stripped of all liabilities associated with said failed investments and businesses except to CFC.

[70] The JDS contained a copy of the Restructured Note Agreement. Article V thereof restricts CoServ's ability to make investments in businesses other than CoServ's utility businesses.

6.75% interest rate, is less than the balance of CoServ's Utility businesses pre-organization loan of $389 Million.

148. At the time of the CoServ Bankruptcy Restructuring, CFC stated that non-accrual status of CoServ was a short-term situation. *See* CFC's 2003 10K, FN 13(d), p. 104 (After the effective date, CFC reclassified the outstanding loan to CoServ as restructured and **in the near term will maintain the restructured CoServ loan on non-accrual status**…) Seven years is not in the near term.

149. CFC is amortizing the CoServ Loan Loss, which is impermissible pursuant to GAAP, by applying the 'cost recovery methodology.' 12 CFR 621.5(c), in application of GAAP, provides that Farm Credit institutions, including CoBank, shall: "Charge-off loans, wholly or partially, as appropriate**, at the time they are determined to be uncollectible**[71]." (Emphasis and footnote added)

150. 12 CFR 621.5(c) is GAAP, FAS 114. FAS 114 requires a charge-off –

a. *FAS 114, ¶ 8* states "A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement."

b. *FAS 114, ¶ 10* states "*Probable.* The future event or events are likely to occur."

c. *FAS 114, ¶ 13* states "Regardless of the measurement method, a creditor

[71] This regulation is no different than the requirements of Security Law. Securities law, SEC 17 CFR Part 211, Financial Reporting Release 28, requires collateral generally **should be considered repossessed in substance and accounted for at its fair value** when (i) on a fair value basis, the debtor has little or no equity in the collateral; (ii) repayment of the loan can be expected to come only from the operation or sale of the collateral; and (iii) the debtor has formally or effectively abandoned control of the collateral to the creditor.

shall **measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable**. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral." (Emphasis added)

d. *FAS 114 ¶ 69* states "After considering comments received, the Board decided that when a creditor determines that foreclosure is probable, a creditor should remeasure the loan at the fair value of the collateral **so that loss recognition is not delayed until actual foreclosure**." (Emphasis added)

e. *FAS 5 ¶ 8* states: "An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued **by a charge to income** if *both* of the following conditions are met:

a. Information available **prior to issuance of the financial statements** indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b. The amount of loss can be reasonably estimated." (Emphasis added)

GAAP requires CFC to recognize the CoServ Loan Loss no later than the November 30, 2002.

152. The fact that CFC ties the amortization of the CoServ loan loss to the timing of CoServ's payments doesn't change the fact that the 'cost recovery methodology' is being deployed to amortize the CoServ Loan Loss and <u>smoothing out</u> CFC's reported earnings.

*Proof of Amortization – General Methodology.*

153. Overview: Since CFC is so persuasive in convincing people that an orange is an

apple, the following is a year-by-year analysis on a calendar year basis to demonstrate that CFC's application of the payment received from CoServ do not comport with either the use of a 6.75% interest rate or the 3.06% blended interest rate. Calendar year 2003 is ignored because it is impossible to determine how $652 Million CoServ Loan Balance reported in the 11/30/2002 10Q became a $634 Million[72] CoServ Loan Balance as reported in the 2/28/2003 10Q.

154. Exhibit C, CFC/CoServ Financial Forecast, is set forth on a calendar year basis.

155. The Restructure Note, as set forth in the JDS, requires CoServ to make payments quarterly as of the last day of March, June, September and December of each year.

156. CFC reports on a quarterly basis for a fiscal year ending May 31st with publicly filed financial statements for the quarter ending the last day of August, November, February and May of each year.

157. Because the CoServ Loan is being reported to this day on a non-accrual basis (earned but unpaid interest is not reported), the CoServ Loan Balance reported at the end of each February[73] by CFC is the immediately preceding December 31st CoServ Loan Balance.

158. Since there is no payment due until March 31st and CFC is not accruing interest, the February 28th CoServ Loan Balance reported in CFC's 10Q can be compared to the year-end balance reported in Exhibit C of the JDS (Joint Disclosure Statement) which is referred to as the *Debtors' 2002 Post-Bankruptcy Financial Projections* ("CFC/CoServ Financial Forecast").

*Proof of Amortization – Calendar year 2004.*

159. For calendar year 2004, CFC reported a $23 Million decrease in the CoServ Loan Balance which is the difference between the balance reported in CFC's 2/29/2004 10Q, p. 24,

[72] CoBank could be part of it - $10 Million – but the difference is $18 Million.

[73] The February 10Q would reflect the December 31st payment but not the March 31st payment.

which was $623 Million, and the balance reported in CFC's 2/28/2005 10Q, p. 24, which was $600 Million. This means the CoServ Loan payments received in calendar year 2004 were allocated or charged against the CoServ Loan Balance.

160. Pursuant to the JDS, the CFC/CoServ Financial Forecast for calendar year 2004 called for a payment of $24,443,299[74] with <u>$24,428,202 allocated to interest</u> using a 6.75% interest rate and with principal payment of $15,097.

161. **Based upon the CFC/CoServ Financial Forecast** (the JDS Forecast), CFC allocated the CoServ payment entirely to the outstanding CoServ Loan Balance (principal) materially understating reported interest income by $24,428,202 during 2004.

162. **Based upon the CFC/CoServ Financial Forecast,** CFC's December 31, 2004 CoServ Loan Balance of $600 Million as well as CFC's then reported equity is ***overstated by $238 Million***.

163. Using CFC's blended interest rate of 3.06% (a 2.25% interest rate the first five years) and a $634 Million beginning balance (the balance in the 2/28/2003 10Q) (hereinafter the "*3.06% Amortization Schedule*"), during 2004 the CoServ payments of $24,443,299 should have been applied <u>as $13,945,891 of interest</u> and $10,497,408 of principal.

164. **Based upon the 3.06% Amortization Schedule**, CFC allocated the CoServ payment entirely to the outstanding CoServ Loan Balance (principal) materially understating interest income for calendar year 2004 by $13,945,891.

165. The application of the CoServ payments for calendar year 2004 does not comport with either the amortization of a $362 Million loan with a 6.75% interest rate or $634 Million loan with a 3.06% blended interest rate.

[74] The difference between $23 Million and $24,443,299 is due to rounding - figures are presented in millions.

166. The application of the CoServ payments supports only one conclusion, for calendar year 2004 CFC is amortizing the CoServ Loan Loss by applying all payments to the CoServ Loan Balance and thus, smoothing out CFC's reported earnings.

*Proof of Amortization – Calendar year 2005.*

167. For calendar year 2005, CFC reported a $25 Million decrease in the CoServ Loan Balance which is the difference between the balance reported in CFC's 2/28/2005 10Q, p. 24, which was $600 Million and the balance reported in CFC's 2/28/2006 10Q, p. 24, which was $575 Million. This means the CoServ Loan payments received in calendar year 2005 were allocated or charged against the CoServ Loan Balance.

168. Pursuant to the JDS, the CFC/CoServ Financial Forecast for calendar year 2005 had a scheduled payment of $24,443,299 with <u>$24,427,183[75] allocated to interest</u> using a 6.75% interest rate and with a principal payment of $16,116.

169. **Based upon the CFC/CoServ Financial Forecast**, CFC allocated the CoServ payment entirely to the outstanding CoServ Loan Balance (principal) materially understating reported interest income by $24,427,183 during 2005.

170. **Based upon the CFC/CoServ Financial Forecast,** CFC's December 31, 2005 CoServ Loan Balance of $575 Million as well as CFC's then reported equity is ***overstated by $213 Million***.

171. Using CFC's 3.06% Amortization Schedule, during 2005 the CoServ payments of $24,443,299 would be applied <u>as $13,707,699 of interest</u> and $10,735,600 of principal.

172. **Based upon the 3.06% Amortization Schedule**, CFC allocated the CoServ payment entirely to the outstanding CoServ Loan Balance (principal) materially understating interest income by $13,707,699 during 2005.

[75] The $25 Million decrease is a result of rounding when figures are presented in the millions.

173. The application of the CoServ payments for calendar year 2005 does not comport with either the amortization of a $362 Million loan with a 6.75% interest rate or $634 Million loan with a 3.06% blended interest rate.

174. The application of the CoServ payments supports only one conclusion, for calendar year 2005 CFC is amortizing the CoServ Loan Loss by applying all payments to the CoServ Loan Balance thus smoothing out CFC's reported earnings.

*Proof of Amortization – Calendar year 2006.*

175. For calendar year 2006, CFC reported a $24 Million decrease in the CoServ Loan Balance which is the difference between the balance reported in CFC's 2/28/2006 10Q, p. 24, which was $575 Million and the balance reported in CFC's 2/28/2007 10Q, p. 23, which was $551 Million. This means the CoServ Loan payments received in calendar year 2006 were allocated or charged against the CoServ Loan Balance.

176. Pursuant to the JDS, the CFC/CoServ Financial Forecast for calendar year 2006 had a scheduled payment of $24,443,299 <u>with $24,426,095 allocated to interest</u> using a 6.75% interest rate and with a principal payment of $17,204.

177. **Based upon the CFC/CoServ Financial Forecast**, CFC allocated the CoServ payment entirely to the outstanding CoServ Loan Balance (principal) materially understating reported interest income by $24,426,095 during 2006.

178. **Based upon the CFC/CoServ Financial Forecast,** CFC's December 31, 2006 CoServ Loan Balance of $551 Million as well as CFC's then reported equity is ***overstated by $189 Million***.

179. Using CFC's 3.06% Amortization Schedule, during 2006 the CoServ payments of $24,443,299 would be applied <u>as $13,464,102 of interest</u> and $10,979,197 of principal.

180. **Based upon the 3.06% Amortization Schedule**, CFC allocated the CoServ payment entirely to the outstanding CoServ Loan Balance (principal) materially understating interest income by $13,464,102 during 2006.

181. The application of the CoServ payments for calendar year 2006 does not comport with either the amortization of a $362 Million loan with a 6.75% interest rate or $634 Million loan with a 3.06% blended interest rate.

182. The application of the CoServ payments supports only one conclusion, for calendar year 2006 CFC is amortizing the CoServ Loan Loss by applying all payments to the CoServ Loan Balance thus smoothing out CFC's reported earnings.

*Proof of Amortization – Calendar year 2007.*

183. For calendar year 2007, CFC reported a $25 Million decrease in the CoServ Loan Balance which is the difference between the balance reported in CFC's 2/28/2007 10Q, p. 23, which was $551 Million, and the balance reported in CFC's 2/29/2008 10Q, p. 24, which was $526 Million. This means the CoServ Loan payments received in calendar year 2007 were allocated or charged against the CoServ Loan Balance.

184. Pursuant to the JDS, the CFC/CoServ Financial Forecast for calendar year 2007 had a scheduled payment of $24,443,300 with $24,424,934 allocated to interest using a 6.75% interest rate and with a principal payment of $18,366.

185. **Based upon the CFC/CoServ Financial Forecast**, CFC allocated the CoServ payment entirely to the outstanding CoServ Loan Balance (principal) materially understating interest income by $24,424,934 during 2007.

186. **Based upon the CFC/CoServ Financial Forecast,** CFC's Y/E 2007 CoServ's Loan Balance of $526 Million as well as CFC's then reported equity is ***overstated by $164***

***Million***.

187. Using CFC's 3.06% Amortization Schedule, during 2007 the CoServ payments of $24,443,300 would be applied as $13,214,978 of interest and $11,228,322 of principal.

188. **Based upon the 3.06% Amortization Schedule**, CFC allocated the CoServ payment entirely to the outstanding CoServ Loan Balance (principal) materially understating interest income by $13,214,978 during 2007.

189. The application of the CoServ payments for calendar year 2007 does not comport with either the amortization of a $362 Million loan with a 6.75% interest rate or $634 Million loan with a 3.06% blended interest rate.

190. The application of the CoServ payments supports only one conclusion, for calendar year 2007 CFC is amortizing the CoServ Loan Loss by applying all payments to the CoServ Loan Balance thus smoothing out CFC's reported earnings.

*Proof of Amortization – Calendar year 2008.*

191. For calendar year 2008, CFC reported a $28 Million decrease in the CoServ Loan Balance which is the difference between the balance reported in CFC's 2/29/2008 10Q, p. 24, which was $526 Million, and the balance reported in CFC's 2/28/2009 10Q, p. 26, which was $498 Million. This means the CoServ Loan payments received in calendar year 2008 were allocated or charged against the CoServ Loan Balance.

192. Pursuant to the JDS, the CFC/CoServ Financial Forecast for calendar year 2008 had a scheduled payment of $28,429,960 with $24,423,694 allocated to interest using a 6.75% interest rate and with a principal payment of $4,006,266.

193. **Based upon the CFC/CoServ Financial Forecast**, CFC allocated the CoServ payment entirely to the outstanding CoServ Loan Balance (principal) materially understating

interest income by $24,423,694 during 2008.

194. **Based upon the CFC/CoServ Financial Forecast,** CFC's December 31, 2008 CoServ Loan Balance of $498 Million as well as CFC's then reported equity is ***overstated by $140 Million***.

195. Using CFC's 3.06% Amortization Schedule, during 2008 the CoServ payments of $28,429,960 would be applied as approximately <u>$17,633,926 of interest</u>[76] and $10,796,032 of principal.

196. **Based upon the 3.06% Amortization Schedule**, CFC allocated the CoServ payment entirely to the outstanding CoServ Loan Balance (principal) materially understating interest income by $17,633,926 during 2008.

197. The application of the CoServ payments for calendar year 2008 does not comport with either the amortization of a $362 Million loan with a 6.75% interest rate or $634 Million loan with a 3.06% blended interest rate.

198. The application of the CoServ payments supports only one conclusion, for calendar year 2008 CFC is amortizing the CoServ Loan Loss by applying all payments to the CoServ Loan Balance thus smoothing out CFC's reported earnings.

*Proof of Amortization – Calendar year 2009.*

199. For calendar year 2009, CFC reported a $28 Million decrease in the CoServ Loan Balance which is the difference between the balance reported in CFC's 2/28/2009 10Q, p. 26, which was $498 Million, and the balance reported in CFC's 2/28/2010 10Q, p. 26, which was $470 Million. This means the CoServ Loan payments received in calendar year 2009 were allocated or charged against the CoServ Loan Balance.

[76] A 3.06% interest rate is used which understates interest. The rate had to be higher than 3.06% because the first five years was at 2.25% per year.

200. Pursuant to the JDS, the CFC/CoServ Financial Forecast for calendar year 2009 had a scheduled payment of $28,429,960 with $24,153,271 allocated to interest using a 6.75% interest rate and with a principal payment of $4,276,689.

201. **Based upon the CFC/CoServ Financial Forecast**, CFC allocated the CoServ payment entirely to the outstanding CoServ Loan Balance (principal) materially understating interest income by $24,153,271 during 2009.

203. **Based upon the CFC/CoServ Financial Forecast,** CFC's December 31, 2009 CoServ Loan Balance of $470 Million as well as CFC's then reported equity is ***overstated by $116 Million***.

204. Using CFC's 3.06% Amortization Schedule, during 2008 the CoServ payments of $28,429,960 would be applied as approximately $17,299,760 of interest and $11,130,200 of principal.

205. **Based upon the 3.06% Amortization Schedule**, CFC allocated the CoServ payment entirely to the outstanding CoServ Loan Balance (principal) materially understating interest income by $17,299,760 during 2009.

206. The application of the CoServ payments for calendar year 2009 does not comport with either the amortization of a $362 Million loan with a 6.75% interest rate or $634 Million loan with a 3.06% blended interest rate.

207. The application of the CoServ payments supports only one conclusion, for calendar year 2009 CFC is amortizing the CoServ Loan Loss by applying all payments to the CoServ Loan Balance thus smoothing out CFC's reported earnings.

*Proof of Amortization – 7 Years of History.*

208. As of December 31, 2009 using the CFC 2/28/2009 10Q CoServ Loan Balance

and comparing it to the CFC/CoServ Financial Forecast, the CoServ Loan Balance of $470 Million as well as CFC's then equity is ***overstated by $116 Million***[77].

209. As of December 31, 2009 using the CFC 2/28/2009 10Q CoServ Loan Balance and comparing it to the 3.06% Amortization Schedule, the CoServ Loan Balance of $470 Million as reported by CFC and CFC's equity **is understated by over $88 Million**. Applying a 2.25% interest rate through calendar year 2007 and a 3.06% interest rate thereafter, the CoServ Loan Balance should be reported at approximately $558 Million[78].

210. CFC's reporting of the CoServ Loan Balance from year-to-year over this period of more than seven years does not comport with and materially departs from both –

a. The amortization of the CoServ Loan assuming a 6.75% interest rate as reflected in the CFC/CoServ Financial Forecast; and

b. The amortization of the CoServ Loan assuming a 3.06% blended interest rate as CFC purports to use in SEC filings.

CFC's amortization doesn't conform to either of the above because CFC is amortizing the CoServ Loan Loss.

211. Keeping the CoServ Loan on non-accrual basis for over seven years and three months cannot be justified.

212. The Federal Regulations, 12 C.F.R. § 621.9, applies GAAP to reinstatement of accrual status as follows:

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[77] Relator's contends that the CoServ Loan Balance was inflated by part of the CoServ loan loss and that CFC is amortizing this loss. The amortization is indicated by the reduction of the overstatement of the CoServ Loan Balance: $238 Million as of 12/13/2004; $213 Million as of 12/13/2005; $189 Million as of 12/13/2006; $164 Million as of 12/13/2007; $140 Million as of 12/13/2008; and $116 Million as of 12/13/2009. The amortization is accomplished by materially underreporting interest income. If this is not income smoothing than there is no such thing.

[78] Which is over $204 Million larger than 2009 year-end loan balance pursuant to CFC/CoServ Financial Forecast.

**§ 621.9 Reinstatement to accrual status.**

A loan may be reinstated to accrual status, when each of the following criteria are met:

(a) All contractual principal and interest due on the loan is paid and the loan is current;

(b) Prior chargeoffs are recovered, except for troubled debt restructures;

(c) No reasonable doubt remains regarding the willingness and ability of the borrower to perform in accordance with the contractual terms of the loan agreement; and

(d) Reinstatement is supported by a period of sustained performance in accordance with the contractual terms of the note and/or loan agreement. Sustained performance will generally be demonstrated by 6 consecutive monthly payments, **4 consecutive quarterly payments**, 3 consecutive semi-annual payments, or 2 consecutive annual payments. (Emphasis added)

Pursuant to the above regulation of the Farm Credit Administration, after 4 consecutive quarterly payments, CFC should have reported CoServ on accrual basis.

213. As noted, whether the CoServ Loan is reported as non-accrual basis or accrual basis, there is no support for NOT reporting interest income received as interest income unless the collection of loan principal is in doubt. *See* 12 C.F.R. § 621.8.

214. CoServ was a successful reorganization because CoServ was left with the utility business and CFC assumed all CoServ's troubled assets. In fact, there has been a member suit against CoServ's management and one of the allegations was premised upon the failure of CoServ to distribute enough of the profits to members. *See Brady et al v. Denton County Electric Cooperative, Inc.*, Dis. Ct. for the Eastern District, case no. 4:09-cv-00130.

215. CoServ had met ALL the requirements of 12 C.F.R. § 621.9 to be returned to accrual status, at the latest, as of March 31, 2004.

216. For the seven year period that CFC did not recognize interest income for the CoServ payments, CFC has **understated CFC's interest income** by approximately $172 Million if the payments were applied as required by the **CFC/CoServ Financial Forecast**.

217. For the seven year period that CFC did not recognize interest income for the CoServ payments, **CFC has understated CFC's interest income** by approximately $103 Million if the payments were applied as required using the using the **3.06% Amortization Schedule**.

218. CFC's accounting for the payments has diverged from any form of loan amortization of the CoServ Loan because CFC has intentionally overstated the CoServ Loan Balance and is amortizing the CoServ Loan Loss by smoothing out CFC's earnings.

219. CFC's accounting methodology with respect to the CoServ Loan is unsupportable by GAAP and is a material departure from GAAP notwithstanding the fact that 18 USC § 1350(c) criminalizes the false certifications of Defendants[79] Lilly and Petersen.

**CFC & the CoServ Foreclosed Assets.**

220. CFC recorded $369.393 Million as the Fair Value of the foreclosed assets received from CoServ and CoServ's affiliates. *See* 2/28/2003 10Q, FN 4, p. 13.

221. Upon information and belief, CFC overstated the value of Foreclosed Assets received in order to avoid recognizing a CoServ loan loss in fiscal year 2003 and further, to smooth out earnings by recognizing the loss over a period of time.

222. In the November 2002 *Motion To Enforce The TeleCom Plan* (the "Telecom Motion"), CFC pled that the value of Telecom was agreed between CoServ and CFC to have an agreed value of $28 Million. *See* ¶ 125 above which quotes ¶16 of CFC's November 27, 2002 *Motion To Enforce The TeleCom Plan*. Besides crediting the $28 Million, CFC agreed to pay

[79] The *new aristocrats* are organizations that spread around enough money on the hill, influence enough votes, or both so as to operate above the law.

$6.5 Million[80] of liabilities associated with CoServ's Telecom business.

223. After a ten month holding period, CFC sold the Telecom Assets for $31 Million which validates the agreed price[81]. In the 2/29/2004 10Q, FN 4, p. 13, CFC stated: "On October 27, 2003, CFC sold the Denton Telecom Partners d/b/a Advantex (telecommunication assets received as part of the CoServ bankruptcy settlement) for $31 million in cash."

224. Nevertheless, CFC recorded the Telecom assets received in the foreclosure in CFC's business records at a value of $38.5 Million or more than 37% higher than the Agreed Value stated in the Telecom Motion. *See* 2/28/2003 10Q, FN 4, p. 13.

225. CFC wrote up the Telecom Assets above the agreed value that was the product of negotiations by and between CFC and CoServ[82], upon information and belief, for the purpose of determining earnings for the full fiscal year of 2003 and thereafter, to determine CFC's ability to recognize loss while regularizing CFC's reported earnings – smoothing out CFC's earnings.

226. CFC's 5/31/003 10K recognized an impairment loss for Foreclosed Assets of $19.7 Million. Of the $19.7 Million, CFC specifically stated: "An impairment loss of $10 million was recorded to write down telecommunications assets based on a letter of intent to purchase these assets." *See* CFC's 2003 10k, FN 3, pgs. 88-89.

227. CFC's accounting for the foreclosed assets does not conform to GAAP; that is, FAS 15, ¶ 28, which states foreclosed assets "shall account for those assets (including an equity

[80] Payments that add nothing to the value of the Telecom Assets other than to free those assets from the grip of creditors: an expense to obtain the assets.

[81] There is no way of knowing CFC's investment in the Telecom assets during the 10 month holding period.

[82] In CFC's 2/28/2003 10Q, FN 11(d), p. 23, it states: "On that date, CoServ transferred the telecommunications assets to entities controlled by CFC. The loan balance to CoServ was reduced by $39 million, the fair value of the telecommunications assets received less estimated costs to sell."

interest) at their fair value at the time of the restructuring." FAS 15, ¶ 81 provides *Fair value* is defined in paragraph 181 of *APB Statement No. 4* as "the approximation of exchange price in transfers in which money or money claims are not involved."

228. The following support that all the Foreclosed Assets received from CoServ's affiliates has been materially overstated by CFC:

a. CFC's intentional overstatement of the Telecom Assets by more than a third[83] demonstrates the *mens rea* to commit accounting fraud with respect to Foreclosed Assets;

b. The fact that CFC did not recognize a loss on the CoServ restructuring;

c. The fact that CFC intentionally overstated the CoServ Loan Balance demonstrates the *mens rea* to commit accounting fraud with respect to the CoServ Loan;

d. The fact that CFC has dribbled out over seven years impairment charges (charge-offs) related to the valuation of the Foreclosed Assets through the CFC 2/28/2010 10Q of $47 Million;

e. The fact pursuant to CFC's 2/28/2010 10Q, FN 4, p. 15, that $55 Million in foreclosed assets[84] have been placed on non-accrual basis over seven years after the CoServ Restructuring;

f. The fact that the **sum total earned**[85] on foreclosed assets from the December 2002 acquisition through February 28, 2010 was $65 Million[86]; and

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[83] If CFC used the same approach with other foreclosed assets this means Foreclosed Assets were overstated by over $100 Million, a material sum.

[84] These nonaccrual loans are land development loans that were inherited from CoServ over 7 years ago.

[85] The capitalization of earnings methodology would value the Foreclosed Assets far less than one-half of the value CFC valued such assets.

g. If recognized impairments over the life of the foreclosed assets ($47 Million) **are netted or offset** against the income produced by foreclosed assets ($65 Million), foreclosed assets produced net income of only $18 Million over a seven year period which does not comport valuation of foreclosed assets.

An $18 Million return in one year (not seven years) might support at a 10% capitalization rate[87] which in turn supports a $180 Million valuation of foreclosed assets. The overstatement of Foreclosed Assets was material and substantial.

229. CFC materially and intentionally departed from GAAP by overstating the Fair Value of Foreclosed Assets.

**The CoServ Loss.**

230. Upon information and belief, CFC accounting for foreclosed assets and departure from GAAP avoided the recognition of CFC of **at least** $100 Million loss on the CoServ Loan in fiscal year 2003.

231. Using the $634 Million balance set forth in CFC's 2/28/2003 10Q, CFC's departure from GAAP reported the CoServ Loan Balance $270 Million higher than the $362 Million loan balance required by GAAP (which is much higher than Fair Value).

232. CFC had an **unrecognized** loan loss related to the CoServ Loan of at least $370 Million, a material sum and a material departure from GAAP. CFC's Adjusted Members' Equity[88] for FY 2003 was $454 Million. *See* CFC's 2003 10K, p. 33.

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[86] Impairments recognized over the life that CFC held the foreclosed assets is $47 Million while total income recognized is over $64.3 Million making the net produced less than $18 Million.

[87] An 8% capitalization rate of $18 Million income produced in one year would infer a $225 Million assets value and a 6% Capitalization Rate would infer a $300 Million asset value.

[88] CFC's 2002 10K gave this explanation for adjustments related to fluctuations in the Fair Value of derivatives: "As long as CFC holds its derivative instruments to maturity and CFC and its counter parties

233. Upon information and belief, conformity with GAAP in CFC's financial reporting would have resulted in the financial collapse of CFC before the payment of any False Claim.

**PART TWO: ICC Loan Accounting Fraud**

234. Overview: Innovative Communication Corporation ("ICC") is another loan in which CFC has experienced a catastrophic and largely unreported loan loss. This section makes it evident from the objective facts, CFC's response to reporting a $114 Million provision for the ICC loan, that CFC could not and cannot the financial ramifications reporting catastrophic loan losses.

235. Part two approaches this matter as follows:

a. *ICC as an Unreported Restructured Loan* addresses ICC's default and loan restructuring that went unreported even though as of May 31, 2001, the ICC loan was then $591 Million or 3% of CFC's Total Loan Portfolio – thus, material.

b. *The 2nd ICC Loan Restructuring* addresses ICC's April 2003 loan restructuring that went unreported even though as of May 31, 2003, the ICC loan was then $623 Million or 3.2% of CFC's Total Loan Portfolio – thus, material.

c. *The ICC Loan Loss Fraud: The Limited Loan Recovery* addresses CFC's/RTFC's inconsequential recovery from the ICC estate from the sale of all assets but for the Group I Assets.

d. *The Credit Bid* addresses how a failed sale effort resulted in CFC bidding $250 Million[89] to commit accounting fraud by not recognizing the ICC Loan Loss by

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perform in accordance with the terms of the instruments, there will be no impact on earnings or cash flow over the life of the derivative as a result of adopting SFAS 133. It is CFC's policy to hold derivatives to maturity." *See* 2002 10K , p. 32

[89] Described by the Trustee's counsel this month (July of 2010) in a bankruptcy hearing as a bid from another galaxy more than twice the market value of the assets.

deploying the CoServ Foreclosed Asset Methodology – merely overprice the assets.

e. *The ICC Loan Loss Fraud: The Loan Loss Reserve for the ICC Loan* addresses why CFC's repeated statement that management believes that their adequate reserves is false and further, that CFC is carrying an unrecognized loan loss with respect to ICC of approximately $286 Million.

f. *The ICC Loan Loss Fraud: GAAP & Securities Law Mandate the Charge-off* addresses why CFC should charge-off the ICC Loan.

g. *The ICC Loan Loss Fraud: NO Charge-off in FY 2008* addresses why the ICC Loan Loss should have been recognized in the annual report, the 10K, for fiscal year 2008.

h. *The ICC Loan Loss Fraud: The Fraud In Postponing Recognition of the ICC Loan Loss* relates to CFC's postponement of the recognition of any ICC Loan Loss (CFC did recognize $114 Million in December 2008) because of extra-ordinary need to raise funding in calendar year 2008.

i. *Other Financial Indicators CFC's Distressed Financial Condition & CFC's Fraud* addresses a number of material indicators on CFC's Financial Distress, why CFC cannot recognize the ICC Loss, and material omissions in CFC's disclosure such as not reporting the failure of Group I Asset sale process to over 200 bidders to produce any meaningful bid that would result in a recovery for CFC.

236. ICC was one of RTFC's first members closing a financing in December of 1987 of over $100 Million. Until 2001 ICC had a reasonable relationship with RTFC and RTFC served as ICC's primary lender.

***ICC as an Unreported Restructured Loan*.**

237. ICC defaulted on its RTFC loan in 2001. In July of 2001 ICC and its wholly owned subsidiary, the Virgin Islands Telephone Corporation ("Vitelco"), received letters acknowledging **partial** payment of their loans.

a. The second paragraph of the RTFC letter to ICC stated:

> The partial payment was insufficient to meet the borrower's obligations under the ICC Loans. A balance of $4,469,765.67, (representing the principal payment due on June 30, 2001) remains due and payable in full as of the date of this letter.

b. The second paragraph of the RTFC letter to Vitelco stated:

> The partial payment was insufficient to meet the borrower's obligations under the VITELCO Loans. A balance of $1,707,386.57, (representing the principal payment due on June 30, 2001) remains due and payable in full as of the date of this letter.

The ICC Loan was impaired pursuant to *FAS 114, ¶ 8* which states "A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect **all amounts due** according to the contractual terms of the loan agreement." (Emphasis added)

238. In a 2005 brief submitted to the Virgin Islands Federal District Court, RTFC acknowledged and admitted[90] the 2001 ICC default. RTFC stated, on pages 4-5, of the brief that:

> In mid-March 2001, ICC informed RTFC that it was unable to pay $18.9 million of debt service due on March 31. ICC and Vitelco also missed their June debt service. On July 2, 2001, ICC advised RTFC that it did not have the cash to meet its loan obligations. (Letter and Memo, RTFC Exhibit Binder, Exh. 1.)
> *See* Rural Telephone Finance Cooperative v Innovative Communication, V.I. Federal District Ct., Case No. 2004-0154, Dated October 14, 2005.

CFC[91] controls RTFC and is the sole source of RTFC's funding.

239. As of May 31, 2001, the time of the ICC default, the ICC Loan was $591 Million

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[90] Thus, there is a 2005 admission in Court documents that ICC defaulted in 2001 which not disclosed in either the 2001 10K and 2002 10K.

[91] CFC's management serves as RTFC's management.

or 3% of CFC's Total Loan Portfolio. *See* CFC's 5/31/2001 10K, p. 2 which reports loans by state or territory. ICC was the only Virgin Islands member of RTFC and/or CFC.

240. The ICC Loan was then material requiring separate disclosure[92] by CFC.

241. Because of the default and no means to cure, negotiations ensued between ICC and RTFC which resulted in the August 27, 2001 Loan Agreement (the "2001 Loan Agreement").

242. The 2001 Loan Agreement was formulated by CFC so CFC could wrongfully[93] avoid reporting the ICC Loan as restructured.

243. RTFC's August 20, 2001 Credit Recommendation described the Loan to be made under the 2001 Loan Agreement as follows:

> Loan Purpose/Amount:
> The total amount of this loan is $169,291,578. Funds will be used by ICC as follows: (I) $79,518,056 will refinance the company's outstanding balances on two RTFC bridge lines of credit (VI 802-9904 and 9906) and a general purpose line of credit (VI 802-5105), (ii) $61,539,193 will, in an effort to facilitate better cash management at the company, **these funds will be transferred internally to pay principal payments due under ICC's and Vitelco's RTFC loans** while the borrowers' use internally generated cash to fund construction expenditures, and (iii) $28.234,329 will finance the purchase of SCCs that are in an amount sufficient to result in an overall outstanding debt-to-SCC ratio of 10%. The initial advance will include sufficient SCCs to bring ICC up to the 10% SCC level, thereafter, advances will include the purchase of 10% SCCs. The amortization of SCCs will be used to pay down principal outstanding on both ICC's and Vitelco's RTFC term loans. (Emphasis added)

244. With respect to the 2001 Loan:

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[92] e.g. in CFC's 5/31/01 10K, FN 10, CFC separately reported on Deseret Generation & Transmission Co-operative ("Deseret"), a restructured loan of $655 Million and in CFC's 5/31/04 10K, FN 14(d), a troubled loan of VarTec Telecom, Inc. of $340 Million was subject separate disclosure.

[93] CFC always tried to position the 2001 agreement as a new loan rather than a restructuring when it is apparent that ICC could not comply with the original loan obligations as those obligations became due and thus, RTFC loaned ICC money to make the principal payments for the next two years. A lender could not delve in such fantasy without the complicity of the accounting firm and, under information and belief, the rating agencies.

a. ICC received no cash or disposable funds;

b. RTFC loaned ICC and Vitelco money (in reality, forced ICC and Vitelco to borrow money) to increase their investment in RTFC Subordinate Capital Certificates (which in turn are invested in CFC's Capital Term Certificates); and

c. Borrowed a sum necessary to pay ICC's and Vitelco's principal payments due the next two (2) years, thus effectively placing ICC and Vitelco **on an interest-only basis**.

245. **The ICC loan was restructured** so that:

a. the loan appeared more secure (larger amounts of subordinated capital certificates acquired with new loans) and

b. ICC's only cash obligation (out of pocket) for the next two years to RTFC was to pay interest.

246. FAS 114, ¶ 8, provides:

> A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. As used in this Statement and in Statement 5, as amended, *all amounts due according to the contractual terms* means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. (Emphasis is as set forth in FAS 114)

FAS 118, ¶ 6a, clarifies the phrase "contractual terms" as used in FAS 114 stating that the term means the loan terms and conditions as originally made and not as adjusted in a restructured loan agreement.

247. The ICC loan was impaired because ICC could not and did not make ALL payments as such payments became due pursuant to the ICC-RTFC original loan agreements;

thus, ICC and Vitelco were effectively[94] placed on an 'interest only' basis.

248. The default and loan restructuring took place before CFC issued the FY 2001 10K on August 29, 2001.

249. ICC's default and the 2001 Loan Agreement was a reportable event requiring the ICC loan to be reported as restructured. GAAP, specifically, *FAS 5, ¶ 8,* requires a charge to income of a loss contingency if the information "**available prior to issuance of the financial statements …** indicates that it is probable that an asset had been impaired**"** and the "amount of loss can be reasonably estimated."

250. In a material departure from GAAP, the ICC loan was NOT reported as restructured in CFC's annual report for fiscal year 2001.

251. Had the ICC loan been properly classified as restructured -

a. CFC's total of restructured and non-performing loans which had dramatically increased from $571.6 Million at the end of FY 2000 to $1,466 Million in FY 2001 because of CoServ, a 256% increase, should have increased to $2,053 Million, a 359% increase, because of ICC; and

b. Non-performing and restructured loans should have jumped from 2.90% of the Total Loan Portfolio in FY 2000 to 10.43% of the Total Loan Portfolio in FY 2001 instead of the 7.45% which was falsely reported because the ICC Loan was not reported as restructured.

This nondisclosure violated the principle of completeness set forth in FASB Statement of Concepts No. 2, ¶ 80 and is a material omission as defined by Security law.

252. The ICC Loan was material and represented:

[94] The 2001 loan paid Vitelco's and ICC's principal obligation ("these funds will be transferred internally to pay principal payments due under ICC's and Vitelco's RTFC loans") for the next two (2) years.

a. as of May 31, 2001 3% of the Total Loan Portfolio (when described by state[95], more than the CFC loans to all but 8 states);

b. as of May 31, 2002 represented 3.1% of the Total Loan Portfolio (when described by state[96], more than the loans to all but 7 states); and

c. as of May 31, 2003 represented 3.2% of the Total Loan Portfolio (when described by state[97], more than the loans to all but 6 states).

253. The failure to report the ICC loan in FYs 2001 and 2002 is a material[98] omission by CFC and CFC's Management which makes CFC's financial disclosure materially misleading.

254. Failing to report the ICC loan as restructured in FYs 2001, 2002, and 2003 was an intentional material departure from GAAP and an intentional and material[99] omission making CFC's reporting fraudulent.

255. The fact that the ICC misreporting transpired contemporaneously with the CoServ loan fraudulent reporting only exasperates the material omission: a pattern of misreporting loan losses has been established.

***The 2nd ICC Loan Restructuring*.**

256. In FY 2003, after commencing an unlawful foreclosure (explained in the footnote to the last paragraph of this subpart), ICC and CFC entered into an agreement in April of 2003 to amortize the ICC loan whereby ICC would repay the principal and interest over a 30-year term at

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[95] The smallest number of borrowers in the 8 states was Utah with 11 borrowers.

[96] The smallest number of borrowers in the 7 states was Colorado with 40 borrowers.

[97] The smallest number of borrowers in the 6 states was Colorado with 40 borrowers.

[98] Pursuant to 17 CFR Part 211, Subpart B, SAB 99, 64 FR 45150 and 15 U.S.C. § 78u-4(b)(1)(B) as well as 17 C.F.R. § 240.10b-5(b) (… omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading)

[99] Id.

interest rates for Telephone Loans which was effectively subsidized. RTFC and ICC agreed to a 6% interest rate when the weighted average interest rates for long-term fixed rate Telephone loans were 7.77% as of May 31, 2003.

257. The ICC Loan in FY 2003 and FY 2004 was restructured and should have been reported as such because of each of the following factors:

a. After the end of the interest-only payment period and recommencing principal payments, ICC's principal payments did not conform to the principal amortization required when the loans were originally made;

b. With respect to Telephone loans CFC represents[100] that "Long-term loans are generally for periods of up to 15 years" when the ICC amortization period was 30 years; and/or

c. Vitelco and ICC were given a fixed rate for a longer term than normal and the rates were lower than current rates at which similar loans would be made by CFC to borrowers with similar credit ratings and for the same remaining maturities.

258. The ICC loans were material to CFC in all fiscal years including FY 2004. The ICC loan constituted, as of May 31, 2004, 2.7% of CFC's Total Loan Portfolio (2004 10K, p. 3).

259. The failure to report the ICC loan in FYs 2003 and 2004 is an intentional and material omission by CFC and CFC's Management which makes CFC's Financial Statements materially misleading.

260. On June 1, 2004, CFC and CFC's Management commenced an unlawful foreclosure[101] action against ICC when coupled with CFC manipulations during the foreclosure

[100] *See* 2004 10K, Telecommunications loan programs, long-term loans, p. 8.

[101] ICC challenged RTFC on the allegation of the patronage income between Electric utility members of CFC and RTFC (which in turn is allocated to RTFC members such as ICC). RTFC commenced a

process resulted in ICC's bankruptcy and the attempt to sell ICC's assets.

***The ICC Loan Loss Fraud: The Limited Loan Recovery***.

261. The ICC foreclosure resulted in another catastrophic loan loss for CFC which is being materially misreported because CFC would not exist but for Loan Loss reporting fraud.

262. In summary, the following has occurred in ICC Bankruptcy proceedings:

a. A voluntary petition for bankruptcy was filed by ICC on July 31, 2007. *See In re. Innovative Communication Corporation*, V.I. Br. case no. 3:07-bk-30012 (JKF).

b. Mr. Stan Springel was appointed the Chapter 11 Trustee of Innovative Communication Corporation ("ICC" or "New ICC"), case # 07-30012, on October 4, 2007 (Dkt. No. 125).

c. On February 6, 2008, the Bankruptcy Court entered an order for the sale of all of ICC's assets (the "Sale Procedure Order").

d. The Group II assets (French CATV Franchises) were sold by December of 2008.

e. The Group III assets (miscellaneous assets) were largely disposed of by December 31, 2008.

f. The Group I assets (primarily "Virgin Islands Operations") are in the process of being purchased by CFC through a $ 250 Million credit bid after marketing by two professional organization could not produce a buyer that would have resulted in more than $1 Million to $10 Million recovery for CFC/RTFC.

263. The Trustee of the ICC bankruptcy filed a comprehensive report with the

foreclosure against ICC to conceal CFC's fraudulent Embezzlement Scheme. The Embezzlement Scheme makes CFC's Financial Statements and disclosure materially misleading. Retaliation is a violation of 18 USC§ 1513(e) which was added by Sarbanes-Oxley act of 2002, § 1107.

Bankruptcy Court March 2, 2009 reporting the receipts and disbursements for ICC and its affiliates **through February 20, 2009** (the "Trustee's Comprehensive Summary"). *See* Case 3:07-bk-30012-JKF Doc 1143 Filed 03/02/09. This report was after the sale of all material ICC assets except the Group I Assets.

264. The ICC assets had been divided in three groups of assets for the Trustee's sale.

265. Group I Assets consist of –

a. Virgin Islands Telephone Corporation (Vitelco) which is the exclusive provider of local wireline telephone service in the USVI;

b. Vitelcom Cellular, Inc. which is a provider of mobile telephone services in the USVI;

c. Innovative Long Distance, Inc. which is a provider of long distance service to end users in the USVI and wholesale service to interexchange carriers;

d. St. Croix Cable TV, Inc. which is the exclusive provider of wireline CATV services on St. Croix;

e. Caribbean Communications Corp. which is the exclusive provider of wireline CATV services on St. Thomas and St. John;

f. B.V.I. Cable T.V. Ltd. which is the exclusive provider of wireline CATV services in the British Virgin Islands;

g. Caribbean Teleview Services N.V. which is the exclusive provider of wireline CATV services in Dutch side of St. Martin; and

h. Several other companies.

*See* Case 3:07-bk-30012-JKF, Doc 443, Filed 02/06/08.

266. Group II Assets consists of companies which are the exclusive provider of

wireline CATV services in Guadeloupe, Martinique, and several municipalities in eastern France.

267. The Group III assets consist of the Daily News Publishing Co., Inc. which publishes a daily newspaper in the Virgin Islands.

268. In addition to the Group I, II, and III asset classifications there are a number of other assets sold, the main ones included cars, 727 Aircraft, Camille Pissarro Painting, and the Bjerget House (real property).

269. The Trustee's Comprehensive Summary was dated after the sale and disbursement of proceeds of the Group II Assets, the Group III Assets and the assets not in Group I, II, or III that had any material market value (the "Miscellaneous Assets").

270. The Trustee's Comprehensive Summary reported the following table with respect to the RTFC claim:

| | | |
|---|---|---|
| RTFC Proof of Claim | | $524,910,065 |
| Less: Sales Proceeds Turned Over to RTFC | | |
| 727 Aircraft | $1,523,818 | |
| Pissarro Painting | 3,780,000 | |
| Bjerget House | 7,547,463 | |
| Daily News | 5,245,500 | |
| Group II Sale Proceeds | 9,945,385 | |
| Total Proceeds Turned Over to RTFC | | (28,042,166) |
| Unpaid RTFC Claim | | **$496,867,899** |

271. Notwithstanding the sale and disbursement of proceeds from the sale of the Group II Assets[102], the Group III Assets and the Miscellaneous Assets, the Bankruptcy Estates of ICC, ICC-LLC and Emerging all under the control of the same Trustee (the Chapter 11 Trustee) has

[102] The Group II Assets sold in December of 2008 for €17 Million. As part of the sale of the Group II Assets, ICC had to transfer liabilities to the purchaser owed by the companies that composed the Group II Assets of €87.5 Million – a loss of at least €70.5 Million. *See* Case 3:07-bk-30012-JKF, Doc 1033-1, Filed 12/09/08.

distributed to that date only $28 Million to CFC/RTFC.

272. Not reflected in the above is CFC's/RTFC's obligation to Greenlight which exists independently of the ICC bankruptcy.

273. CFC/RTFC has an obligation to pay Greenlight[103] a minimum payment of $27.5 Million under an "Intercreditor Agreement" whereby CFC/RTFC have agreed to buy the Greenlight claim against ICC. *See* Case 3:07-bk-30012-JKF, Doc 1, pgs. 6 thru 28, Filed 07/05/07. This obligation is independent of the ICC bankruptcy.

274. The salient financial concessions and financial obligations of CFC/RTFC that run to the benefit of Greenlight are:

a. Upon ICC's bankruptcy, RTFC was to pay Greenlight -

> "RTFC shall pay the Greenlight Entities the aggregate sum of $15,000,000 and, upon such payment, the Greenlight Entities shall be deemed to have sold and assigned to RTFC $60,000,000 of the Greenlight Claim"
> *See* Case 3:07-bk-30012-JKF Doc 1, Page 13 of 38, Filed 07/05/07

b. Upon the sale of the ICC assets, RTFC was to pay Greenlight a minimum payment of -

> "RTFC shall pay the Greenlight Entities the aggregate sum of $12,500,000, and, upon such payment, the Greenlight Entities shall be deemed to have sold and assigned to RTFC the balance of the Greenlight Claim …."
> *See* Case 3:07-bk-30012-JKF Doc 1, Page 13 of 38, Filed 07/05/07

c. In addition to the minimum payment of $12.5 Million from the sale of the ICC assets, RTFC was to pay Greenlight additional consideration of –

> "10% of the value of any such additional payment or distribution *(i.e.,* payments or distributions over and above the first $327,500,000 …."

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[103] Greenlight refers collectively to GREENLIGHT CAPITAL, INC. ("Capital"), a Delaware Corporation; Defendant GREENLIGHT CAPITAL QUALIFIED, L.P. ("Capital Qualified"), a Delaware limited partnership; Defendant GREENLIGHT CAPITAL, L.P. ("Greenlight Capital"), a limited partnership, and Defendant GREENLIGHT CAPITAL OFFSHORE, LTD. ("Offshore"), which all have their principal office in New York and are legally domiciled in New York or Delaware.

*See* Case 3:07-bk-30012-JKF Doc 1, Page 14 of 38, Filed 07/05/07

d. As additional incentive to Greenlight, the Intercreditor Agreement provided with respect to Jeff Prosser's personal estate, the Chapter 7 Estate, that –

> "RTFC agrees to subordinate its claims against the Prosser Assets to the first $35,000,000 of the Greenlight Entities' claims against the Prosser Assets."
> *See* Case 3:07-bk-30012-JKF Doc 1, Page 15 of 38, Filed 07/05/07

Thus, CFC/RTFC has a financial obligation to Greenlight independent of any recovery from the sale of the ICC assets of over $27.5 Million: the $15 Million due and payable upon ICC's bankruptcy and the $12.5 Million due and payable when the ICC assets are sold ("Greenlight Obligation").

275. CFC/RTFC has never disclosed the existence of, or the reason for, the Intercreditor Agreement in CFC's financial reports or SEC filings; a material omission.

276. On February 2, 2009, CFC paid Greenlight the initial $15 Million. *See* Case 3:07-bk-30012-JKF, Doc 1470, Filed 10/06/09. There was no reporting of this payment to Greenlight in CFC's SEC filings.

277. Through the sale of the Group II Assets and the Group III Assets, RTFC has recovered, after the Greenlight Obligation, an immaterial sum constituting less than $1 Million; that is, before CFC's outlay for attorney fees. Upon information and belief, CFC's direct payments of attorney fees related to the ICC foreclosure and sale of assets exceed $28 Million.

***The Credit Bid***.

278. The only ICC assets remaining, the Group I Assets, consists of numerous subsidiary entities (the "Non-Debtor Subs") which have their own internal liabilities that are separate and independent of ICC's indebtedness to RTFC.

279. Until April of 2009, the Non-Debtor Subs liabilities ranged from $175 Million to

$185 Million.

280. For RTFC to recover a dime from the sale of the Group I Assets, the Non-Debtor Subs, a bid has to exceed the $175 Million to $185 Million, Non-Debtor Subs' indebtedness, as well as additional millions to cover unpaid administrative costs directly related to the administration of the ICC estate.

281. After extensive marketing efforts for nearly a year, the Group I Assets did not attract a bid that **would yield any recovery whatsoever** for CFC/RTFC on the ICC loan.

282. Further, there can be no expected recovery from the Chapter 7 Estate of Jeffrey J. Prosser since it is less than the $35 Million of the RTFC claim subordinated to the Greenlight claim pursuant to the Intercreditor Agreement.

283. The market value of the Group I Assets has been unequivocally established at a gross value (before deducting subsidiary debt) of approximately $200 Million:

a. The bid deadlines for the ICC assets –

(i) The first bid deadline was May 5, 2008. *See* Case 3:07-bk-30012-JKF, Doc 443, Page 28 of 35, Filed 02/06/08.

(ii) The second bid deadline was June 10, 2008. *See* Case 3:07-bk-30012-JKF, Doc 531-1, Page 5 of 11, Filed 03/20/08.

(iii) The third bid deadline was July 29, 2008. *See* Case 3:07-bk-30012-JKF, Doc 714, Page 2 of 4, Filed 06/04/08.

b. All the bid deadlines **passed without a qualified bid** on the Group I Assets.

<u>Testimony of Adam Dunayer, Managing Director of Houlihan Lokey</u>

I believe eight of the 12 management presentations that were had on the Group II

assets [[104]] were done by the Alvarez team. And then there was a **final bid deadline whereby no one submitted a final bid on the Group II assets** at that point in the process which is about when we -- we came in shortly thereafter [August of 2008]. (Emphasis and footnote added)
*See* Hearing transcript from the sale of the Group II Assets, Case 3:07-bk-30012-JKF, Doc 1068, Page 72 of 254, Filed 01/06/09.

There was 175 to $185 million dollars of liabilities that needed to be satisfied or settled in some way at the operating companies, and so, just to find somebody to come in for a dollar, whether or not we could've gotten the RTFC to release their -- release that stock, because it was their stock they were holding for a dollar, that's beside the point for this hypothetical, but that is, you know, **without significant debt financing, we weren't able to achieve those kind of evaluations**.
…
So, the RTFC surprisingly put forth a term sheet to the bidding field. So, anybody that was qualified was – would be able to borrow … This is $185 million of new capital to qualified buyers to help with their purchase of the stock of New ICC.
…
I think the debt [the RTFC Term Sheet] was dramatically helpful in people's evaluation of the process. **Without that debt, the process would've died November -- October even**. (Emphasis added)
*See* Hearing transcript from the sale of the Group I Assets, Case 3:07-bk-30012-JKF, Page 145-146 of 287.

c. There was no net market value to the ICC assets. The marketing process that ascribed a Market Value to the Group I Assets after the payment of the Non-Debtor Subs' liabilities of a sum that after the payment of administrative expenses accrued and incurred while regulatory approvals were received would have resulted in no recovery.

Testimony of Adam Dunayer, Managing Director of Houlihan Lokey

The Alvarez Firm [Alvarez and Marsal] put together a confidential information memorandum and data room of diligence information as well as a presentation that was delivered by management to various bidders. **Collectively both Alvarez and Houlihan [Houlihan Lockey] contacted over 300 people for these assets**, and most of them were

[104] Group II Assets were primarily French CATV companies which were sold by December 2008 and the proceeds therefrom were accounted for in the February 20, 2009 Trustee's Comprehensive Summary discussed hereinabove.

initially contacted by Alvarez. We contacted a few more when we got on the ground. (Emphasis added)
*See* 12/19/2008 Hearing Transcript from the sale of the Group II Assets (French CATV), Case 3:07-bk-30012-JKF, Doc 1068, Page 72 of 254, Filed 01/06/09

Question and Answer Testimony of Adam Dunayer, Managing Director of Houlihan Lokey

**A** … But, the valuations that people were willing to put on the table for this particular process was in the $200 million range. So, approximately $15 million or so above and beyond the debt that the RTFC was offering to qualifying bidders.
**Q** So, if I understand you that means with respect to the roughly half of a billion dollars owed to the RTFC, currently they would've gotten about $15 million?
**A** No, I -- that -- most of that $15 million was going to get picked up by the administration of this case.
**Q** What would have netted to the RTFC, if anything, in a bid around 200 million?
**A** I believe it would be nothing to single digit millions. Insignificant in the grand scheme of this process.
**Q** In your experience as an investment banker selling distressed assets including out of Chapter 11s, what is the best indicator of value of what's being sold?
**A** A broad marketing process that's highly accessible to qualified bidders.
**Q** Do you consider that the process undertaken by Houlihan and Alvarez prior to Houlihan was such a process?
**A** I do.
**Q** And as a result of that do you feel that the **200 million range** was a fair indicator of value for the Group I assets?
**A** Yes.
*See* 4/6/2009 Hearing Transcript from the sale of the Group I Assets, Case 3:07-bk-30012-JKF, Page 147-148 of 287 (Emphasis added)

The "200 Million Range" was the value[105] before deducting the debt of the non-debtor subsidiaries or represents a $25 Million to $15 Million recovery for the estate before payment of administrative expenses.

284. Houlihan Lokey was engaged by the Chapter 11 Trustee because RTFC mandated

[105] The Court giving interium approval to the sale to RTFC found: [Finding] E. As demonstrated by the evidence in support of the Motion, the Trustee and his financial advisors have marketed the Group 1 Assets and conducted the sale process in compliance with the Sale Procedures Order and have conducted a fair, full and complete marketing process. *See* Case 3:07-bk-30012-JKF Doc 1206-1 Filed 04/09/09

the engagement and agreed to backstop the cost of the engagement of Houlihan Lokey after the Chapter 11 Trustee's and that of the Trustee's firm, Alvarez and Marsal, marketing efforts did not yield a qualified bid.

a. <u>The Trustee acknowledges that Houlihan was hired at RTFC's insistence</u>:

> In the Trustee's discussions with the RTFC regarding the sale process, … the **RTFC has requested that the Trustee retain Houlihan Lokey Howard & Zukin Capital, Inc**. ("Houlihan Lokey"), as his financial advisor and to provide investment banking services in order to assist the Trustee in the sale process. (Emphasis added)
> *See* Trustee's Motion to hire Houlihan, Case 3:07-bk-30012-JKF, Doc 869, page 4 of 10, ¶ 9, Filed 09/05/08.

b. <u>Court Order approving Houlihan acknowledges RTFC's backstopping Fees:</u>

> **ORDERED** that, per the agreement set forth on the record: (a) in the event that the RTFC's claim against the Estate is paid in full, the allowed fees and expenses owing to Houlihan Lokey in accordance with the Engagement Letter and this Order shall be paid as a surcharge against the RTFC's collateral in accordance with 11 U.S.C. § 506(c), or (b) in the event that the RTFC's claim against the Estate is not paid in full, the RTFC has agreed to subordinate its claim to the payment of allowed fees and expenses owing to Houlihan Lokey in accordance with the Engagement Letter and this Order.
> *See* Court's Order, Case 3:07-bk-30012-JKF, Doc 937, page 3 of 3, Filed 10/07/08.

In substance, the opinion of Adam Dunayer of Houlihan constitutes the opinion of the CFC's/RTFC's expert engaged through the Trustee and involved in the sale process.

285. As of April 6, 2009, an extensive marketing process carried on by two nationally recognized firms, Alvarez and Marsal followed by Houlihan Lokey, for more than a year, and held to be fair, full and complete marketing process proved that CFC/RTFC would have **NO net recovery** from the sale of ICC's assets in the open market; nevertheless, two days after the hearing, CFC published the 2/28/2009 10Q reflecting the ICC Loan Balance at $492 Million[106].

286. The marketing efforts of the ICC assets provided the best evidence of value of the

[106] *See* 2/28/2009 10Q, p. 26 – "At February 28, 2009 and May 31, 2008, RTFC had $492 million in loans outstanding to ICC."

ICC Loan: CFC's/RTFC's loss on the ICC loan is one hundred percent (100%) of the ICC loan, plus legal fees and other expenses (such as Houlihan Lokey) incurred.

***The ICC Loan Loss Fraud: The Loan Loss Reserve for the ICC Loan*.**

287. CFC had reported the ICC Loan at a carrying value from $475 Million[107] to $500 Million plus since May 31, 2005.

288. CFC repeatedly states in Financial Disclosure that "Based on its analysis, the Company believes that it is adequately reserved for its exposure to ICC at [applicable date]" (the "Adequately Reserve Claim").

289. CFC's disclosure of its exposure to the ICC Loan is intentionally devoid of all relevant data necessary to determine the veracity of CFC's Adequately Reserve Claim.

290. CFC's known Loan Loss Provisions for the ICC loan are wholly inadequate.

a. In an non-public, August 18, 2004 memo (the "Grier Memo"), the current controller of CFC, Bob Grier, memorialized his discussions with Ernst stating:

> "I think that I satisfied them with the following
> - **ICC is a viable business** that can be operated in a manner to pay the debt service
> - existing management continually is pushing the edge and **we have finally decide we have had enough and want to replace management**.
> - while we believe that the **company has the ability to pay debt service**, the green light litigation and the company's issuance of preferred stock - one of issues in our litigation - has increased the uncertainty related to the credit.
> - that while **we initially moved the reserve up to $99 million, we subsequently reduced it to $92 million** based on the analysis and adding the pat cap to that analysis as an offset.
> Cain has asked us to provide with what ICC would have been at the minimum - we gave them the calculation - $87 million.
> - I think that they should be ok with the slight increase due to the increase in uncertainty related to green light and RTFC litigation." (Emphasis added)

[107] 2005 10K, FN 14(e), p. 103 – "As of May 31, 2005 and 2004, RTFC had $475 million and $553 million, respectively, in loans outstanding to ICC."

The Grier Memo establishes the Loan Loss reserve for the ICC loan after RTFC commenced foreclosure in 2004 was initially $92 Million.

b. CFC took another Loan Loss Provision of $114 Million against the earnings reported in the 10Q for the Q/E 11/30/2008 with respect to the ICC Loan. This amount of the loan loss provision allocated to the ICC loan was actually disclosed in more detail in the 10Q for the Q/E 2/28/2009 which stated on page 51, that:

> In late November 2008, the Company engaged an outside consultant to renew the valuation of ICC that had been performed during the summer of 2008. The update of the appraisal of ICC assets was triggered by the changing economic conditions that occurred during the Company's second quarter of fiscal year 2009, especially the tightening of the credit markets, coupled with indicators the Company was receiving from potential third party investors responding to the upcoming auction of the ICC assets. As a result of this new information, the Company recorded **an addition to the provision for loan losses of $114 million during the quarter ended November 30, 2008**. (Emphasis added)

c. Note in the 2009 10K, p. 40, CFC claims an additional provision for the ICC loan of $13 Million in the 3rd and 4th quarters of FY 2009 (nothing was explained in the 3rd qtr. 10Q when the $114 Million provision was explained) though, the total CFC Loan Loss Provision for fiscal year 2009 was less than $114 Million[108,109].

291. A comparison of CFC's Loan Loss Provisions from FY 2004 through FY 2009 supports the conclusion that there have been NO further Loan Loss Provisions for the ICC Loan -

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[108] CFC's Loan Loss Provision through the 6 months ended November 30, 2008 was $ 137 Million; however, the loan loss provision for the full year was $113.7 Million. This disappearing loan loss provision is never explained. In FN 2, p. 106, CFC reflects a provision of $113.7 Million ($23 Million vanished between the 2nd quarter and yearend), charge-offs of $6 Million, and recoveries of $0.3 Million.

[109] The statement "We believe that, as a result of this additional provision for losses and an additional $13 million provision in the third and fourth quarter, we have adequately reserved against losses associated with ICC at May 31, 2009" is a fabrication.

a. CFC's Loan Loss Provisions for FY 2005 through FY 2009, inclusive, in total, were only $116 Million[110]; and

b. Except for the ICC provision of $114 Million recognized in the 10Q for the CFC's Q/E November 30, 2008, **CFC's total additions to the LLR for all other loans during those years** (FYs 2005 thru 2009, inclusive) **was $2.4 Million[111], a span of 4 years**.

292. CFC's known Loan Loss Provisions for the ICC Loan through FY 2009 (May 31, 2009) totaled **$206 Million** ($92 Million plus $114 Million).

293. CFC and CFC's Management is intentionally misleading the investing public and the Federal Government by:

a. After the April 6, 2009 testimony established the complete loan loss for RTFC, on April 8, 2009 CFC filed the 10Q for the Q/E 2/28/2009 in which in FN 14d, p. 26, carried the ICC Loan at $492 Million, **a $7 Million increase in the ICC Loan balance** since reporting the ICC Loan balance at $485 Million for the Q/E 11/30/2008 (*See* FN 13d, p. 25).

b. In the FY 2009 3rd quarter 10Q, filed after the April 6, 2009 Hearing, CFC falsely represented: "Based on its analysis, the Company believes that it is adequately reserved for its exposure to ICC at February 28, 2009." (Q/E 2/28/2009 19Q, FN 14d, p. 27)

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110 $16.4 MM for FY 2005 per 2007 10K, p. 82; $23.2 MM for FY 2006 per 2007 10K, p. 82; -$6.9 MM for FY 2007 per 2007 10K, p. 82; -$30.3 MM for FY 2008 per 2009 10K, p. 92; and $113.7 MM for FY 2009 per 2009 10K, p. 92.

111 Taking into account the 1st Quarter 10Q for FY 2010, a recognition of income of $16.2 Million resulting from an adjustment that decreases CFC's loan loss reserve means that for the period beginning June 1, 2004 through August 31, 2009, excluding the $114 provision for ICC, CFC's loan loss reserve in fact decreased.

c. CFC is carrying a bloated ICC Loan Balance that, after applicable Loan Loss Reserves, represents a loan loss or an unrecognized charge to CFC's earnings of a minimum of **$286 Million or more**[112] ($492 Million less $206 Million in LLR).

***<u>The ICC Loan Loss Fraud: GAAP & Securities Law Mandate the Charge-off</u>***.

294. Pursuant to applicable GAAP and Federal Securities laws, there is no justification whatsoever for having the ICC Loan on CFC's books by the 3rd Quarter 10Q (Q/E 2/28/2009).

295. Securities law, <u>SEC 17 CFR Part 211, Financial Reporting Release 28</u>, requires collateral generally **should be considered repossessed in substance and accounted for at its fair value** when (i) on a fair value basis, the debtor has little or no equity in the collateral; (ii) repayment of the loan can be expected to come only from the operation or sale of the collateral; and (iii) the debtor has formally or effectively abandoned control of the collateral to the creditor.

296. All the conditions of <u>SEC 17 CFR Part 211, Financial Reporting Release 28</u> have, as of the time of the Trustee's displacement of Jeff Prosser's operating control over ICC in October of 2007, been satisfied. The obligation to examine the impairment is a continuing obligation.

297. The Fair Value of the remaining ICC Assets as of 2/28/2009 after the testimony of April 6, 2009 reciting facts known earlier was $0.00, requiring the charge-off of the Bloated ICC Loan Balance.

298. Securities law is no different than the force and effect of GAAP –

a. *FAS 114, ¶ 8* states "A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts

[112] For FYs 2007 and 2008, CFC actually pulled money from its Loan Loss Reserves and recognized such as income so it is very possible, indeed probable, that the ICC Loan Loss Reserve of $92 Million established in FY 2004 was decreased over time.

due according to the contractual terms of the loan agreement."

b. *FAS 114, ¶ 10* states "*Probable.* The future event or events are likely to occur."

c. *FAS 114, ¶ 13* states "Regardless of the measurement method, a creditor shall **measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable**. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral." (Emphasis added)

d. *FAS 114 ¶ 69* states "After considering comments received, the Board decided that when a creditor determines that foreclosure is probable, a creditor should remeasure the loan at the fair value of the collateral **so that loss recognition is not delayed until actual foreclosure**." (Emphasis added)

e. *FAS 5 ¶ 8* states: "An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued **by a charge to income** if *both* of the following conditions are met:

> a. Information available **prior to issuance of the financial statements** indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
>
> b. The amount of loss can be reasonably estimated." (Emphasis added)

GAAP clearly requires CFC to recognize the ICC Loan Loss no later than the February 28, 2009 10Q (filed after the testimony).

299. The April 6, 2009 Bankruptcy Court hearing was held to obtain approval of the sale of the Group I Assets to CFC.

300. Applying the fraudulent practices related to CFC's CoServ Loan Loss fraud with a special emphasis on foreclosed assets, CFC stated in its 10Q for the 3rd quarter of FY 2009 (Q/E 2/28/2009) that:

> On March 13, 2009, RTFC and the Trustee entered into a Purchase Agreement as part of **a $250 million credit bid** for the ICC Group 1 Assets. The Purchase Agreement is conditional upon the approval of the bankruptcy court and applicable regulators. On April 6, 2009, the Bankruptcy Judge approved, on an interim basis, the sale of the ICC Group I Assets to RTFC. RTFC will now begin the process of obtaining the applicable regulatory approvals. The Court has scheduled a status hearing for July 22, 2009, with a final hearing regarding the sale tentatively scheduled for August 31, 2009.
> *See* 2/28/2009 10Q, FN 14d, p. 27.

The nondisclosure of the marketing efforts results in light of CFC's disclosure of the $250 Million credit bid violated the principle of completeness set forth in FASB Statement of Concepts No. 2, ¶ 80 and is a material omission as defined by Security law.

301. CFC's credit bid (the "Credit Bid") is to justify maintaining the Bloated ICC Loan Balance on CFC's books.

302. CFC and CFC's Management have departed from GAAP and SEC accounting requirements in that –

a. The SEC staff Emerging Issues Task Force (EITF) in Topic No. D-80, *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio* (EITF Topic D-80), FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (FIN 14) states:

> Institutions should maintain prudent, conservative, but not excessive, loan loss allowances that fall within an acceptable range of estimated losses. Consistent with GAAP, an institution should record its best estimate within the estimated range of credit losses, including when the best estimate is at the high end of the

range.

b. SEC 17 CFR Part 211, Financial Reporting Release 28, states:

On page 5 -

> "However, where fair value accounting is required by generally accepted accounting principles ("GAAP"), the mere adoption of strategies (such as a hold-for-the-future strategy that is based on expectations of future price increases, or a strategy of operating the repossessed collateral for one's own behalf) **cannot justify use of derived accounting valuations that portray results of operations more favorably than would use of current values in active markets**." (Emphasis added)

On page 6 -

> "The Commission will presume that active markets reflect objective measures of current fair values, determined by the beliefs of reasonably informed persons regarding the present and future economic utility of the items being traded and the risks associated therewith. Thus, without independent and objective support for derived valuations that can be demonstrated to more appropriately reflect fair value in particular sets of circumstances, **derived valuations exceeding current values in active markets should not be used in cases where fair value accounting is required by GAAP.**" (Emphasis added)

c. See FAS 114 and FAS 5 quoted in the foregoing paragraphs of the complaint which set forth the fundamental principal requiring a conservative presentation of assets and income.

303. Acquiring assets for debt when the debt has NO intrinsic or fair market value (no different than play money) cannot serve as a basis to value assets.

304. Pursuant to GAAP and applicable Federal securities laws detailed above, CFC should have charged-off the ICC Loan Balance before publishing the 10Q for the Q/E 2/28/2009, in fact, **CFC should have charged-off the ICC loan balance no later than May 31, 2008** – the

end of FY 2008. This is an ongoing fraud by CFC, CFC's Management and Deloitte[113], CFC's Outside Auditor.

***<u>The ICC Loan Loss Fraud: NO Charge-off in FY 2008</u>.***

305. Alvarez and Marsal received court authorization to begin selling the ICC assets on February 6, 2008 (Case 3:07-bk-30012-JKF, Doc 443, Sales Procedure Order) with a target date of May 5, 2008 for firm offers to purchase all the ICC assets.

306. Testimony in the December 19, 2008 Hearing on the sale of the Group II Assets and on the April 6, 2009 hearing on RTFC's credit bid established that Alvarez canvassed the market contacting over 200 potential buyers, distributing approximately 130 Confidential Offering Memorandums, allowing access to Electronic data room; made management presentations to interested parties, and

a. failed to obtain a qualified bid for the Group I Assets or the Group II Assets **by May 5, 2008**;

b. failed to obtain a qualified bid for the Group I Assets or the Group II Assets **by June 10, 2008**, the extended bid deadline; and

c. failed to obtain a qualified bid for the Group I Assets or the Group II Assets **by July 29, 2008**, the further extended bid deadline.

All these dates preceded the filing of CFC's 10K for fiscal year 2008.

307. In addition to the testimony, other evidence that establishes that:

a. Several memos from the Virgin Islands Public Services Commission established that the prospect of a Virgin Islands Telephone Corporation ("Vitelco")

[113] Deloitte has a copy of the April 6, 2009 Bankruptcy Court Hearing in which Houlihan Lokey testified.

bankruptcy loomed large with an August 4, 2008 memo[114] stating in caps "MANY OF THE DOWNSIDE SCENARIOS THAT WE HAVE DESCRIBED IN PREVIOUS MEMOS HAVE SUDDENLY AND SIGNIFICANTLY INCREASED THEIR PROBABILITY OF REALIZATION." (author's emphasis)

b. In a complaint filed on December 18, 2008 by the Chapter 7 Trustee against Vitelco stated that a $45,000 payment due June 3, 2008, from Vitelco to the Chapter 7 Estate could not be made because the Chapter 11 Trustee stated that VITELCO was suffering a liquidity problem[115].

c. On August 20, 2008, the Preferred Shareholders (some not all) wrote a letter to re-open a case against Vitelco because Vitelco did not obtain PSC approval of the stipulated judgment for $76 Million, plus interest, and plus attorney fees by June 10, 2008.

d. RTFC's valuations of ICC always were weighed heavily on the basis of Vitelco's enterprise value which constituted over seventy percent (70%) of ICC's enterprise value.

308. The following two considerations are relevant to the timing of loan loss recognition:

a. GAAP, specifically, *FAS 5, ¶ 8,* requires a charge to income of a loss contingency if the information "**available prior to issuance of the financial statements … indicates that it is probable that an asset had been impaired"** and the "amount of loss can be reasonably estimated"; and

[114] This was before the 10K for FY 2008 was filed.

[115] RTFC had real time knowledge of ICC's Financial Condition. Vitelco's CEO and ICC's COO, Mr. Garnett, operating as RTFC consultant (and being concurrently paid by ICC and RTFC), RTFC had actual knowledge of ICC's dire financial circumstances.

b. The Chapter 11 Trustee pleaded that throughout "the sale process, the Trustee has endeavored to keep the Rural Telephone Finance Cooperative ("RTFC") apprised of his efforts and progress. *See* Case 3:07-bk-30012-JKF, Doc 869, Page 3 of 10, Filed 09/05/08.

c. Clark Garnett was concurrently employed as COO of New ICC, CEO, president, and chairman of the board of Vitelco, and consultant to RTFC throughout the sale process – CFC had real time knowledge.

CFC and CFC's Management had real time information on the Trustee's attempts to sell the ICC asset to make the relevant decisions on further provisions of the ICC Loan.

309. The critical date pursuant to GAAP to determine if CFC should have charged-off the ICC loan as of May 31, 2008 is **August 29, 2008,** the date that CFC filed the 10K for FY 2008.

310. The market had indicated by May of 2008, coupled with declining operating results (established in testimony in which the Telephone business was described as a dying business), that it was probable (likely) that the marketing would result in bids that would provide no recovery for RTFC.

311. Consistent with both GAAP and SEC accounting releases that require collateral dependent loans to be reflected at Fair Value, CFC, CFC's Management and Deloitte should have reflected a **$400 Million Loan Loss** on its May 31, 2008 Financial Statement; that is, the $492 Million ICC Loan balance less the $92 Million Loan Loss Reserve[116] taken in FY 2004.

312. To NOT reflect the **$400 Million ICC loan loss as of May 31, 2008** was an intentional act of CFC and CFC's Management with the complicity of Deloitte that made CFC

[116] The additional loan loss of $114 Million was not reflected until November 30, 2008 or later so there was a reserve of only $92 Million as of May 31, 2008 for the ICC Loan.

financial statements materially misleading with a material omission.

***The ICC Loan Loss Fraud: The Fraud In Postponing Recognition of the ICC Loan Loss.***

313. CFC's loan margins[117], if any, are too miniscule to absorb loan losses forcing CFC Hobson's Choice, especially when faced with catastrophic loan losses such as ICC and CoServ, to commit additional fraud or go out of business.

314. For example, CFC's single largest category of loans are Long-Term Fixed Rate Loans in the Electric Loan Portfolio (which constitute approximately one-half of the Total Loan Portfolio) which CFC stopped separately reporting on after fiscal year 2004. As of the end of the year the following demonstrates CFC's pricing policy:

| Fiscal year | Weighted Aver. Interest rate |
|---|---|
| 1992 | 9.16% |
| 1993 | 9.15% |
| 1994 | 8.63% |
| 1995 | 8.63% |
| 1996 | 7.92% |
| 1997 | 7.65% |
| 1998 | 7.12% |
| 1999 | 6.69% |
| 2000 | 6.66% |
| 2001 | 6.78% |
| 2002 | 6.56% |
| 2003 | 5.92% |
| 2004 | 5.38% |

This pricing policy with respect to long-term, fixed rate secured Electric loans was not only reckless but made possible by the Embezzlement Scheme and made access to the Federal fisc a necessity.

315. CFC elected to commit loan loss fraud with respect to ICC and the only issue was the amount of the ICC loan loss fraud.

[117] e.g., During fiscal year 2004 CFC refinance $3.3 Billion in RUS loans because the RUS lending rate was too high – the RUS rate was 5%, *See* CFC's 2004 10K, p. 12.

316. It is clear from CFC's financial statements in CFC's SEC filings that CFC ultimately decided as follows:

a. To recognize an additional $114 Million in the November 30, 2008 10Q for the 2nd quarter of FY 2009 (announced in an 8K filed December 2, 2008);

b. To use its, RTFC's, credit bid of $250 Million that establishes an asset value for the ICC assets of over $400 Million to unlawfully avoid recognition mandatory charge-off of the ICC Loan Balance of at least $250 Million in addition to the $114 Million provision; and

c. To juggle CFC's loan loss reserve to avoid recognition of any further loan loss that should lawfully be recognized with respect to the ICC Loan.

317. CFC avoided the recognition of the $114 Million loan loss provision until announced in the 8K on December 2, 2008. The announcement stated:

> For the quarter ending November 30, 2008, National Rural Utilities Cooperative Finance Corporation ("National Rural") expects to record a loss provision ranging from $90 million to $140 million primarily related to loans previously classified as impaired to Innovative Communication Corporation. The anticipated increase to the loss provision is primarily due to the significant disruptions in the capital markets, which have contributed to a decrease in the fair value of the collateral supporting the impaired loans. National Rural is continuing to evaluate market data related to the fair value of the collateral supporting impaired loans to this borrower.

The provision as stated in the 3rd quarter 10Q, p. 51, CFC stated: "As a result of **this new information**, the Company recorded an addition to the provision for loan losses of $114 million during the quarter ended November 30, 2008." (emphasis added) There was no new information[118] only the issue of timing and how much!

[118] There was the agreement in early December of 2009 to sale the Group II Assets (French CATV Franchises) for The Group II Assets sold in December of 2008 for €17 Million or a loss of approximately

318. The postponement of the recognition of ICC loan loss provision of $114 Million was due to extra-ordinary funding requirements that CFC was then facing.

319. On October 15, 2007, CFC filed a 10Q for the Q/E 8/31/2007 which in FN 15, p. 26, acknowledged an extra-ordinary funding requirement for CFC, stating:

> Subsequent to the end of the quarter, holders of $2,040 million of the Company's extendible debt elected not to extend the maturity. As a result, a total of $1,795 million of extendible debt reported in long-term debt at August 31, 2007 will be reclassified as short-term debt during the quarter ended November 30, 2007 based on maturity dates in September and October 2008.

This funding requirement was in addition to CFC's normal funding requirements and equals 18.05% of the indebtedness that CFC classifies as long-term pursuant to FN 6, p. 16, of the 10Q for the Q/E 8/31/2007.

320. CFC intentionally postponed ANY ICC Loan Loss provision (recognition) even though it was absolutely apparent that the ICC Loan was a complete charge-off before the 10K was filed the fiscal year ending May 31, 2008 because of CFC's reliance and need to access funds to refinance CFC's indebtedness.

321. In addition to funds that CFC accesses daily through an extensive broker-dealer market, CFC accessed the following funds during calendar year 2008, after the Chapter 11 Trustee had obtained effective control over the ICC assets:

| Date | | (in Thousands) Amounts |
|---|---|---|
| Jan-08 | 5.45% Collateral Trust Bonds due 2018 | 700,000 |
| Mar-08 | Farmer Mac of floating rate debt due in 2013 | 400,000 |
| Jun-08 | 5.50% Collateral Trust Bonds due 2013 | 900,000 |
| | Floating Rate Collateral Trust Bonds due 2010 | 400,000 |

€70.5 Million. *See* Case 3:07-bk-30012-JKF, Doc 1033-1, Filed 12/09/08. No information about the loss on the sale of Group II Assets was disclosed.

| | | |
|---|---|---|
| Sep-08 | REDLG program loan | 500,000 |
| Oct-08 | 10.375% Collateral Trust Bonds due 2018 | 1,000,000 |
| | Total Funds Raised | 3,900,000 |

322. CFC and CFC's Management, based upon false and misleading publicly financial statements, **raised $3.9 Billion** in calendar year 2008 before announcing any further reserve with respect to the ICC loan. $2.8 Billion of the $3.9 Billion were secured after the second bid deadline passed for ICC's Group I Assets and Group II Assets without one acceptable bid. Of the $3.9 Billion, $900 Million was raised through false claims.

323. In fact, the last $1.5 Billion was raised after the date that CFC insisted Houlihan Lokey be engaged by the Chapter 11 Trustee because Alvarez and Marsal was unsuccessful in marketing the ICC assets.

324. CFC's financial desperation is apparent by the fact that CFC agreed to pay 10.375% on collateralized bonds issued in October of 2008, when compared to earnings CFC receives on members' loans. CFC's FY 2008 10K, FN 2, p. 96, stated that the weighted average interest rate earned on all CFC loans outstanding during the fiscal years ended May 31st of FYs 2006, 2007 and 2008 was:

| | 2008 | 2007 | 2006 |
|---|---|---|---|
| Long-term fixed rate | 6.05% | 5.87% | 5.64% |
| Long-term variable rate | 6.94% | 7.58% | 6.43% |
| Loans guaranteed by RUS | 5.49% | 5.59% | 5.34% |
| Short-term | 5.89% | 7.06% | 6.07% |
| Non-performing | 0.01% | 0.02% | 0.01% |
| Restructured | 0.64% | 0.61% | 0.08% |
| Total | 5.81% | 5.79% | 5.48% |

325. The negative leverage accepted by CFC to obtain $1 Billion was significant: 381 basis points above the weighted average interest rate earned on CFC's highest priced loans (Long-term variable rate) and 494 basis points above the average weighted average interest rate

earned on CFC's Total Loan Portfolio.

326. The same motivation that caused CFC to accept $1 Billion in collateralized investments is the same motivation that causes CFC to commit accounting fraud including fraud in reporting loan losses.

327. Under information and belief, had CFC and CFC's Management

a. Knew that the provision of $92 Million was insufficient in calendar year 2007;

b. Postponed the recognition the ICC Loan Loss Provision of just $114 Million, which is still wholly insufficient, because CFC would not have been able to raise the $2.8 Billion raised in June through October of 2008 and CFC would have financially collapsed.

***<u>Other Financial Indicators Of CFC's Distressed Financial Condition & CFC's Fraud</u>*.**

328. Overview: CFC affirmatively misleads investors as to the events of the ICC bankruptcy.

329. In justifying a loan loss provision of $114 Million for the ICC Loan, CFC's 2/28/2009 10Q, p. 51, stated: "In late November 2008, the Company engaged an outside consultant to renew the valuation of ICC that had been performed during the summer of 2008 …."

330. Referring to an outside consultant while failing to disclose the facts that CFC's expert in restructuring hired by the Trustee, that is, Mr. Dunayer of Houlihan, testified to under oath only days before the filing of this 10Q[119], that CFC would have little or no recovery, is an intentional material omission. This nondisclosure violated the principle of completeness set forth

[119] The 2/28/2009 10Q was filed on April 8, 2009 and both Mr. Springel and Mr. Dunayer testified on April 6, 2009.

in FASB Statement of Concepts No. 2, ¶ 80 and is a material omission pursuant to security laws.

331. In the second quarter conference call with investors, Steve Lilly, CFC's CFO, **lied**[120] to an analyst from AIG stating the sale price of Group II Assets (French CATV Franchises) was not public[121]. In fact, all the records including the purchase contract were public information in early December and after a December 19, 2008 hearing approving the sale of the Group II Assets, the transaction closed on December 23, 2008. *See* V.I. Bankr. case 3:07-bk-30012-JKF, Doc 1096, Filed 01/23/09.

333. CFC's 2009 10K, FN 16, p. 128, CFC stated:

> "In April 2009, RTFC acquired $85 million of Vitelco preferred stock and $12.5 million of accrued and unpaid dividends relating to such shares for a total purchase price of $30 million. We believe that the acquisition of the preferred shareholders interests at a discount **has improved our estimated recovery from the collateral**." (Emphasis added)

334. On June 9, 2006, the Preferred Shareholders that had instigated litigation against Vitelco and ICC's counsel, on December 13, 2007, agreed[122] to a <u>stipulated judgment</u> since against Vitelco, ICC's most valuable subsidiary[123], for the sum of $76 Million[124], plus interest, and plus attorney fees that required PSC approval by June 10, 2008. *See B.E. Shaw Laminar*

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[120] JIM FERGUSON: Good morning, Steve. On the -- referring to page 16, the group 2 asset sale at ICC. Can you tell us, is it public information as to what the sale proceeds were?
MR. LILLY: **It is not public information at this time**, and as I indicated earlier to someone who asked a question, we are working through the distribution of the net sale proceeds with the Chapter 11 trustee. (Emphasis added)

[121] Mr. Lilly is intentionally misrepresenting the procedures of a Federal Bankruptcy Court!

[122] With RTFC's consultant serving as ICC's COO and Vitelco's president, this settlement did not occur without RTFC's consent and knowledge. RTFC's management is CFC's management.

[123] RTFC valuations have repeatedly attributed 70% of ICC's value to Vitelco.

[124] Not every preferred shareholder was involved in the suit and thus, accounted for in the settlement. The Judgment was for $1,038.051 per share (more than the $1,000 face value of the shares), plus unpaid interest, and attorney fees.

*Lending, Inc., et al. v. Virgin Islands Telephone Corp. d/b/a Innovative Telephone*, U.S. District Court for the Southern District of New York, 06-CV-4373 (PAC), Request for Pre-Motion Conference. The existence of the Stipulated Judgment has never been disclosed by CFC.

335. CFC's statement in the CFC's 2009 10K that: "We believe that the acquisition of the preferred shareholders interests at a discount has improved our estimated recovery from the collateral" is misleading without disclosing the prior stipulated judgment and providing reasons supporting a discount. This nondisclosure violated the principle of completeness set forth in FASB Statement of Concepts No. 2, ¶ 80 and is a material omission as defined by Security law.

336. If the Preferred Shareholders did in fact discount their claim[125], the full disclosure to a reasonable investor would support only one conclusion, the value of Vitelco had deteriorated to a point that the Preferred Shareholders' claim exceeded the whole value of Vitelco's equity value[126].

337. This settlement with the Preferred Shareholders confirms Mr. Dunayer's (Houlihan) statement at the April 6, 2009 Hearing Transcript:

> "it's [wireline – telephone] been on a downward trajectory. I'm not sure of the exact percent, but the entire industry on the wire line basis is on -- in a pretty dramatic downward trajectory. I believe Innovative's is less than the industry's for various reasons, but the industry itself is -- ***some would say a dying industry. It's just a question of the rate of death.***"
> *See* 4/6/2009 Hearing Transcript on the sale of the Group I Assets, p. 141, ln. 25 – p. 142, ln. 7.

The foregoing are the assets the CFC, under information and belief, will allocate over $250 Million or more of the ICC Loan Balance.

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[125] No settlement agreement is on file. CFC could have easily paid the Preferred Shareholders by assuming a direct obligation to those plaintiffs.

[126] Preferred stock has the first equity claim against the value of Vitelco's assets.

338. CFC's improper capitalization of expenses into the ICC Loan Balance which increase the balance from $475 in CFC's 2005 10K to over $492 Million represents a fraction of CFC's costs related to the ICC foreclosure as admitted by CFC in the following statement: "Loans outstanding to ICC continue to increase due to accrued legal costs associated with ongoing litigation to recover the outstanding loan balance." *See* CFC's 10Q for Q/E 8/31/2007, FN 13e, p. 23.

339. The improper capitalization of expenses by rolling those expenses into ICC's Loan Balance is an intentional and material departure from GAAP (FAS 15, ¶ 38) committed by CFC and CFC's Management to manipulate CFC's reported income to meet earnings performance targets.

340. Subject – Negative Leverage[127]. In November of 2008 CFC began offering Capital Member Certificates to CFC's members at an interest rate of 7.5%. Once again, CFC is selling a debt instrument with **negative leverage;** that is, interest rates exceeding any interest rates CFC charges on any category of loans in CFC's Loan Portfolio.

341. In a financing business[128], negative leverage is a tell-tale sign of CFC's financial distress.

342. Overview: The recognition of merely a $114 Million of the ICC Loss forced CFC to terminate a number of profitable derivative contracts to meet performance measurements. This departure from CFC's *hold to maturity strategy* is another tell-tale sign of CFC's financial distress.

[127] Negative leverage is akin to the clique that "I'm losing money on each sale but I hope to make the losses up on volume."

[128] Some businesses where the underlying assets are appreciating in value can make use of negative leverage if they can survive to realize the appreciation. In the lending business, the face value of the loan does not increase in value.

343. CFC professes[129] to hold derivative contracts to termination and thus, excludes fluctuations in the value of derivative contracts in determining CFC's Adjusted Net Margin, CFC's primary measurement of performance[130].

344. In the quarter following the recognition of the ICC Loss but in the same fiscal year, CFC's 2/28/2009 10Q, additional provision for loan loss of $114 Million, CFC, **in an extra-ordinary event**, liquidated many of the profitable derivative contracts, stating on p. 19 that:

> Cash settlements includes periodic amounts that were paid and received related to the Company's interest rate swaps, as well as amounts accrued from the prior settlement date. During the third quarter of fiscal year 2009, the Company terminated several receive fixed, pay variable interest rate swaps with notional amounts totaling $583 million that **resulted in a payment to the Company of $97 million that was recorded in the statement of operations as derivative cash settlements**. Of the $583 million notional amount of derivative contracts terminated, the Company initiated the termination on $495 million, while the counterparty initiated the request to terminate $88 million (these swaps were terminated at par resulting in no cash payments or receipts). As a result of these terminations, the Company recorded a charge to the derivative forward value line for the three and nine months ended February 28, 2009 to reduce the derivative asset by $97 million. **The income recorded in cash settlements for the payments received and the charge to derivative forward value are offsetting, and therefore there was no effect on reported net income as a result of these transactions.** Terminating these swaps had the benefit of reducing the Company's counterparty risk exposure to two out of the three counterparties to these instruments. The economic effect of terminating these transactions was to accelerate into the current period the benefit the Company would have realized in future periods in the form of lower debt costs.
>
> *See* CFC's 2/28/2010 10Q, p. 19. (Emphasis added) (the "3rd Quarter Derivative Statement")

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[129] E.g., "The Company is neither a dealer nor trader in derivative financial instruments." *See* CFC's 2007 10K, p. 22 and also, CFC's 2002 10K gave this explanation for adjustments related to fluctuations in the Fair Value of derivatives: "As long as CFC holds its derivative instruments to maturity and CFC and its counter parties perform in accordance with the terms of the instruments, there will be no impact on earnings or cash flow over the life of the derivative as a result of adopting SFAS 133. It is CFC's policy to hold derivatives to maturity." *See* 2002 10K , p. 32

[130] Bank lines of credit are tied to TIER Ratio which itself is premised upon CFC's Adjusted Net Margin.

345. For the nine months ended February 28, 2009, derivative cash settlements were $117 Million versus $30 Million (an $87 Million increase) for the comparable period in fiscal year 2008. *See* CFC's 2/28/2010 10Q, p. 4.

346. The 3rd Quarter Derivative Statement is misleading stating that "… income recorded in cash settlements for the payments received and the charge to derivative forward value are offsetting, and therefore there was no effect on reported net income as a result of these transactions …." This misleads investors without further explaining (a material omission) that:

a. While technically true, nevertheless the statement is misleading because CFC fails to disclose that derivative cash settlements **are included** for purposes of CFC's Adjusted Tier Ratio; and

b. Changes in derivative forward value **are NOT[131] included** in the determination of CFC's Adjusted Tier Ratio.

So the premature termination of derivative contracts inflates CFC's "primary performance measure", CFC's Adjusted Tier Ratio, even though it does not increase CFC's income[132]!

347. Further, the income recognized as a result of the management's actions described in 3rd Quarter Derivative Statement was an 'extraordinary item of income' because:

a. It was a material change in policy to prematurely terminate derivative contracts, CFC traded derivatives after repeatedly representing in public documents that

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[131] "**The Company's primary performance measure is TIER**. …. TIER is a measure of the Company's ability to cover interest expense requirements on its debt. The Company adjusts the TIER calculation to add the derivative cash settlements to the interest expense, to add minority interest net income back to total net income and to remove the derivative forward value and foreign currency adjustments from total net income." *See* CFC's 2007 10K, p. 51.

[132] Of course, that statement is true only if CFC properly values derivative contracts. Since CFC readily departs from GAAP in valuing loans, there is no comfort in CFC's valuation of derivatives.

CFC holds derivatives until maturity[133]; and

b. The early termination of Derivative Contracts materially and negatively affects CFC's future Adjusted Tier Ratios.

Even in the document were CFC disclosed the premature termination of derivative contracts, CFC stated: "With the exception of redeeming subordinated deferrable debt under early redemption provisions, terminating derivative instruments under early termination provisions and allowing borrowers to prepay their loans, we have held and intend to hold all financial instruments to maturity." *See* CFC's 2009 10K, FN 15, p.124.

348. The effect on future Adjusted Tier Ratio of management's actions described in 3rd Quarter Derivative Statement is illustrated by comparing derivative cash settlements before and after the extra-ordinary management action –

a. For the 4 quarters of fiscal year 2008, before the extra-ordinary termination of derivative contracts, CFC's cash settlements were \$8.3 Million for the 1st quarter, \$11.5 Million for the 2nd quarter, \$10.5 Million for the 3rd quarter, and (\$3.2 Million) for the 4th quarter.

b. For the 4 quarters following the extra-ordinary termination of derivative contracts, CFC's cash settlements were (\$4 Million) for the 4th quarter of FY 2009, (\$3.5 Million) for the 1st quarter of FY 2010, (\$10.7 Million) for the 2nd quarter of FY 2010, and (\$5.6 Million) for the 3rd quarter of 2010.

The early termination of derivative contracts has materially affected future calculations of the Adjusted Net Income because CFC's derivative cash settlements went from a positive

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[133] "With the exception of redeeming collateral trust bonds and subordinated deferrable debt under early redemption provisions, terminating derivative instruments under early termination provisions and allowing borrowers to prepay their loans, the Company has held and intends to hold all financial instruments to maturity." CFC's 2007 10K, FN 14, p. 109.

contributor to CFC's Adjusted TIER Ratio to a negative contributor.

349. Upon information and belief, the recognition of merely $114 Million of the unreserved loss related to the ICC Loan <u>forced the early termination of the profitable derivative contracts</u> so that CFC could manage its primary measurement of performance, the Adjusted Tier Ratio. The willingness to jeopardize the future over $114 Million loss recognition is another sign of CFC's financial distress.

350. Over 95% of CFC's assets in fiscal years 2008 and 2009 consist of what Relator describes as *trust me assets*; that is, loans and derivative assets. These assets are subject to CFC's determination of impairment and CFC's determination of Fair Value. Upon information and belief, CFC has numerous other loan problems and valuation problems which are concealed and remain undisclosed.

**Part Three: CoServ and ICC as of May 31, 2009**

351. As of May 31, 2009, the end of CFC's fiscal year 2009, CFC had:

a. Unamortized and unrecognized CoServ Loan Loss of $116 Million. *See Proof of Amortization – Calendar year 2009*.

b. An ICC Loan Balance of $524 Million. *See* CFC's 2009 10K, FN 16(d), p. 128.

c. A Loan Loss Reserve for $20,192 Million in loans of $623 Million. *See* CFC's 2009 10K, p. 90.

d. Members' equity of $604 Million. *See* CFC's 2009 10K, p. 17.

352. The unamortized and unrecognized CoServ Loan Loss and the ICC Loan total

$640 Million without considering any overstatement in Foreclosed Assets[134].

353. The CFC assets known overstatement of $640 Million attributable to the CoServ and ICC loans exceeds CFC's total loan loss reserves of $623 Million for a loan portfolio of $20,192 Million as of May 31, 2009, a material sum.

354. The CFC assets known overstatement of $640 Million attributable to the CoServ and ICC loans exceeds Members' Equity of $604 Million as of May 31, 2009, a material sum.

355. The misreporting of the CoServ and ICC loans predated the first funding of Farmer Mac in July of 2005.

356. The misreporting of the CoServ and ICC loans predated the first funding of a REDLG Loan in November of 2005.

**PART FOUR: The Embezzlement Scheme**

357. Under information and belief, CFC accessed Farmer Mac and FFB (REDLG Loans) funds with financial statements which are either combined or consolidated with RTFC.

358. RTFC is an appendage of CFC through which CFC made telephone loans to rural telephone companies.

359. As proven through a comparison of CFC's audited Financial Statements, specifically the Segment Information, to RTFC's audited Financial Statements for the same period, it is known that CFC was embezzling net margin (coops equivalent to net income) from RTFC and its members.

360. Under information and belief, CFC's embezzlement scheme commenced with the first Telephone Loan made through RTFC in 1987 and continues to this day.

361. The embezzlement scheme part of a racketeering activity within the meaning of

[134] As of May 31, 2009, the Foreclosed Assets had a balance of $48.7 Million (2009 10K, p. 90) and CFC classified those assets, two land development loans (which have been on the books since November of 2002), on non-accrual (CFC's 2/28/2009 10Q, p. 15).

Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 USC § 1561 *et seq.*

362. The Federal Government through Farmer Mac loans and REDLG loans is funding CFC, a coop engaged in racketeering activity.

***CFC's Dominium & Control over RTFC*.**

363. CFC's Management Defendants served dual functions –

a. Defendant Petersen at all relevant time periods has served and continues to serve as the Chief Executive Officer (the "CEO") of CFC and RTFC;

b. Defendant Lilly at all relevant time periods has served and continues to serve as the Chief Financial Officer (the "CFO") of CFC and RTFC;

c. Defendant List at all relevant time periods has served and continues to serve as the General Counsel (the "GC") of CFC and RTFC;

d. Non-Defendant Borak at all relevant time periods has served and continues to serve as the Senior Vice President of Credit Risk Management (the "Credit Manager") of CFC and RTFC;

e. Non-Defendant Evans at all relevant time periods has served and continues to serve as the Senior Vice President of Operations (the "Operations Manager") of CFC and RTFC;

f. Non-Defendant Larochelle at all relevant time periods has served and continues to serve as the Senior Vice President of Corporate Relations (the "Corp. Relations Manager") of CFC and RTFC;

g. Non-Defendant Zawalick[135] during all relevant time periods was and is RTFC's Senior Vice President & Administrative Coordinator and, under information and belief, a Vice President of CFC; and

h. Non-Defendant Reed[136] at all relevant time periods has served and continues to serve as the Associate Vice President and Account Manager (the "Account Manager") of CFC and RTFC.

All of CFC's senior management also serves as RTFC's senior management.

364. All acts taken by or through RTFC directly involved the actions of one or more of CFC's Management acting with the knowledge and assent of the other members of CFC's Management for a common end. "Common End" refers to CFC's use of the dominion and control over RTFC in furtherance of the racketeering activities whether those involve the embezzlement of money from RTFC (as explained herein) and hence, rural telephone companies.

365. From the creation of RTFC through FY 2001 (May 31, 2001), CFC's dominion and control over RTFC was augmented by a patently illegal[137] voting arrangement. CFC's 2001 10K, FN 1b, p. 88, states:

> "CFC has a $1,000 membership interest in RTFC. CFC exercises control over RTFC through majority representation on their Boards of Directors."

366. Through FY 2001, RTFC had over 500 Members that collectively could not elect

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[135] Regarding Zawalick, CFC's 2009 10K, p. 67, states:

> Mr. Zawalick joined National Rural in 1980. Throughout his career with National Rural, Mr. Zawalick has held various positions. In April 1995, he was appointed Vice President of Business Development for National Rural and Administrative Coordinator of RTFC. In February 2000, Mr. Zawalick was named National Rural's Senior Vice President of RTFC.

[136] On March 15, 2000 Robin Reed testified: "RTFC is under a management agreement with CFC so CFC is my employer. I provide services for RTFC." Robin Reed is a CFC employee who provides services to RTFC.

[137] *See* SDCL § 47-16-10 which requires one member, one vote.

a board of directors for RTFC.

367. Upon information and belief, CFC surrendered the voting arrangement only because of the collapse of Arthur Andersen and a new auditor, Defendant Ernst, which would not accept such a patently unlawful arrangement.

368. CFC, through a $1,000 investment, elected a majority of RTFC's Board in violation of South Dakota statutes (RTFC was then domiciled in South Dakota) and in violation of tax law which both implement the coop principle (a key principle that distinguished Coop from other corporations) of **one-member, one-vote**. *See SDCL § 47-16-10*; *Etter Grain Co. v. United States*, 462 F.2d 259 (5th Cir. Tex. 1972) (These provisions envision tax exempt associations organized according to a model of a widely-based participatory democracy[138] in which all the **members are able to exercise a franchise of equal strength**.)

369. In hypocritical fashion, CFC publishes and promotes coop values[139] and Defendant Petersen lectures upon coops principles including the one-member, one-vote known as Democratic Control[140] while intentionally denying RTFC members voting control over RTFC.

370. In addition to interlocking management, CFC's strangle-hold over RTFC is augmented through a series of contractual arrangements whereby:

a. CFC is the sole lender to RTFC with CFC's Management representing both lender and borrower;

b. CFC and CFC's Management manages the affairs of RTFC through a

[138] RTFC members did not have and do not have a right to participation.

[139] Nevertheless, Defendant NRECA, which participates in the management of CFC, provides a "Credentialed Cooperative Director Certificate". CFC publishes coop values on its web cite!

[140] "Democratic control refers to the periodic assembly of the members at a democratically conducted meeting at which each member ordinarily has only one vote." *See* General Counsel Memorandum 38061; 1979 GCM LEXIS 372.

long-term management agreement;

c. All amounts borrowed by RTFC from CFC may be accelerated if RTFC obtains financing from another source; and

d. All RTFC loans require the approval of the CFC's Loan Advisory Committee.

*See* CFC's 2002 10K, FN 1b, p. 72.

371. If the foregoing was not enough, CFC and CFC's Management cements CFC's domination of RTFC's business affairs by:

a. Generally insuring that RTFC's outside counsel involved in general representation (in contrast to representation on a single transaction) of RTFC, besides reporting to CFC's General Counsel (Defendant List) serving as RTFC's General Counsel, are employed to simultaneously represent CFC;

b. Insuring that RTFC's auditors are employed to simultaneously audit CFC. RTFC is denied independent counsel and accountants especially in relationship with RTFC dealings with CFC;

c. Insuring RTFC does not have a single officer involved in the day-to-day business affairs that is not a CFC employee; and

d. While RTFC must be a member to be a patron (borrower) of CFC, CFC and CFC's Management structured the arrangement so that **RTFC is a non-voting member[141] and patron of CFC** with no voice in CFC's business affairs – especially the allocation of CFC's patronage income.

372. CFC's and CFC's Management domination over RTFC and RTFC's business

[141] CFC's 2004 10K, p. 101, states "RTFC is a class E member of CFC." On page 2, CFC describes Class E Members as Associates are not entitled to vote at any meeting of the members and are not eligible to be represented on CFC's board of directors."

affairs is so complete that CFC has referred to RTFC:

a. As "a controlled affiliate of CFC" even though CFC was one (1) member out of five hundred sixteen (516) RTFC members. *See* CFC's 2001 10K, FN 1a, p. 58.

b. As CFC's "affiliated organization" even though CFC has NO ownership interest whatsoever in RTFC after 2001. *See* CFC's 2002 10K, p. 11.

c. As a "managed affiliate" of CFC even though CFC has NO ownership interest whatsoever in RTFC. *See* CFC's press release dated 1/30/2009, announcing CFC's credit bid for ICC.

373. The dominion and control over RTFC is essential to the conduct of CFC's and CFC's Management embezzlement scheme.

***A Bird's Eye View of CFC's Racketeering Activities*.**

374. Many of the Racketeering Activities set forth herein involve the relationship of two cooperative associations (hereinafter "coops"): CFC and CFC's Management, the perpetrator of the fraud and the Racketeering Activities, and RTFC, the Enterprise.

375. RTFC, a financing coop, is engaged in a legitimate business of lending to rural telephone companies which are members of RTFC ("Telephone Members"). CFC and CFC's Management manages RTFC and CFC is the exclusive provider of funds to RTFC.

376. CFC, a financing coop, is a niche lender. CFC lends:

a. directly to rural electric companies which are its members which are electric coops ("Electric Members"); and

b. indirectly to rural telephone companies through loans to RTFC which in turn fund RTFC loans to Telephone Members.

RTFC is a direct patron of CFC and thus, RTFC's Telephone Members are indirect patrons of

CFC.

377. RTFC is and always has been a non-voting member of CFC[142]; therefore, RTFC and RTFC's Telephone Members have no input, no vote, or no say in CFC's allocation of patronage income among CFC's Electric Members and RTFC.

378. CFC's Management implements the Embezzlement Scheme by determining and effecting the allocation of patronage income between CFC's Electric Members and RTFC, and then serving as RTFC's management, among RTFC's members.

379. CFC discloses as a risk factor that "We [CFC] could jeopardize our federal tax exemption if we fail to conduct our business in accordance with our exemption from the Internal Revenue Service." *See* 2009 10K, p. 15. CFC is a tax-exempt coop pursuant to *26 U.S.C. § 501(c)(4)*. Continued eligibility for tax-exempt treatment requires that CFC operate in accord with its articles and bylaws – this is referred to as the Operational Test[143].

380. RTFC is a taxable coop that pays income tax based on its net margins, excluding net margins allocated to its members, as allowed by law pursuant to Subchapter T of the Internal Revenue Code.

381. Embezzling from RTFC means over 500 companies are unknowingly underreporting income.

382. The "**Embezzlement Scheme**" involves CFC's unlawful operation of RTFC pursuant to a long-term scheme to systematically embezzle income that belongs to RTFC and thus RTFC's Telephone members coupled with continuous acts of accounting and securities

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[142] Both CFC and RTFC lend only to members.

[143] The following is a reference to the operational test: "We could jeopardize our federal tax exemption if we fail to conduct our business in accordance with our exemption from the Internal Revenue Service." *See* CFC's 2009 10K, p. 15.

fraud to conceal the Embezzlement Scheme from investors and RTFC members.

383. A fraud upon RTFC is a fraud upon RTFC's Members who under coop law (principles) own RTFC's income (including RTFC's income illegally converted[144] by CFC) and to whom the income is legally required to be allocated in the form of patronage income.

384. CFC's retaliation, the ICC foreclosure, directly relates to the ICC who discovered CFC's Embezzlement Scheme. CFC, acting through RTFC, engaged in activities against Whistle Blowers that were extortionary, retaliatory and designed to crush and suppress whistleblowers in order to conceal the Embezzlement Scheme Racketeering Activity from investors and RTFC members through material omissions and material misrepresentations of the foreclosure suit filed by RTFC against ICC. The object was to avoid accountability and to continue with CFC's and CFC's Management ongoing activities as a racketeering enterprise.

***Coop Principles*.**

385. Coops can be incorporated or unincorporated entities which operate the business "on a cooperative basis". There are three fundamental characteristics to coops, which are:

(a) Subordination of capital which means that a members' capital[145] (which nevertheless must be allocated to the members and is deemed owned by members) may be retained by the coop if necessary for the greater good of the Coop and all members;

(b) Democratic control of the coop by the worker-members themselves means one-member, one-vote in contrast to voting based upon ownership of the coop's capital; and

(c) The vesting in and the allocation among the worker-members of all fruits

[144] Under Coop legal principles, RTFC as a member of CFC owns the net profit it contributes to CFC and in turn, RTFC members (rural telephone companies) own RTFC's profit.

[145] All coop capital and earnings are deemed to be the members' capital and earnings; thus, the subordination of capital refers to the fact that coops may retain an individual member's capital and earnings to serve the needs of the collective membership represented by the coop entity.

and increases arising from their cooperative endeavor in proportion to the worker-members' active participation in the cooperative endeavor (referred to as the "operation at cost" principle or the Internal Revenue Service's characterization as "operating as a conduit") which means the coops earnings are in reality the coop member's earnings whose patronage (business) generated the profit.

The foregoing is supported by and taken from a federal publication: *IRS General Counsel Memorandum on Cooperative Netting*, GCM 38061, 1979 WL 52855 citing *Puget Sound Plywood, Inc. v. Commissioner,* 44 T.C. 305 (1965).

386. These principles are essential to understanding the racketeering activities; for instance, as developed hereinafter, CFC would not be a tax-exempt entity but for the application of coop principles; however, CFC operated and continues to operate in complete disregard of those principles.

***The Absolute Legal Requirement: Income Must Be Allocated to the Patron Whose Business Generated CFC's Profit*.**

387. CFC's Articles of Organization and CFC's bylaws have **mandatory requirements** regarding the allocation of CFC's Net Margin (net income) which are NOT elective. Adherence to these provisions are required as a 'matter of law' in order for CFC to qualify for a tax exemption pursuant to *26 U.S.C. § 501(c)(4)*.

388. *26 U.S.C. § 501(c)(4)* requires CFC to –

a. not be organized for profit (*26 U.S.C. § 501(c)(4)(a))*;

b. operate exclusively for the promotion of social welfare (*26 U.S.C. § 501(c)(4)(a))*;

c. devote the net earnings '**exclusively**' to charitable, educational, or recreational purposes (*26 U.S.C. § 501(c)(4)(a))*; and

d. the requirement in subparagraph (c) is further emboldened with the prohibition that "**no part of the net earnings of such entity inures to the benefit of any private shareholder or individual**" (*26 U.S.C. § 501(c)(4)(b))*.

389. CFC distributes cash patronage dividends to their members. Distributions of cash patronage dividends have been and are at odds with the legal requirements:

(i) that net earning must be devoted "exclusively' to charitable, educational, or recreational purposes (*26 U.S.C. § 501(c)(4)(a))*; and

(ii) the prohibition of *26 U.S.C. § 501(c)(4)(b)* that "no part of the net earnings of such entity inures to the benefit of any private shareholder or individual."

390. Tax-exempt coops legally circumvent the strict legal requirements[146] of *26 U.S.C. § 501(c)(4)* because of an **accepted tax fiction applicable to all coops[147]**. A recent tax court case, *Affiliated Foods, Inc. v. Comm'r*, 128 T.C. 62, 85 (T.C. 2007), discussed the two accepted theories that serve as the basis for the fiction: (i) the so-called "**agency theory**" (the cooperative is conceived of as an agent, bailee, or trustee for the patrons, serving merely as a 'conduit' for their income which it does not own[148]) and (ii) "**price adjustment theory**" (upon the theory that patronage dividends are in reality rebates on purchases or deferred payments on sales[149] allocated

[146] The only differences between an IRC § 501(c)(3) organization (which include churches and schools) and a (c)(4) organization is that contributions to (c)(3) organizations are deductible and contributions to (c)(4) organizations are not deductible and further, (c)(4) organizations, but not (c)(3) organizations, are permitted to engage in substantial lobbying to advance their exempt purposes. *Regan v. Taxation with Representation*, 461 U.S. 540, 543 (U.S. 1983).

[147] It is the unique nature of coops recognized by law including tax law.

[148] In the case of a financing coop, the excess profit derived from the patrons' interest payments belong to the patron or patrons that made the interest payments.

[149] In the case of a financing coop, the patronage allocation is deemed an interest rate adjustment.

or distributed pursuant to a pre-existing obligation of the cooperative).

391. Under either tax fiction, **the patron is the *owner*[150] of the profit earned by the Coop as a result of the patron's business**.

392. If the member owns the net margin; then and only then, under the tax fiction[151], the distribution of patronage income does NOT run afoul the prohibition of *26 U.S.C. § 501(c)(4)(b)* that "no part of the net earnings of such entity inures to the benefit of any private shareholder or individual."

393. This Embezzlement Scheme involves CFC's and CFC's Management's illegal allocation and allocation in contravention CFC's bylaws of RTFC's profit to Electric Members as well as fraudulent activity directly and indirectly related thereto. The two tier coop structured is used to allocate RTFC's income to Electric Members of CFC.

394. CFC qualifies for tax exempt status **only because** Article XI, sections 1, 4(a) and 4(e) of CFC's bylaws integrate the accepted tax fiction into CFC's bylaws by explicitly stating:

> Section 1: Nonprofit Operation. The Association shall at all times be operated … for the primary and **mutual benefit** of its patrons. … **All net savings** **[152]**, representing the excess of revenues over operating costs and expenses, **shall be received** by the Association **with the understanding** that they **are furnished by its patrons as capital** and that the Association is obligated to pay by credits to a capital account … for each patron ... **in proportion to their patronage**. (Emphasis and footnote added)
>
> Section 4(a). Patronage Capital Certificates. … that at the end of each fiscal year the amount of patronage capital, if any, in the form of **net savings so furnished by *each* patron** [153 ] is clearly reflected and credited in an appropriate record to the capital

[150] Even though the profit is held by the coop; hence, the requirement to allocate profits to the patron's capital account.
[151] The net margin (net income) is not CFC's income and the distribution thereof is a price rebate (interest rebate) or a distribution that the agent (CFC) holds for the principal (members).

[152] CFC's Articles are premised clearly upon the **net margin (net income)** CFC derives from each patron. RTFC is a patron of CFC.

[153] See Footnote 115 above.

> account **of each patron**. … (Emphasis and footnote added)
>
> Section 4(e). The patrons of the Association, by dealing with the Association, acknowledge that the terms and conditions of the Articles of Incorporation and Bylaws shall constitute and be a contract between the Association and each patron, and both the Association and the patron are bound by such contract as fully as though each patron had individually signed a separate instrument containing such terms and provisions.

With respect to IRC §501(c)(3) organizations, this is referred to as the Organizational Test: to be granted tax-exempt status the organizational documents of the applicant must comply[154] with the requirements of tax law.

395. CFC's bylaws implement the tax fiction (as well as a unique and inherent characteristic of coops) by mandating that net savings (net income) received by CFC "are furnished by its patrons **as capital** … in proportion to their patronage" coupled with the requirement that the "net savings [net income] so furnished by *each* patron is clearly reflected and credited … to the capital account of each patron." (Emphasis added)

396. Under those provisions of CFC's bylaws, RTFC owns its contribution to CFC's income; it is as if RTFC made a capital contribution to CFC.

397. Under those provisions of CFC's bylaws, Electric Members own their contribution to CFC's income.

398. CFC's organizational documents are **tax compliant** pursuant to the agency theory (conduit) and/or under the price adjustment theory (rebates) because, CFC's bylaws require patronage income to be allocated among the patrons based upon the income "so furnished by *each* patron" and the net savings contributed by the patron are deemed capital contributions by the patron (CFC bylaws, Art. XI, Sec. 1).

399. The allocation of net margin contributed by RTFC members to CFC's electric

[154] CFC filed an IRS Form 1024 which requires the submission of complete conformed copies of CFC's organization documents in order to be granted tax exempt status.

members cannot be reconciled to either the agency theory or the price adjustment theory.

400. To effect the Embezzlement Scheme, CFC and CFC's Management does NOT allocate income consistent with CFC's bylaws. CFC and CFC's Management embezzles from RTFC by allocating income which is generated by RTFC's loans and is RTFC's income and therefore RTFC members' capital (and under the bylaws, capital contributions of RTFC members) to CFC's voting members, the Electric Members. In furtherance thereof, CFC's Management serving as RTFC's Management functions to disenfranchise RTFC's Members by acting as a buffer between those Members and CFC.

401. CFC's and CFC's Management's allocations of RTFC's income to the Electric Members is an ultra vires allocation in direct contradiction of express provisions of the CFC bylaws and also violates CFC's tax-exempt status – one of many tax frauds committed by CFC and CFC's Management.

***Proof of CFC's Embezzlement Scheme*.**

402. The Embezzlement Scheme is proven by audited financial statements which are published at CFC's and CFC's Management's direction and under the control of CFC and CFC's Management. Thus the Embezzlement Scheme is proven by CFC's own information.

403. CFC's and RTFC's fiscal year-end is May 31$^{st}$ of each year.

404. CFC is registrant within the meaning of *17 C.F.R. 210.1-02(t)*, the Securities Exchange Act of 1934, as amended, because CFC issues debt instruments listed on the New York Stock Exchange, debt instruments through an extensive broker/dealer network, and debt instruments to its members.

405. As a registrant, CFC and CFC's Management publicly files reports with the Securities and Exchange Commission ("SEC") which includes filing quarterly reports, SEC

Form 10Qs, and filing annual reports, SEC Form 10Ks.

406. CFC's 10K for the fiscal year ended May 31, 2002 ("FY 2002") stated in **Segment Information** footnote, a mandatory disclosure pursuant to Generally Accepted Accounting Principles ("GAAP"), Footnote 13, on page 97 of the FY 2002 10K that:

> The **new presentation** [first implemented in FY 2002] provides a breakout of the income statement between electric loans and telecommunications loans that reflects the full gross margin earned by each portfolio. The telecommunications system income statement **now represents the total earned on telecommunications loans at both the CFC and RTFC levels**. The electric system income statement is **now only** the amount earned on loans to electric member systems. (Emphasis added)

CFC earns money at the CFC level (within CFC) from RTFC because of loans from CFC[155] to RTFC to fund telephone loans to the Telephone Members; thus, the statement "total earned on telecommunications loans at both the CFC and RTFC levels" refers to the profit from Telephone Members' loans part of which is captured within CFC and part of which is left with RTFC.

407. The Embezzlement Scheme involves the RTFC income captured within CFC and which CFC and CFC's Management allocated to Electric Members whom did not contribute or own that profit.

408. Pursuant to *18 U.S.C. § 1350* (a Sarbanes-Oxley amendment) both Defendant Lilly, CFC's and RTFC's Chief Financial Officer, and Defendant Petersen, CFC's and RTFC's Chief Executive Officer, certified, subject to criminal penalties, that "The information in the Report [which includes the Segment Information] fairly presents, in all material respects, the financial condition and results of operations of CFC."

409. The Embezzlement Scheme is proven by a simple comparison of the Audited Financial Statements of RTFC (non-public information) to the Segment Information footnote set

[155] Note that CFC's management is on both sides of the inter-coop loans representing the lender and the borrower.

forth as an integral part of CFC's Audited Financial Statements. Segment Information is a mandatory disclosure pursuant to GAAP.

410. CFC SEC Form 10K ("CFC's 10K") for FY 2002[156], Footnote ("FN") 13, page 98, reports the following Segment Information '**for FY 2000**':

| (Dollar amounts in thousands) | **For the year ended May 31, 2000** | | |
|---|---|---|---|
| | **Electric Systems** | **Telecommunications Systems** | **Total Combined** |
| Income statement: | | | |
| Operating income | $ 780,809 | $ 240,189 | $ 1,020,998 |
| Cost of funds | 688,271 | 173,053 | 861,324 |
| Gross margin | 92,538 | 67,136 | 159,674 |
| General and administrative expenses | 21,256 | 5,730 | 26,986 |
| Provision for loan losses | 6,155 | 11,200 | 17,355 |
| Net margin | $ 65,127 | $ 50,206 | $ 115,333 |
| Assets: | | | |
| Loans outstanding, net | $ 12,807,525 | $ 3,642,228 | $ 16,449,753 |
| Other assets | 499,129 | 134,558 | 633,687 |
| Total assets | $ 13,306,654 | $ 3,776,786 | $ 17,083,440 |

Telecommunications systems refer to RTFC loans (see paragraph 393 above).

411. The following RTFC's Audited Income Statement '**for FY 2000**':

RURAL TELEPHONE FINANCE COOPERATIVE

Statements of Income, Expenses and Net Margins

*For the Years Ended May 31, 2001 and 2000*

| | 2001 | 2000 |
|---|---|---|
| **Operating Income** – Interest on loans | $ 419,523,919 | 240,189,383 |
| Less – Cost of funds | 415,127,567 | 236,126,623 |
| Gross operating margin | 4,396,352 | 4,062,760 |
| **General and Administrative Expenses** | 578,951 | 565,657 |
| Operating margin | 3,817,401 | 3,497,103 |
| **Non-Operating Income** | | |
| Patronage capital allocation from CFC | 34,187,286 | 23,344,638 |
| Interest income from Commercial Paper investment | 93,153 | 38,140 |
| **Total Non-Operating Income** | 34,280,439 | 23,382,778 |
| **Net Margin** | $ 38,097,840 | 26,879,881 |

*The accompanying notes are an integral part of these financial statements.*

[156] CFC SEC Form 10 K for FY 2007 and other references to 10Ks will be "2002 10K."

412. Thus, for FY 2000 RTFC Audited Income Statement reported income of nearly $27 Million while in the CFC's SEC filings (in the Segment Information) reported RTFC's contribution to the Combined Earnings of CFC/RTFC at over $50 Million[157] (after allowance for loan losses). **This is proof of the embezzlement of over $23 Million** – nearly as much income as RTFC reported earnings.

413. CFC and CFC's Management has been asked but has not ever proffered an explanation of the $23 Million discrepancy for FY 2000.

414. CFC's 2002 10K, Footnote ("FN") 13, page 98, reports the following Segment Information '**for FY 2001**':

| (Dollar amounts in thousands) | **For the year ended May 31, 2001** | | |
|---|---|---|---|
| | **Electric Systems** | **Telecommunications Systems** | **Total Combined** |
| Income statement: | | | |
| Operating income | $ 968,771 | $ 419,524 | $ 1,388,295 |
| Cost of funds | 804,384 | 313,455 | 1,117,839 |
| Gross margin | 164,387 | 106,069 | 270,456 |
| General and administrative expenses | 23,790 | 8,696 | 32,486 |
| Provision for loan losses | 74,404 | 30,800 | 105,204 |
| Net margin | $ 66,193 | $ 66,573 | $ 132,766 |
| Assets: | | | |
| Loans outstanding, net | $ 14,113,354 | $ 5,238,599 | $ 19,351,953 |
| Other assets | 473,734 | 173,155 | 646,889 |
| Total assets | $ 14,587,088 | $ 5,411,754 | $ 19,998,842 |

Note that RTFC earnings contribution (net margin above) of $66.6 Million **exceeds** Electric Members earnings contribution even though Telephone Loan Portfolio is only $5.4 Billion of a $20 Billion Total Loan Portfolio.

415. RTFC made $38 Million as income pursuant to RTFC's 2001 Audited Income Statement **for FY 2001** (see paragraph 398 above that reports RTFC's Net Margin [income] at $38,097,840).

[157] $50 Million "… *represents the total earned on telecommunications loans at both the CFC and RTFC levels.*" *See* CFC's 2002 10K, FN 13, p. 97.

416. Thus, for FY 2001 RTFC Audited Income Statement reported income of slightly over $38 Million while in the CFC's SEC filings (the Segment Information) reported RTFC's contribution to the Combined Earnings of CFC/RTFC at over $66 Million (after allowance for loan losses). **This is proof of the embezzlement of over $28 Million for FY 2001.**

417. CFC and CFC's Management has been asked, but has not ever proffered an explanation of the $28 Million discrepancy for FY 2001.

418. CFC's 2002 10K, Footnote ("FN") 13, page 98, reports the following Segment Information '**for FY 2002'**:

| (Dollar amounts in thousands) | For the year ended May 31, 2002 | | |
|---|---|---|---|
| | **Electric Systems** | **Telecommunications Systems** | **Total Combined** |
| Income statement: | | | |
| Operating income | $ 812,768 | $ 373,765 | $ 1,186,533 |
| Cost of funds | 628,651 | 257,187 | 885,838 |
| Gross margin | 184,117 | 116,578 | 300,695 |
| General and administrative expenses | 27,593 | 9,919 | 37,512 |
| Provision for loan losses | 144,349 | 55,000 | 199,349 |
| Operating margin | 12,175 | 51,659 | 63,834 |
| SFAS 133 cash settlements | 24,264 | 9,927 | 34,191 |
| SFAS 133 forward value | 30,804 | 11,074 | 41,878 |
| Cumulative effect of change in accounting principle | 20,878 | 7,505 | 28,383 |
| Net margin | $ 88,121 | $ 80,165 | $ 168,286 |
| Assets: | | | |
| Loans outstanding, net | $ 14,604,091 | $ 4,936,276 | $ 19,540,367 |
| Other assets | 575,931 | 207,044 | 782,975 |
| Total assets | $ 15,180,022 | $ 5,143,320 | $ 20,323,342 |

Before adjustments for contractual agreements between CFC and RTFC, RTFC's earnings contributed for FY 2002 was $80.1 Million.

419. RTFC's 2003 Annual Report reports the following Audited Income Statement **for FY 2002**:

## statements of income, expenses and net margin

| For the years ended May 31, 2003 and 2002 | 2003 | 2002 |
|---|---|---|
| **OPERATING INCOME** — Interest on loans | $ 344,491,756 | 373,765,221 |
| Less — Cost of funds | 337,602,152 | 367,894,050 |
| Gross operating margin | 6,889,604 | 5,871,171 |
| **GENERAL AND ADMINISTRATIVE EXPENSES** | 846,122 | 641,863 |
| **GUARANTY FEE EXPENSE TO CFC** | 773,504 | 374,253 |
| **MANAGEMENT FEE EXPENSE TO CFC** | 2,507,552 | 1,675,340 |
| Operating margin | 2,762,426 | 3,179,715 |
| **NON-OPERATING INCOME** | | |
| Patronage capital allocation from CFC | 25,150,995 | 23,636,017 |
| **TOTAL NON-OPERATING INCOME** | 25,150,995 | 23,636,017 |
| **NET MARGIN** | $ 27,913,421 | 26,815,732 |

See accompanying notes.

RTFC reported less income for FY 2002 than FY 2001 even though RTFC's contribution increased by $13 Million. FY 2002 RTFC income declined to $26.8 Million in FY 2002 from $38.1 Million in FY 2001 (see Paragraph 398 above which has RTFC's Audited Income Statement for FY 2001) even though RTFC's contribution per the Segment Information increased from $66.6 (see paragraph 401) for FY 2001 to $80.2 Million for FY 2002 (see paragraph 405). Simply, without any further adjustment, it is apparent that CFC embezzled more[158] from RTFC for FY 2002 than FY 2001.

420. Thus, for FY 2002 RTFC Audited Income Statement reported income of nearly $27 Million while CFC's FY 2002 SEC filings reported RTFC's contribution to the Combined Earnings of CFC/RTFC at over $80 Million (after allowance for loan losses). This is proof of an **embezzlement of over $53 Million** – more income was embezzled from RTFC than RTFC's

[158] CFC had a $1 Billion loan, the CoServ Loan, which was a troubled loan.

reported earnings.

421. The above analysis **understates the theft for FY 2002**. The discrepancy needs to be adjusted for a contractual relationship between CFC and RTFC that alters their financial relationship for fiscal years 2002 and later. Ironically, the most forthright explanation of the contractual change is in the 2004 10K. The contractual provision is explained in the FY 2006 10K, on page 23, as follows:

> "CFC has agreed to indemnify RTFC and NCSC for loan losses, with the exception of the NCSC consumer loans that are covered by the NCSC loan loss allowance. Therefore, there is no loan loss allowance required at RTFC and only a small loan loss allowance is required at NCSC to cover the exposure to consumer loans."

Thus, for a fee, **CFC[159] indemnifies RTFC for all loan losses** after FY 2001.

422. RTFC's guaranty fee of $.374 Million for FY 2002 decreases RTFC's income as reported in the Segment Information; however, reversing the loan loss adjustment of $55 Million increases RTFC's income as reported in the Segment Information.

423. The foregoing adjustments for the guaranty agreement actually increase RTFC's Segment Income contribution from the $80 Million reported to approximately $135 Million; thus, dramatically increasing the deficiency or sums embezzled from $ 53 Million for FY 2002.

424. Additionally, for years after FY 2001 (thus for FY 2002) adjustments must be made removing the income reported as "SFAS 133 forward value" of $11 Million and the "Cumulative effect of change in accounting principle" of $7.5 Million for a total adjustment of $19 Million (collectively, the "Fair Value Adjustments"). The Fair Value Adjustments reflected as income and/or expense *are excluded in determining the income for purposes of patronage*

[159] This was not a gratuitous provision but a perceived accounting requirement to fraudulently present CFC and RTFC as a 'single entity' for financial presentation purposes even though CFC had no direct voting control or ownership interest in RTFC post-2001. The 'single entity' presentation is essential to disguising and concealing the racketeering activities.

*income and distributions*[160].

425. The Fair Value Adjustments reduce RTFC's Segment Contribution from $135 Million by the sum of $19 Million to $116 Million.

426. In conclusion, RTFC Audited Income Statement for FY 2002 reported income of nearly $27 Million while CFC's FY 2002 SEC filings reported RTFC's contribution to the Combined Earnings of CFC/RTFC at over $80 Million which when adjusted equates to over $116 Million. **This is proof of an embezzlement of over $89 Million for FY 2002** – an amount more than twice RTFC's reported earnings.

427. CFC and CFC's Management has been asked, but has not ever proffered an explanation of the $89 Million FY 2002 discrepancy.

428. CFC SEC Form 10K for FY 2004, Footnote ("FN") 15, page 135, reports the following Segment Information '**for FY 2003**':

| | For the year ended May 31, 2003 | | |
|---|---|---|---|
| (Dollar amounts in thousands) | Electric Systems | Telecommunications Systems | Total |
| Income statement: | | | |
| Operating income | $ 726,384 | $ 344,491 | $ 1,070,875 |
| Cost of funds | (652,991) | (277,856) | (930,847) |
| Gross margin | 73,393 | 66,635 | 140,028 |
| Operating expenses: | | | |
| General and administrative expenses | (28,609) | (9,560) | (38,169) |
| Provision for loan losses | (5,777) | (37,294) | (43,071) |
| (Provision) recovery for guarantee losses | (25,330) | 135 | (25,195) |
| Total operating expenses | (59,716) | (46,719) | (106,435) |
| Results of operations of foreclosed assets | 1,249 | — | 1,249 |
| Impairment loss on foreclosed assets | (19,689) | — | (19,689) |
| Total loss on foreclosed assets | (18,440) | — | (18,440) |
| Derivative cash settlements | 86,162 | 36,663 | 122,825 |

[160] CFC 2009 10K, p. 18, states: "National Rural is required by District of Columbia cooperative law to have a mechanism to allocate our net income to our members. We allocate our net income, **excluding the non-cash effects of the accounting for derivative financial instruments and foreign currency translation**, annually to a cooperative educational fund, a members' capital reserve and to members based on each member's patronage of our loan programs during the year."

| | | | |
|---|---|---|---|
| Derivative forward value | 567,564 | 189,648 | 757,212 |
| Foreign currency adjustments | (182,304) | (60,916) | (243,220) |
| Net margin | $ 466,659 | $ 185,311 | $ 651,970 |

429. RTFC's 2003 income reported by CFC in the Segment Information must be adjusted for

a. the loan loss adjustment of $37 Million which adjustment *increases* RTFC's income;

b. the net Fair Value Adjustments of $128 Million which adjustment *decreases* RTFC's income; and

c. the RTFC guaranty fee of $0.773 Million which adjustment *decreases* RTFC's income.

430. RTFC Segment Information contribution for FY 2003 **adjusted** (per foregoing paragraph) is nearly $94 Million.

431. RTFC Audited Income Statement for FY 2003 reported income of nearly $28 Million (see ¶ 41 above). **The embezzlement is approximately $65 Million for FY 2003** – an amount more than twice the income RTFC was allocated.

432. CFC and CFC's management has been asked, but has not ever proffered an explanation of the $65 Million FY 2003 discrepancy.

433. CFC SEC Form 10K for FY 2004, Footnote ("FN") 15, page 134, reports the following Segment Information '**for FY 2004**':

| | For the year ended May 31, 2004 | | | |
|---|---|---|---|---|
| (Dollar amounts in thousands) | Electric Systems | Telecommunications Systems | Other | Total |
| Income statement: | | | | |
| Operating income | $ 682,199 | $ 307,305 | $ 16,016 | $ 1,005,520 |
| Cost of funds | (662,386) | (245,252) | (6,590) | (914,228) |

| | | | | |
|---|---|---|---|---|
| Gross margin | 19,813 | 62,053 | 9,426 | 91,292 |
| Operating expenses: | | | | |
| General and administrative expenses | (35,168) | (4,267) | (957) | (40,392) |
| Recovery (provision) for loan losses | 98,538 | (145,927) | (7,532) | (54,921) |
| Recovery (provision) for guarantee losses | 1,152 | 66 | (367) | 851 |
| Total operating expenses | 64,522 | (150,128) | (8,856) | (94,462) |
| Results of operations of foreclosed assets | 3,818 | — | — | 3,818 |
| Impairment loss on foreclosed assets | (10,877) | — | — | (10,877) |
| Total loss on foreclosed assets | (7,059) | — | — | (7,059) |
| Derivative cash settlements | 82,064 | 26,118 | 1,905 | 110,087 |
| Derivative forward value | (170,804) | (54,362) | (3,966) | (229,132) |
| Foreign currency adjustments | (48,685) | (15,495) | (1,130) | (65,310) |
| Total loss on derivative and foreign currency adjustments | (137,425) | (43,739) | (3,191) | (184,355) |
| Operating loss | (60,149) | (131,814) | (2,621) | (194,584) |
| Income tax expense | (35) | (217) | (3,565) | (3,817) |
| Minority interest — RTFC and NCSC net margin | — | (1,989) | — | (1,989) |
| Cumulative effect of change in accounting principle | — | — | 22,369 | 22,369 |
| Net (loss) margin | $ (60,184) | $ (134,020) | $ 16,183 | $ (178,021) |

434. RTFC's 2004 income reported by CFC in the Segment Information must be adjusted for –

a. the loan loss adjustment of $146 Million which adjustment *increases* RTFC's income;

b. the net Fair Value Adjustments of $70 Million which adjustment *increases* RTFC's income; and

c. the RTFC guaranty fee of $1 Million which adjustment *decreases* RTFC's income.

435. RTFC's contribution or income pursuant to the **adjusted** (per foregoing paragraph) Segment Information for FY 2004 is nearly $83 Million.

436. The Audited Income Statement from the RTFC 2004 Annual Report reports RTFC's income for FY 2004 as:

| | | 2004 | | 2003 |
|---|---|---|---|---|
| OPERATING INCOME | $ | 306,579,369 | $ | 344,491,756 |
| Less: Cost of funds | | 300,281,490 | | 337,602,152 |
| Gross operating margin | | 6,297,879 | | 6,889,604 |
| GENERAL AND ADMINISTRATIVE EXPENSES | | 821,871 | | 811,022 |
| GUARANTY FEE EXPENSE TO CFC | | 1,018,980 | | 773,504 |
| MANAGEMENT FEE EXPENSE TO CFC | | 2,414,831 | | 2,507,552 |
| Total Expenses | | 4,255,682 | | 4,092,078 |
| Operating margin | | 2,042,197 | | 2,797,526 |
| NON-OPERATING INCOME | | | | |
| Patronage capital allocation from CFC | | 24,215,258 | | 25,150,995 |
| TOTAL NON-OPERATING INCOME | | 24,215,258 | | 25,150,995 |
| NET MARGIN BEFORE INCOME TAXES | $ | 26,257,455 | $ | 27,948,521 |
| INCOME TAX EXPENSE | | 52,500 | | 35,100 |
| NET MARGIN | $ | 26,204,955 | $ | 27,913,421 |

437. For FY 2004 RTFC reported over $26 Million while RTFC's adjusted contribution per the Segment Information was nearly $83 Million, **an embezzlement of nearly $57 Million for FY 2004** or more than twice the income RTFC reported.

438. CFC and CFC's Management has been asked, but has not ever proffered an explanation of the $57 Million FY 2004 discrepancy.

439. The sums embezzled (the discrepancies) from RTFC and the Telephone Members by CFC and CFC's Management derived from in the comparison of Segment Information as publicly reported as compared to RTFC Income statement, both of which are audited, for FYs 2000 through 2004, inclusive, ***is over $262 Million*** - $23 Million for FY 2000; $28 Million for

FY 2002; $89 Million for FY 2002; $65 Million for FY 2003; and $57 Million for FY 2004.

440. The following table demonstrates the effect of the Embezzlement Scheme integrating the **cash patronage dividends** (the patronage capital payouts) demonstrating the discrepancy between sums contributed and CFC payouts. The following table addresses only FYs 2000 thru 2004, **the only years for which CFC published transparent segment information**. "RTC" refers to rural telecommunications companies and "REC" refers to rural electric companies.

| | Segment Information's Adjusted Net Margin | | RTFC's Audited Income Statement | | Patronage Cash Dividends | |
|---|---|---|---|---|---|---|
| Fiscal Year - | RTCs | RECs | | Embezzlement | RTCs | RECs |
| 2000 | 50,206 | 65,127 | 26,880 | 23,326 | 18,816 | 58,623 |
| 2001 | 66,573 | 66,193 | 38,098 | 28,475 | 26,669 | 71,654 |
| 2002 | 116,212 | (18,187) | 26,816 | 89,396 | 18,771 | 55,851 |
| 2003 | 92,964 | 45,014 | 27,913 | 65,051 | 19,539 | 51,037 |
| 2004 | 82,668 | 6,564 | 26,205 | 56,463 | 19,539 | 59,412 |
| | **408,623** | **164,711** | **145,912** | **262,711** | **103,334** | **296,577** |
| | **71.27%** | **28.73%** | | | **25.84%** | **74.16%** |
| | 100.00% | | | | 100.00% | |

441. Based upon the foregoing table for FYs 2000 thru 2004, inclusive, -

a. Electric Members contributed $165 Million and received cash patronage dividends of $297 Million or $132 Million more than contributed; and

b. RTFC Members, in the same span, contributed $408 Million and received cash patronage dividends of $103 Million or $305 Million less than contributed[161].

RTFC Members or the Telephone Loan portfolio contributed 71.27% of CFC's/RTFC's Net

[161] The difference between total earnings and total cash patronage distributions represents 'allocated but retained income.' Over the 5 years in which there is transparent segment information Electric Members received in cash more than twice the Electric Members' income. CFC's allocated but retained income was furnished entirely by RTFC.

Margin and received only 25.86% of the cash patronage distributions while Electric Members or the Electric Loan Portfolio contributed 28.73% of CFC's/RTFC's Net Margin and received 74.16% of the cash patronage distributions.

442. The Embezzlement Scheme netted CFC's Electric Members $262 Million over a 5-year period commencing FY 2000 and ending FY 2004 permitting CFC distribute to Electric Members 180% of their contributions to CFC's income as cash patron dividends[162].

***<u>Pre-2000 Fiscal Years and Post-2004 Fiscal Years</u>.***

443. The sums embezzled from RTFC pursuant to the Embezzlement Scheme for FYs before FY 2000 and after FY 2004 cannot be determined because CFC and CFC's Management fraudulently reports Segment Information in a material departure from GAAP.

444. The FY 2002 10K, FN 13, page 97, states:

> "CFC operates in two business segments - rural electric lending and rural telecommunications lending. … [than, referring to FYs before FY 2001] The amount reported for the electric systems represented the total earned on loans from CFC to its electric members and RTFC. The amount reported for the telecommunications systems represented the incremental amount earned on its CFC loans that it re-lent to the telecommunications systems."

The foregoing is an admission made under penalties of perjury by CFC that the results of the Electric Loan Portfolio included "total earned on loans from CFC to … RTFC" for fiscal years before FY 2002. The Telephone Loan Portfolio only reported as income "the incremental amount earned [by RTFC] on its CFC loans that it re-lent to the telecommunications systems."

445. A comparison of the Segment Information as originally reported for FY 2000 and FY 2001 (the overlap years) illustrates the effect of CFC's fraudulent reporting style.

a. "FY 2000" as reported in the 2001 10K, FN 11, p. 78 –

[162] This absolutely violates the prohibition in 26 USC § 501(c)(4) that "no part of the net earnings of such entity inures to the benefit of any private shareholder or individual" because the distribution exceeds the Electric Members' earnings.

**"FY 2000" As Originally Reported**

| (Dollar amounts in thousands) | For the year ended May 31, 2000<br>Electric Systems | Telecommunications Systems | Total Combined |
|---|---|---|---|
| Income statement: | | | |
| Operating income | $ 780,809 | $ 240,189 | $ 1,020,998 |
| Cost of funds | 624,033 | 236,127 | 860,160 |
| Gross margin | 156,776 | 4,062 | 160,838 |
| Operating expenses | 26,421 | 565 | 26,986 |
| Loan loss provision | 17,355 | | 17,355 |
| Net margin before extraordinary item | 113,000 | 3,497 | 116,497 |
| Extraordinary item | (1,164) | — | (1,164) |
| Net margin (1) | $ 111,836 | $ 3,497 | $ 115,333 |

b. FY 2000 as reported in the 2002 10K, FN 13, p. 98 -

**"FY 2000" As Revised & Reported in FY 2002 10K**

| (Dollar amounts in thousands) | For the year ended May 31, 2000<br>Electric Systems | Telecommunications Systems | Total Combined |
|---|---|---|---|
| Income statement: | | | |
| Operating income | $ 780,809 | $ 240,189 | $ 1,020,998 |
| Cost of funds | 688,271 | 173,053 | 861,324 |
| Gross margin | 92,538 | 67,136 | 159,674 |
| General and administrative expenses | 21,256 | 5,730 | 26,986 |
| Provision for loan losses | 6,155 | 11,200 | 17,355 |
| Net margin | $ 65,127 | $ 50,206 | $ 115,333 |

c. FY 2000 Comparison - $3.5 Million as originally reported compared to $50 Million, as revised. **Neither figure, the $3.5 Million or the $50 Million, comports to the $27 Million reported by RTFC as income for FY 2000 in RTFC's Audited Income Statement for FY 2001**. (*See* paragraph 47 which sets forth RTFC's audited financial statement for FYs 2000 and 2001)

d. "FY 2001" as reported in the 2001 10K, FN 11, p. 78 -

**"FY 2001" As Originally Reported**

| | For the year ended May 31, 2001 | | |
|---|---|---|---|
| (Dollar amounts in thousands) | Electric Systems | Telecommunications Systems | Total Combined |
| Income statement: | | | |
| Operating income | $ 968,771 | $ 419,524 | $ 1,388,295 |
| Cost of funds | 702,426 | 415,128 | 1,117,554 |
| Gross margin | 266,345 | 4,396 | 270,741 |
| Operating expenses | 31,907 | 579 | 32,486 |
| Loan loss provision | 105,204 | | 105,204 |
| Net margin before extraordinary item | 129,234 | 3,817 | 133,051 |
| Extraordinary item | (285) | — | (285) |
| Net margin (1) | $ 128,949 | $ 3,817 | $ 132,766 |
| Assets: | | | |

e. FY 2001 as reported in the 2002 10K, FN 13, p. 98 -

**"FY 2001" As Revised & Reported in FY 2002 10K**

| | For the year ended May 31, 2001 | | |
|---|---|---|---|
| (Dollar amounts in thousands) | Electric Systems | Telecommunications Systems | Total Combined |
| Income statement: | | | |
| Operating income | $ 968,771 | $ 419,524 | $ 1,388,295 |
| Cost of funds | 804,384 | 313,455 | 1,117,839 |
| Gross margin | 164,387 | 106,069 | 270,456 |
| General and administrative expenses | 23,790 | 8,696 | 32,486 |
| Provision for loan losses | 74,404 | 30,800 | 105,204 |
| Net margin | $ 66,193 | $ 66,573 | $ 132,766 |

f. FY 2001 Comparison - $3.8 Million as originally reported compared to $66.5 Million, as revised. **Neither figure, the $3.8 Million or the $66.6 Million, comports to the $38.1 Million reported by RTFC as income for FY 2000 in RTFC's Audited Income Statement for FY 2001.** (*See* paragraph 47 which sets forth RTFC's audited financial statement for FYs 2000 and 2001)

***GAAP Requirements in Segment Reporting*.**

446. After RTFC commenced a foreclosure suit on June 1, 2004 against Prosser

Entities, for FY 2005 and later, CFC intentionally[163] reverted to the same methodology of reporting RTFC profits in the Segment Information as existed prior to changes in the Segment Reporting made in the FY 2002 10K. Thus, once CFC secured AA's old auditor, Defendant Johnston, now associated with Defendant Deloitte, CFC, with the complicity of Defendants Deloitte and Johnston, re-adopted AA's methodology to report Segment Information to intentionally conceal RTFC's actual contribution to CFC/RTFC income.

447. CFC's Segment Reporting for FYs before FY 2002 and after FY 2004 (hereinafter the "***Segment Misreporting Methodology***"), is an intentional and material departure from Generally Accepted Accounting Principles ("GAAP") intended to conceal the Embezzlement Scheme. This intentional departure from GAAP is "to conceal or disguise the … source, the ownership, … of the proceeds of specified unlawful activity." *See 18 USC §1956(1)(B)(i).*

448. Financial Accounting Standards ("FAS") No. 131, ¶ 3, provides that the objectives of Segment Reporting is to help users of financial statements: (i) better understand the enterprise's performance; (ii) better assess its prospects for future net cash flows; and (iii) make more informed judgments about the enterprise as a whole.

449. CFC's ***Segment Misreporting Methodology*** intentionally renders meaningless the objectives of FAS 131, a mandatory footnote. Showing RTFC's contribution at $3.5 Million for FY 2000 and $3.8 Million for FY 2001 is intentionally and materially misleading in violation of GAAP and applicable law.

450. CFC, CFC's Management, Deloitte, and Johnston intentionally depart from FAS 131, ¶ 27(b), which requires "revenues from transactions with other operating segments of the same enterprise" by offsetting the Electric Loan Portfolio's actual interest expense with the sum of interest income accrued by CFC upon CFC loans to RTFC. Offsetting interest expense with

[163] This was after RTFC had commenced the retaliatory foreclosure against ICC.

the profit accrued on CFC loans to RTFC has the same force and effect as reporting the interest income – it intentionally inflates the gross margin of the Electric Loan Portfolio. Further, it is inconsistent with both -

a. The "**agency theory**" (the cooperative is conceived of as an agent, bailee, or trustee for the patrons, serving merely as a 'conduit' for their income which it does not own[164]) and

b. the "**price adjustment theory**" (upon the theory that patronage dividends are in reality rebates on purchases or deferred payments on sales[165] allocated or distributed pursuant to a pre-existing obligation of the cooperative),

since Telephone Loan Portfolio's income belonging to RTFC is reported as Electric Loan Portfolio's income.

451. It is incongruent that under the ***Segment Misreporting Methodology*** Electric Loan Portfolio for FY 2000, as originally reported, is attributed with producing 97.47% of the FY 2000 CFC/RTFC Gross Margin (the Combined Gross Margin) when, pursuant to Footnote 2, the Telephone Loan Portfolio constitutes 22.18% of the Total Loan Portfolio and as of May 31, 2000 the Telephone Loan Portfolio is earning a weighted average interest of 84 basis points **more than** the weighted average interest of the Electric Loan Portfolio. Such discrepancies are inexplicable[166].

452. An analysis for FY 2001 further augments the conclusion that the ***Segment Misreporting Methodology*** misleads investors. It is incongruent that the Electric Loan Portfolio

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[164] In the case of a financing coop, the excess profit derived from the patrons' interest payments belong to the patron or patrons that made the interest payments.

[165] In the case of a financing coop, the patronage allocation is deemed an interest rate adjustment.

[166] There is one explanation – fraud.

for FY 2001, as originally reported using the ***Segment Misreporting Methodology***, is attributed with producing 98.38% of the FY 2001 CFC/RTFC Gross Margin (the Combined Gross Margin) when, pursuant to Footnote 2, the Telephone Loan Portfolio constitutes 27.05% of the Total Loan Portfolio and as of May 31, 2001 the Total Loan Portfolio was earning a weighted average interest of 141 basis points **more than** the weighted average interest of the Electric Loan Portfolio. Such discrepancies are inexplicable.

453. As to years after FY 2004, the 2005 10K, FN 15, p. 105, the Segment Information footnote, reports a gross margin of $104 Million **for fiscal year 2005** with approximately $89.8 Million or 90% of the FY 2005 Gross Margin attributable to the Electric Loan Portfolio (74.95% and 81.73% of the Total Loan Portfolio as of the beginning and the end of the FY); approximately $5.3 Million or 5% attributable of the FY 2005 Gross Margin to the Telephone Loan Portfolio (22.66% and 15.77% of the Total Loan Portfolio as of the beginning and the end of the FY); and approximately $9 Million or 8.65% of the FY 2005 Gross Margin attributable to the NCSC Loan Portfolio (2.39% and 2.5% of the Total Loan Portfolio as of the beginning and the end of the FY).

454. The reported result **is impossible** given that fact that as of May 31, 2004, based upon the information disclosed in FN 2 of the 2004 10K, the Electric Loan Portfolio, on a weighted average basis, had NO interest spread[167] and 88% of the Electric Loan Portfolio was invested in long-term loans. CFC changed its disclosure with respect to footnote 2 after FY 2004 so that it is now impossible to compute the weighted average interest rates of the loan portfolios: Electric Loan Portfolio, the Telephone Loan Portfolio, and NCSC Loan Portfolio.

455. CFC intentionally departs from FAS 131, ¶ 31(a), which requires "an enterprise

[167] As of May 31, 2004 the weighted average interest rate on the Electric Loan Portfolio was 4.41% and CFC's weighted average interest rate on debt (including the subordinated capital certificates) was 4.41%.

shall disclose the … [T]the basis of accounting for any transactions between reportable segments." Nowhere does CFC make any disclosure that remotely addresses the basis of accounting that resulted in reporting Telephone Loan Portfolio profit as Electric Loan Portfolio profit.

456. CFC's ***Segment Misreporting Methodology*** is an intentional departure from GAAP to conceal the Embezzlement Scheme.

457. The purpose of Financial Statements include –

- Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions.

- The objectives of financial reporting are not immutable—they are affected by the economic, legal, political, and social environment in which financial reporting takes place.

- Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.

- "Investors" and "creditors" are used broadly and include not only those who have or contemplate having a claim to enterprise resources but also those who advise or represent them.
  *See Statement Financial Accounting Concepts No. 1, Objectives of Financial Reporting by Business Enterprises*, p. 4-5.

458. CFC's ***Segment Misreporting Methodology*** conceals an embezzlement scheme from investors, including the Government, which is material because:

a. If the Government enforced the law, CFC Embezzlement Scheme involves mail fraud[168], a violation of *18 USC § 1341*, to the extent the Embezzlement Scheme deploys or deployed the use of mail in conjunction therewith;

b. If the Government enforced the law, CFC Embezzlement Scheme involves

[168] A racketeering activity within the meaning of *18 USC § 1961(1)*.

wire fraud[169], a violation of *18 USC § 1343,* to the extent the Embezzlement Scheme deploys or deployed the use of electronic communication in conjunction therewith;

c. If the Government enforced the law, CFC Embezzlement Scheme involves money laundering[170], a violation of *18 USC § 1956,* to the extent the Embezzlement Scheme deploys or deployed false tax returns of CFC and RTFC in conjunction therewith[171];

d. The disclosure in every CFC 10K that "National Rural's [CFC's] continued exemption depends on it conducting our business in accordance with our 501(c)(4) status" violates the principle of completeness set forth in FASB Statement of Concepts No. 2, ¶ 80, and is a material omission as defined by Security law[172]; and

e. CFC's fraudulent practices as evidenced by the Embezzlement Scheme would, if the law is enforced, bring the house down (CFC would cease to exist) which presents a material undisclosed (material omission) to investors, including the Government.

459. The AICPA's Statements on Auditing Standards provide:

> .14 The auditor should consider the effect of an illegal act on the amounts presented in financial statements including contingent monetary effects, such as

[169] A racketeering activity within the meaning of *18 USC § 1961(1).*

[170] A racketeering activity within the meaning of *18 USC § 1961(1).*

[171] *18 USC § 666* makes it unlawful for a recipient of Federal funds to – "embezzles, steals, obtains by fraud, or otherwise without authority knowingly converts to the use of any person other than the rightful owner or intentionally misapplies, property…."

[172] *See TSC Industries, Inc. v. Northway, Inc.,* 426 U.S. 438 (1976) (an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important [in context to a proxy] in deciding how to vote.); and 15 U.S.C. § 78u-4(b)(1)(B) as well as 17 C.F.R. § 240.10b-5(b) (… omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading.)

fines, penalties and damages. Loss contingencies resulting from illegal acts that may be required to be disclosed should be evaluated in the same manner as other loss contingencies. Examples of loss contingencies that may arise from an illegal act are: threat of expropriation of assets, enforced discontinuance of operations in another country, and litigation.

.15 The auditor should evaluate the adequacy of disclosure in the financial statements of the potential effects of an illegal act on the entity's operations. If material revenue or earnings are derived from transactions involving illegal acts, or if illegal acts create significant unusual risks associated with material revenue or earnings, such as loss of a significant business relationship, that information should be considered for disclosure.

.18 If the auditor concludes that an illegal act has a material effect on the financial statements, and the act has not been properly accounted for or disclosed, the auditor should express a qualified opinion or an adverse opinion on the financial statements taken as a whole, depending on the materiality of the effect on the financial statements.
*See* AU Section 317, *Illegal Acts by Clients*

460. It is incontestable and irrefutable that the investing public should know that they are funding an entity engaged in a material fraud in the production of its net margin (net income).

461. Financial Statements are legally presumed[173] to be misleading when there is a departure from GAAP. *17 C.F.R. § 210.4-01(a)(1)* provides that "Financial statements filed with the Commission which are not prepared in accordance with GAAP will be presumed to be misleading or inaccurate …". This departure from GAAP is intentional and directly related to Embezzlement Scheme.

462. The Embezzlement Scheme makes CFC's financial information materially misleading.

**PART FIVE: CFC's Access to Farmer Mac Funds**

[173] While legal presumptions are helpful the embezzlement scheme is demonstrated with CFC's own published financial statements.

***Farmer Mac is a Government Instrumentality*.**

463. Senate Committee of Judiciary when adopting the False Claims Reform Act in 1986 stated:

> A claim upon any Government agency or instrumentability, quasi-governmental corporation, or nonappropriated fund activity is a claim upon the United States under the act.
> SEE: S. REP. 99-345, 1986 U.S.C.C.A.N. 5266, at page 5275, p. 10 of the report.

464. Likewise, the House Judiciary Committee's report, Part V. "MAJOR ISSUES DISCUSSION" under section titled "CLAIM DEFINED", the House Report stated:

> For example, each and every claim submitted under a contract, loan guarantee, or other agreement which was originally obtained by means of false statements or other corrupt or fraudulent conduct constitutes a false claim.
>
> **A claim upon any Government agency or instrumentality, quasigovernmental corporation, or nonappropriated fund activity** is a claim upon the United States under the Act.
> *SEE*: *H.R. REP. 99-660*, p. 21. (Emphasis Added).

465. If CFC were to rely upon the case of *U.S. ex rel. Totten v. Bombardier Corp.*, 380 F.3d 488, C.A.D.C., 2004 ("*Totten*") to suggest[174] that Farmer Mac is not the Government[175] within the meaning of the False Claims Act ("False Claims Act"), such reliance would be misplaced.

466. It is error to rely upon *Totten* because the holding is distinguishable:

a. The Court in *Totten* held that "Even prior to 1997 -- indeed, at all times since the company was created in 1971 -- Amtrak 's organic statute has flatly stated that the company 'is not a department, agency, or instrumentality of the United States Government.'" *See* 380 F3$^{rd}$ at 491.

[174] This is equivalent to saying Freddie Mac and Fannie Mae are not GSEs. There is a difference between saying a non-appropriate fund activity like Freddie Mac does not have a Federal Government guarantee and saying that Freddie Mac is not a GSE.

[175] The FALSE CLAIMS ACT refers to the United States Government.

b. Farmer Mac's statutory charter, *12 U.S.C. § 2279aa-1(a)(1),* explicitly states: "There is hereby established a corporation to be known as the Federal Agricultural Mortgage Corporation, **which shall be a federally chartered instrumentality of the United States**." (Emphasis added)

*Totten* cannot be relied upon when Congress explicitly provided that Farmer Mac *was an instrumentality of the United States* and explicitly stated that Amtrak *was NOT an instrumentality of the United States*.

467. Furthermore, the ruling in *Totten* has been overruled by provisions of the Fraud Enforcement and Recovery Act of 2009 (FERA) signed May 20, 2009, by President Obama. FERA effectively overrules *Totten* by changing the definition of "claim" to include requests or demands to certain third parties who are not government officials.

468. Farmer Mac's status as a coop does not disqualify Farmer Mac from being an *instrumentality of the United States*.

469. In a Supreme Court case involving Production Credit Associates which entities operate as coops, after noting on page 824 that the "In the period relevant here (when all PCA stock has been in private hands)", the Supreme Court nevertheless held:

> … PCA's are instrumentalities of the United States because the statute which charters them says so. *SEE* *Ark. v. Farm Credit Servs.*, 520 U.S. 821, 825 (U.S. 1997).

Under the Supreme Court's interpretation, a Government instrumentality is such if so designated by Congress. Ownership is not relevant.

470. Farmer Mac status as a Government Instrumentality is established by lists of considerations which includes, but are not limited to, the following:

a. Farmer Mac is designated by Congress as a "*federally chartered instrumentality of the United States"* pursuant to *12 U.S.C.A. § 2279aa-1(a)(1)*.

b. Congress by legislation writes Farmer Mac's corporate charter[176]. *See* http://www.farmermac.com/fmac/company/history.aspx. & also *12 U.S.C. § 2279aa-1 et. seq.*, Establishment and Activities of Federal Agricultural Mortgage Corporation; *12 U.S.C. § 2279bb et seq.*, Regulation of Financial Safety and Soundness of Federal Agricultural Mortgage Corporation; and *12 U.S.C. § 2279cc*, Receivership, Conservatorship, and Liquidation of the Federal Agricultural Mortgage Corporation

c. *12 U.S.C. § 2279aa-1(a)(2)* states: "The Corporation [Farmer Mac] shall be an institution of the Farm Credit System". *See* Footnote[177].

d. The Farm Credit Administration is "an independent agency in the executive branch of the Government". *SEE 12 U.S.C. § 2241* As an institution within the Farm Credit System, Farmer Mac is part of this Government agency.

e. Farm Credit Administration is a non-appropriated fund agency[178]. *SEE 12 C.F.R. § 600.2*

f. The President directly appoints 5 members of the 15 member Board of Farmer Mac. SEE: http://www.farmermac.com/fmac/company/directors.aspx & *12 U.S.C. § 2279aa-2(b)(2)*.

g. Farm Credit System institutions, themselves government instrumentalities, the only authorized (by statute) holders of Class B Shares in Farmer Mac, elect an

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[176] The Board of Farmer Mac has no authority to extend Farmer Mac's activities beyond activities which are authorized by statute.

[177] While Farmer Mac is a stockholder-owned institution the other institutions composing the Farm Credit System are cooperatives pursuant to *12 U.S.C. § 2001(a)* all subject to the administration by the Farm Credit Administration.

[178] Farmer Mac functions like Freddie Mac and Fannie Mae and thus Farmer Mac carries on its own independent non-appropriated fund activities (issues mortgage-backed bonds and has independent ability to borrow). Nevertheless, Farmer Mac is regulated by the Farm Credit Administration and is a Farm Credit Administration institution.

additional 5 members of the 15 members of Farmer Mac's Board[179]. *12 U.S.C. § 2279aa-4* & *12 U.S.C.A. § 2279aa-2(b)(2)*.

h. "As an institution of the FCS [Farm Credit System], Farmer Mac is subject to the regulatory authority of FCA [the Farm Credit Administration]". SEE: Farmer Mac's 2006 10K, page 24. *12 U.S.C. § 2279bb et seq.* establishes the Office of Secondary Market Oversight of the Farm Credit Administration as the supervisory authority over Farmer Mac.

i. The Federal Reserve Bank is the payment agent[180] for Farmer Mac. *12 U.S.C. § 2279aa-3(d)* states: "The Federal Reserve banks shall act as depositories for, and as fiscal agents or custodians of, the Corporation."

j. Farmer Mac, pursuant to *12 U.S.C. § 2279aa-13,* has authority to issue obligations to the U.S. Treasury up to $1.5 Billion.

Every aspect of Farmer Mac's operations is controlled by the U.S. Code and the Code of Federal Regulations – Title 12, Parts 650, 651, 652 & 655. Non-governmental shareholders only elect 5 members to Farmer Mac's Board.

471. Farmer Mac is an *instrumentality of the United States* within the meaning of the False Claims Act.

***Farmer Mac's Pre-Farm Bill Investments*.**

472. Farmer Mac charter was radically changed in May of 2008 with passage before the 2008 Farm Bill[181].

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179 Two-thirds of Farmer Mac's board is elected by the Government.

180 Farmer Mac has access to the book entry system of the Federal Reserve. *12 U.S.C. § 2279aa-3(e)* I presumed that Farmer Mac can make direct entries that causes monies to be disbursed by the Federal Reserve.

473. Before the 2008 Farm Bill, Farmer Mac made the following investments in CFC –

a. On July 29, 2005 Farmer Mac purchased a $500 Million Corporate Note[182] from CFC which note had no secondary market.

b. On August 1, 2007 Farmer Mac, in a private transaction, the FM Loan Securitization Sale, purchased $40 Million in loans from CFC. *See* CFC's 2007 10K, FN 3, p. 98.

c. On May 15, 2007 Farmer Mac, in a private transaction, the FM Loan Securitization Sale, purchased $365.6 Million in loans from CFC. *See* CFC's 8/31/2007 10Q, FN 3, p. 14.

d. On January of 2008 Farmer Mac, in a private transaction, the FM Loan Securitization Sale, purchased $34 Million in loans from CFC. *See* CFC's 2/29/2008 10Q, FN 3, p. 15-16.

e. On March 28, 2008 Farmer Mac purchased a $500 Million Corporate Note from CFC which note had no secondary market.

474. Farmer Mac had invested $1.34 Billion in CFC before the 2008 Farm Bill when these investments were **non-program investments**[183].

475. These investments were made in violation of Federal regulations intended to preserve the safety and soundness of Farmer Mac. *See* Title 12. Banks and Banking, Chapter VI, Farm Credit Administration, Subchapter B, Farm Credit System, Part 652, Federal Agricultural Mortgage Corporation Funding and Fiscal Affairs, Investment Management.

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[181] Food, Conservation and Energy Act of 2008 (the "2008 Farm Bill").

[182] This funding took place after CFC was approved for the first $1 Billion REDLG Loan but was waiting funding.

[183] Farmer Mac classified these investments as non-program investments in Farmer Mac's 2005, 2006 and 2007 10Ks.

476. 12 C.F.R. § 652.35(d)(1) states that Farmer Mac "not invest more than 25 percent of your regulatory capital in eligible investments issued by **any single entity, issuer or obligor**". At the time, this regulatory cap on Farmer Mac non-program investment in CFC was approximately $60 Million.

477. Farmer Mac breached the regulatory constraint on non-program investments in *any single entity, issuer or obligor* by nearly $1,270 Million.

478. 12 C.F.R. § 652.35(c) is a marketability requirement for investments. It defines marketability as follows: An eligible investment is marketable if you can sell it promptly at a price that closely reflects its fair value in an active and universally recognized secondary market.

479. None of the Farmer Mac investments in Farmer Mac complied with the marketability requirements.

480. Farmer Mac violated the regulatory requirement on non-program investments by making investments in CFC that did not comply with the marketability requirements.

481. As held by the Fourth Circuit a false claim is -

> According to Congress, after the 1986 amendments the False Claims Act should be broadly construed:
>
> > each and every claim submitted under a contract, loan guarantee, or other agreement *which was originally obtained* by means of false statements or other corrupt or fraudulent conduct, *or in violation of any statute or applicable regulation,* constitutes a false claim.
>
> S. Rep. No. 99-345, at 9, *reprinted in* 1986 U.S.C.C.A.N. at 5274 (emphases added). The courts have implemented the principles embodied in the above-quoted passage in a variety of ways.
>
> *See Harrison v. Westinghouse Savannah River Co.,* 176 F.3d 776, 786 C.A. 4 (S.C.), 1999.

482. Since the investment of $1,270 Million (the sum in excess of $60 Million) in CFC by Farmer Mac exceeded the investment cap in the applicable Federal Regulations the investments are false claims within the meaning of the False Claims Act.

483. Since the entire investment of $1,340 Million in CFC by Farmer Mac fails to meet the marketability requirement in the applicable Federal Regulations the investments are false claims within the meaning of the False Claims Act[184].

484. On information and belief, without Farmer Mac breaching the regulations, a violation of the False Claims Act by Farmer Mac and CFC, CFC would have financially collapsed[185].

***Post-Farm Bill Investments*.**

485. The 2008 Farm Bill made investments in "a loan, or an interest in a loan, for an electric or telephone facility by a cooperative lender to a borrower that has received, or is eligible to receive, a loan under the Rural Electrification Act of 1936 (7 U.S.C. 901 et seq.)." The fixed push through Congress by NRECA, CFC and Farmer Mac does NOT work[186] for CFC.

486. Further the bill eliminated the $2.5 Million statutory cap on program mortgages when dealing with CFC loans.

487. This after the fact authority does not redress any false claim associated with Pre-Farm Farmer Mac investment in CFC even though CFC and Farmer Mac have refinanced all

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[184] When questioned by Senator Hagel, Mr. Samuel Robert Coleman, the Director of the Office of Secondary Market Oversight for the FALSE CLAIMS ACT, refers to its authority pursuant to 12 C.F.R. § 652.35(e)(1) to approve other investments. The language of this section is as follows: "You may also purchase non-program investments **other than those listed in the Non-Program Investment Eligibility Criteria Table at paragraph (a)** of this section only with our written prior approval". This response is blather. One reason the excuse is blather is the language of the literal language of the exception. 12 C.F.R. § 652.35(a) is a table that lists different asset classes. Read literally, the exception allows investments into classes of securities that are not listed in the table. The exception does not give the FALSE CLAIMS ACT authority to **waive the application of** subparagraphs (b), (c) and (d) of 12 C.F.R. § 652.35.

[185] It was clear that this is a bail out of CFC. CFC could not survive the waiting game for the fraudulently obtained REDLG loans.

[186] CFC can now sell loans to Farmer Mac; however, this results in CFC going out of business. The more loans CFC sells to Farmer Mac, the smaller and less relevant CFC becomes. Ironically, the fix does not work because CFC is not seeking to be smaller and to be less relevant. CFC seeks only Federal funds at subsidized rates.

corporate notes but not the investments in the FM Loan Securitization Sale transactions[187].

488. Farmer Mac investments in CFC as of February 28, 2010 are comprised of $2,115 Million: $440 Million in FM Loan Securitization Sale transactions completed before the 2008 Farm Bill and $1,675 Million in loans since the 2008 Farm Bill.

489. Post 2008 Farm Bill investments by Farmer Mac were unlawful because CFC has bastardized Farmer Mac's authority: Farmer Mac's charter and authority was amended allowing Farmer Mac to '**buy loans**' from CFC and such authority is being manipulated so that Farmer Mac is functioning as CFC's bank by providing CFC with lines of credit; an ultra vires activity.

490. Farmer Mac's investments in CFC are unlawful because of the nature of the investments – ultra vires loans. Farmer Mac can now purchase mortgages from CFC and use said mortgages to issue Farmer Mac mortgage-backed securities (legal authority to "buy, pool, and resell" with Farmer Mac guarantee); however, that is not how the Farmer Mac/CFC financial relationship operates.

491. All the existing loans (excluding the forgotten and unmentioned $440 Million loan sale) are "**revolving credit facility[ies]** that allows us [CFC] to borrow, repay and re-borrow funds [from Farmer Mac] at any time or from time to time". *See* CFC's 2009 10K, FN 6, p. 114 and CFC's 2009 10K, FN 19, p. 133) (Emphasis added) **Farmer Mac is providing CFC with lines of credit**.

492. Farmer Mac has NO actual or incidental authority to function as CFC's bank and provide "revolving credit facility [ies]" when there is NO intent (absent a default) to acquire the underlying loans. For instance, 12 U.S.C. § 2279aa-1(b) which sets forth Farmer Mac "duties" all related to buying mortgages and issuing mortgage-backed securities: the buy, pool, and resell function, and not to function as a bank. Specifically, 12 U.S.C. § 2279aa-1(b)(4) authorizes

[187] This would be giving the 2008 Farm Bill retroactive effect.

Farmer Mac to "**purchase** qualified loans **and** issue securities". (Emphasis added)

493. The code section setting forth the authority of Farmer Mac, 12 U.S.C. § 2279aa-3(c), which has incidental powers in subparagraph 15, cannot be read to authorize a GSE to function as a bank and provide "revolving credit facility [ies]" for mortgages which Farmer Mac never acquires and has no intent to acquire.

494. Farmer Mac is the equivalent of Freddie Mac and Fannie Mae, which are also GSEs, and notwithstanding Freddie and Fannie problems, neither Freddie nor Fannie deviated so far from their statutory mandate –

a. Freddie and Fannie always **purchased** the underlying mortgages.

b. Neither Freddie nor Fannie used their powers to provide lines of credit with no intent whatsoever to acquire the underlying loans.

Farmer Mac does not represent[188] that it has authority to issue line of credit loans.

495. After the scandals of Freddie Mac and Fannie Mae, Farmer Mac has, in its relationship with CFC, operated in violation of its statutory charter in ways not contemplated by Freddie and Fannie.

496. Given Farmer Mac's size, approximately $5 Billion in total assets, a deviation involving $2 Billion relationship with CFC is material to Farmer Mac.

497. Since the investment of $1,675 Million in CFC by Farmer Mac contravenes Farmer Mac's statutory authority, the investments are false claims within the meaning of the

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[188] "Farmer Mac accomplishes its congressional mission of providing liquidity and lending capacity to agricultural and rural utilities lenders by:

- purchasing eligible loans directly from lenders [express authority];
- guaranteeing securities representing interests in, or obligations secured by, pools of eligible loans [express authority]; and
- issuing long-term standby purchase commitments ("LTSPCs") for eligible loans [incidental authority]."

*See* Farmer Mac's 2009 10K, p. 5.

False Claims Act.

498. Since the Pre-2008 Farm Bill $440 Million in Loan Securitization transactions were unlawful as in breach of Farmer Mac's charter, the investments are false claims within the meaning of the False Claims Act.

499. In CFC's quest to survive at all costs, CFC has corrupted Farmer Mac and the Farm Credit Administration's regulatory arm: the Office of Secondary Market Oversight and is operating in violation of its Statutory Charter.

**PART SIX: CFC's access to the REDLG Loan program funded by the FFB**

500. 12 USC § 2283 provides:

> There is hereby created a body corporate to be known as the Federal Financing Bank, which shall have succession until dissolved by an Act of Congress. The Bank shall be subject to the general supervision and direction of the Secretary of the Treasury. The Bank shall be an instrumentality of the United States Government and shall maintain such offices as may be necessary or appropriate in the conduct of its business.

The Federal Financing Bank ("FFB") is *an instrumentality of the United States Government* within the meaning of the False Claims Act.

501. The mechanics of the REDLG Loan program involves:

a. A CFC application to the USDA's Rural Utilities Services division;

b. Approval of the RUS;

c. The issuance of a CFC bond to the FFB; and

d. A USDA guarantee of the CFC Bond.

CFC provides the USDA a standby pledge of loans to collateralize the USDA's guarantee.

502. By both statute and regulation the CFC bond must be investment grade without the consideration of the USDA's guarantee –

> *7 U.S.C.A. § 940c-1(b)(3)* – "The Secretary may deny the request of a lender for the guarantee of a bond or note under this section if the Secretary determines that-- (B) the

bond or note issued by the lender would not be investment grade quality without a guarantee ….”

*7 CFR § 1720.5(b)(2)* – “The guaranteed bonds to be issued by the guaranteed lender must receive an underlying investment grade rating from a Rating Agency, without regard to the guarantee ….”

*7 CFR § 1720.8(a)(7)* – “The applicant shall provide evidence of an investment grade rating from a Rating Agency for the proposed guaranteed bond without regard to the guarantee ….”

*7 CFR § 1720.8(b)* – “The Secretary shall not issue a guarantee if the applicant is unwilling or unable to satisfy all requirements.”

503. CFC is investment grade rating according to Moody’s, Fitch and S&P only as a result of accounting fraud including but not limited to:

a. The CoServ Loan Loss;

b. The ICC Loan misreporting and fraud; and/or

c. The unlawful activities involving the Embezzlement Scheme.

Egan Jones Rating Agency, a Nationally Recognized Statistical Rating Organization, does not classify CFC or its securities as investment grade.

504. By Federal regulation, CFC must submit three years of audited financial statements.

7 CFR § 1720.6(a) – “Applications shall contain the following: … (5) Consolidated financial statements of the guaranteed lender for the **previous three years** that have been audited by an independent certified public accountant, including any associated notes, as well as any interim financial statements and associated notes for the current fiscal year ….” (Emphasis added)

505. Since CFC’s first REDLG loan of $1 Billion was approved in June of 2005 (*See* CFC’s 8K filed June 14, 2004) and funded in November of 2005 and February of 2006, CFC’s application included the CFC Financial Statements for fiscal years 2002, 2003, and 2004 which

are fraudulent, false and misleading because of the CoServ Loan fraud, the ICC Loan fraud, and the Embezzlement Scheme.

506. The Federal Regulations require CFC to have sound business practices –

> *7 CFR § 1720.8(a)(7)* – "The applicant shall provide evidence of an investment grade rating from a Rating Agency for the proposed guaranteed bond without regard to the guarantee …."
>
> *7 CFR § 1720.8(b)* – "The Secretary shall not issue a guarantee if the applicant is unwilling or unable to satisfy all requirements."

507. CFC's Embezzlement Scheme, CoServ Loan fraud, or the ICC Loan fraud are not a sound business practice.

508. CFC's Electric Loan portfolio was not being managed according to sound business practices because there was little or no interest spread on the Electric Loan Portfolio.

509. As of May 31, 2004, the following is the calculation of the interest rates on the Electric Loan Portfolio:

| | **Electric** | **% of Total** | Interest Rate | Proj. Interest |
|---|---|---|---|---|
| Long-term, fixed-rate loans[189] | 10,897,008 | 70.20% | 5.27% | 574,272 |
| Long-term, variable-rate Loans | 2,904,399 | 18.71% | 2.63% | 76,386 |
| RUS Guaranteed Loans | 263,392 | 1.70% | 4.60% | 12,116 |
| Intermediate-term Secured Loans | 4,616 | 0.03% | 2.50% | 115 |
| Intermediate-term UnSecured Loans | 43,326 | 0.28% | 2.56% | 1,109 |
| Line of credit loans | 792,580 | 5.11% | 2.50% | 19,815 |
| Non-performing loans | - | 0.00% | 0.00% | - |
| Restructure Loans ("CoServ") | 617,808 | 3.98% | 0.00% | - |
| Totals | 15,523,129 | 100.00% | 4.41% | 683,813 |

*See* CFC's 2004 10K, FN 2, p. 108 for the data used to project interest rates and back into the 4.41% interest rate, in total, for the Electric Loan Portfolio.

189 CFC systematically reduced its long-term, fixed rate interest rates from over 9% in 1992 and 1993 to commercially unsound rates for 30-year loans.

510. CFC average cost of funding for FY 2004 was more than CFC is earning from the Electric Loan Portfolio as of May 31, 2004. *See* CFC's 2004 10K, p. 39 ("CFC's average cost of funding for the year ended May 31, 2004 was 4.50% compared to 4.69% in the prior year period. CFC's average adjusted cost of funding, which includes derivative cash settlements, for the year ended May 31, 2004 was 3.96% compared to 4.07% for the prior year period.")

511. To lend funds at less than the costs of funds, a negative interest spread on a $15.5 Billion Electric Loan Portfolio, relying upon derivative contracts for CFC's financial survival is not[190] a sound business practice.

512. CFC does not have sound business practices as mandated by the Federal regulations to obtain REDLG Loans.

513. CFC's access of the Federal Funds under the REDLG Loan program is a false claim within the meaning of the False Claims Act because CFC would not have an investment grade rating but for accounting fraud and further, CFC submitted fraudulent and misleading Financial Statements violating both the REDLG statutes and regulations.

514. CFC's access of the Federal Funds under the REDLG Loan program is a false claim within the meaning of the False Claims Act because CFC does not operate in accord with sound business practices.

515. NRECA and CFC push through special purpose legislation which NRECA and CFC knew CFC could not, in compliance with the law and regulations, qualify for because NRECA and CFC are like a disease: they corrupt the whole of the Farm program.

[190] CFC touts that fact that as a non-profit lender margins are kept low; however, the Telephone Loan Portfolio was earning 6.16% or more than the cost of funds. Relying upon the Embezzlement Scheme CFC shifted its financial house to be dependent upon Telephone Loan Portfolio for its profit. Further, CFC could charge higher interest rates and refund more in the form of patronage dividends which would be a sound business practice.

## PART SEVEN: the Culpability of the Defendants

516. Just like the punch line in the CNBC documentary *Enron: The Smartest Guys in the Room*[191], this fraudulent, if not criminal conduct, is not the act of a few people but requires the complicity of numerous persons.

517. 31 USC § 3729(a)(3) addresses concerted efforts to violate the False Claims Act stating: "[any person who] conspires to defraud the government by getting a false or fraudulent claim allowed or paid."

***Culpability of NRECA, NRECA's CEO English, CFC, and CFC's management of Lilly, List & Petersen*.**

518. Defendants CFC, Lilly, List, and Petersen are liable for the REDLG Loans because they knowingly presented the false claim using false financial statements and knowing that CFC's qualification rested upon:

a. such fraudulent financial statements; And

b. unsound business practices.

519. Defendants Lilly and Petersen pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Sections 1350(a) and (b)) intentionally falsely certified that all 10Ks (annual reports) and 10Qs (quarterly reports) filed for fiscal years 2003 and later:

a. fully complying with the Exchange Act; and

b. as fairly presenting the financial condition and results of operations of CFC.

This false certification of CFC's fraudulent Financial Statements was a prerequisite to obtaining the REDLG loans and Farmer Mac's pre-2008 Farm Bill investments.

520. Defendants CFC, Lilly, List, and Petersen are liable for the pre-2008 Farm Bill

[191] A 2005 documentary film based on the best-selling 2003 book of the same name by *Fortune* reporters Bethany McLean and Peter Elkind, a study of one of the largest business scandals in American history.

investments Farmer Mac investments because they knowingly obtained Farmer Mac funds, a non-appropriated fund activity, using false Financial Statements with actual knowledge that the investments violated Federal regulations meant to protect Farmer Mac's safety and soundness.

521. Defendants CFC, Lilly, List, and Petersen are liable Post-2008 Farm Bill Farmer Mac investments, because the obtained such loans knowing that the investments vitiated and abrogated the Federal statutes which constitute Farmer Mac's charter.

522. Defendant NRECA sponsored the creation of CFC's creation and has had permanent representation on CFC's Board.

523. Defendant English has been NRECA's CEO and has served on CFC's Board from 1994 until December 9, 2005. *See* CFC's 12/9/2005 8K.

524. Defendant English and NRECA are the Electric Coops' lobbyists with actual knowledge of CFC's fraud, fraudulent financial statements, precarious financial situation, and unsound business practices whom instigated:

a. The passage of Special Purpose Legislation: The Farm Security and Rural Investment Act of 2002 implemented *7 U.S.C. § 940c-1* which is the statutory basis that allows CFC access to the REDLG program;

b. The special Purpose Legislation: The 2008 Farm Bill, "Food, Conservation, and Energy Act of 2008", Sec. 5406, "Rural utility loans" that made CFC's loans program investments knowing the fixed ( the purchase of loans by Farmer Mac) was an unworkable solution for CFC and that CFC and Farmer Mac would have operated outside of Farmer Mac's statutory charter;

c. The funding of the REDLG program in 2004 (*See* 12/27/2004 WSJ article, *Co-op Pleased With Loan Program*);

d. The relationships that allow cronyism in the Farm Programs to trump fidelity to the law and used those relationships, to pave the way for CFC to have access to Federal funds from Farmer Mac and the REDLG program; and

e. Make use of the Politics of Influence[192] to quash or skew every investigation into CFC.

525. NRECA and English induced and caused Farmer Mac to make investment in CFC, and with respect to the REDLG loans, induced and caused the RUS and FFB to make the investments in CFC, with actual knowledge that:

a. CFC's Financial Statements were fraudulent;

b. CFC's business practices were unsound;

c. Farmer Mac did not have the authority to make the Pre-2008 Farm Bill investments; and

d. Farmer Mac's Post-2008 Farm Bill investments vitiated and abrogated Farmer Mac's statutory charter.

526. NRECA and English conspired with CFC and CFC's management (Defendants List, Lilly and Petersen) to have CFC access the Federal fisc "by means of false statements or other corrupt or fraudulent conduct, *or in violation of any statute or applicable regulation*."

***Culpability of CFC's & RTFC's Public Accountants*.**

527. Defendant Ernst audited CFC and RTFC for fiscal years 2002, 2003, and 2004 (the "Ernst Audits").

528. Defendant Deloitte audited CFC and RTFC for all fiscal years after 2007 (the "Deloitte Audits").

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[192] Quashing any investigations so that CFC can continue unabated criminal activity is the worse use of Politics of Influence.

529. Defendant Johnston is a partner at Deloitte Touché USA LLP, an international accounting firm, and a former partner at Arthur Andersen LLP ("AA"), the former auditors of CFC and RTFC through fiscal year 2001. Defendant Johnston was the primary Deloitte audit partner with responsibility for the Deloitte Audits.

530. Ernst is culpable because –

a. Ernst attested to CFC's Financial Statements with actual knowledge as to the fraudulent reporting of the CoServ Loan Loss which was a material departure from GAAP;

b. Ernst attested to CFC's Financial Statements with actual knowledge as to the fraudulent reporting of the ICC Loan restructurings which was a material departure from GAAP;

c. CFC's *Segment Misreporting Methodology* deployed by Johnston and AA was corrected by Ernst making Ernst acutely aware of the unlawful Embezzlement Scheme which Ernst improperly failed to disclosed;

d. Ernst attested to CFC's Financial Statements with actual knowledge of the Embezzlement Scheme which Financial Statements contained material and undisclosed criminal, civil, tax, and regulatory risks with respect thereto;

e. As part of the scheme to perpetuate CFC's Embezzlement Scheme, Ernst attested to RTFC Financial Statements that Ernst had actual knowledge that (i) RTFC's equity was understated, (ii) RTFC's receivables due from CFC were understated, and (iii) RTFC's income was understated because of the economic consequences of the unlawful Embezzlement Scheme;

f. Under information and belief, Ernst participated in the preparation and submission of false tax returns and tax filings by CFC and RTFC knowing that such false filings perpetuated CFC's unlawful tax exempt status and further, constituted money laundering because of the false tax returns caused numerous rural telephone companies to under-report their income;

g. Under information and belief, Ernst knew that CFC was under extreme financial distress as of May 31, 2004 and wrongly did not issue a 'going concern' qualification to Ernst's attestation because of the likelihood that CFC was going to receive REDLG loans and Farmer Mac investment with False Financial Statements knowing that there would reliance placed upon Ernst's attestation; and

h. Ernst had actual knowledge that RUS, in agreeing to furnish the requisite guarantee, relied upon Financial Statements attested to by Ernst which did not comport to GAAP and purposely misled RUS as to CFC's unlawful Embezzlement Scheme[193].

531. Deloitte and Johnston, the lead partner in the Deloitte audits through 2007, are culpable because –

a. Deloitte attested to CFC's Financial Statements with actual knowledge as to the fraudulent reporting of the CoServ Loan Loss which was a material departure from GAAP;

b. Deloitte attested to CFC's Financial Statements with actual knowledge as to the fraudulent reporting of the ICC Loan restructurings which was a material departure from GAAP;

[193] Federal law criminalizes the Embezzlement Scheme (*18 USC § 666* makes it unlawful for a recipient of Federal funds to – "embezzles, steals, obtains by fraud, or otherwise without authority knowingly converts to the use of any person other than the rightful owner or intentionally misapplies, property….") but incongruently CFC is being bailed out by cheap Federal money avoiding the consequences of pricing long-term loans to Electric coops at uneconomical rates because CFC relied upon the Embezzlement Scheme.

c. CFC's *Segment Misreporting Methodology* deployed by Johnston and AA, which was corrected by Ernst, was redeployed by Johnston and Deloitte in fiscal year 2005 in a material departure from GAAP to affirmatively conceal the unlawful Embezzlement Scheme and concealed financial risks assumed by investors;

d. Deloitte attested to RTFC Financial Statements that Deloitte knew understated RTFC's equity, RTFC's receivables due from CFC, and RTFC's income because of economic consequences of the unlawful Embezzlement Scheme;

e. Under information and belief, Deloitte participated in the preparation and submission of false tax returns and tax filings by CFC and RTFC knowing that the fraudulent filings perpetuated CFC's unlawful tax exempt status and constituted money laundering because the false tax returns caused numerous rural telephone companies to under-report their income;

f. Under information and belief, Deloitte knew that CFC was under extreme financial distress as of May 31, 2005 and as of May 31, 2006, and wrongfully, did not issue a 'going concern' qualification to Deloitte's attestation relying upon the likelihood that CFC was going to receive additional REDLG loans and Farmer Mac investments;

g. Deloitte had actual knowledge as the auditors of both Farmer Mac and CFC that Farmer Mac's pre-2008 Farm Bill investments in CFC were unlawful because the investments violated applicable Federal regulations and concealed this knowledge from the investing public and the RUS;

h. Deloitte knew that Farmer Mac, in making the Pre-2008 Farm Bill investments in CFC's corporate notes, were relying upon Financial Statements attested to by Deloitte which did not comport to GAAP and purposely misled Farmer Mac as to

CFC's unlawful Embezzlement Scheme[194];

i. Deloitte[195] knew that Farmer Mac's Post-2008 Farm Bill investments in providing CFC lines of credit does not comport to Farmer Mac's statutory charter and concealed this material fact from investors by attesting to CFC's Financial Statements and Farmer Mac's Financial Statements; and

j. Deloitte had actual knowledge that RUS, in agreeing to furnish the requisite guarantee relying upon Financial Statements attested to by Deloitte and which did not comport to GAAP, purposely misled RUS as to CFC's unlawful Embezzlement Scheme.

532. Ernst conspired with CFC and CFC's management (Defendants List, Lilly and Petersen) to have CFC access the Federal fisc "by means of false statements or other corrupt or fraudulent conduct, *or in violation of any statute or applicable regulation*."

533. Defendants Deloitte and Johnston conspired ) with CFC and CFC's management (Defendants List, Lilly and Petersen) to have CFC access the Federal fisc "by means of false statements or other corrupt or fraudulent conduct, *or in violation of any statute or applicable regulation*."

***Culpability of Credit Rating Agencies*.**

534. As a non-bank private financial institution, CFC exist in a regulatory void.

535. To come full circle[196] CFC needed to suborn and corrupt two outside sources (besides Farmer Mac officers) that were a check on CFC's fraudulent conduct and cozening: the

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[194] Id. footnote above.

[195] CFC and Farmer Mac are audited by the same office of Deloitte.

[196] From an entity form with Government support to access the public markets, to an entity that now has approximately 25% of its funding from the Federal government.

accountants and the credit rating agencies.

536. Relator knows that Fitch (until recently[197]), S&P, and Moody's have routinely examined CFC's file and the non-public documents with respect to the ICC Loan.

537. Upon information and belief, Fitch (until recently), S&P, and Moody's have routinely examined CFC's file and the non-public documents with respect to the CoServ Loan.

538. Upon information and belief, Fitch, S&P, and Moody's are culpable because –

a. had actual knowledge as to the fraudulent reporting of the CoServ Loan which was a material departure from GAAP and have actual knowledge that the CoServ Loan misreporting makes every CFC issued Financial Statement since November 30, 2002 materially misleading;

b. had actual knowledge that CFC is amortizing the CoServ Loan Loss to smooth out CFC's earnings;

c. had actual knowledge as to the fraudulent reporting of the ICC Loan restructurings which was a material departure from GAAP;

d. had knowledge that CFC's *Segment Misreporting Methodology* deployed by Johnston and AA had been corrected making Fitch, S&P, and Moody's acutely aware of the unlawful Embezzlement Scheme;

e. had an expert's knowledge of CFC's sources of profit and sources of cash flow as well as CFC's disproportionate allocation thereof to Electric members making Fitch, S&P, and Moody's acutely aware of the unlawful Embezzlement Scheme;

f. knew that CFC was under extreme financial distress as of May 31, 2004 and knew that Ernst wrongly did not issue a 'going concern' qualification to the Ernst's attestation because of the likelihood that CFC was going to receive REDLG loans with

[197] Just recently, CFC did not renew its contract with Fitch.

False Financial Statements and unlawful Embezzlement Scheme and did not adjust their ratings;

g. knew that CFC was under extreme financial distress as of May 31, 2005 and May 31, 2006 and CFC relied in part upon favorable adjustments to CFC's Loan Loss Reserve reported as income and extra-ordinary items to met CFC's performance measurements;

h. had a copy of the April 6, 2009 transcript which established by testimony of experts of actual market conditions related to the ICC Loans and know of CFC's unreserved and unrecognized loss with respect to the ICC Loan;

i. had actual knowledge that the credit bid is being submitted to depart from GAAP by valuing the ICC Group I Assets by the adoption by CFC of strategies (such as a hold-for-the-future strategy that is based on expectations of future price increases, or a strategy of operating the repossessed collateral for one's own behalf) to justify use of derived accounting valuations that portray results of operations more favorably than would use of current values in active markets;

j. had actual knowledge that CFC's ability to access the REDLG program was dependent upon Fitch, S&P, and Moody's maintaining investment grade ratings for CFC; and

k. knew that without Federal funds, CFC would financially collapse.

539. Further, there is a dramatic divergence in ratings assigned to CFC by National Recognized Statistical Rating Organization ("NRSROs"), in that -

a. Egan Jones Ratings Company ("Egan Jones"), since December 21, 2007 recognized as a NRSRO[198], rates CFC as a "junk bond", a "B+" rating as of Feb. 4, 2007 which has been downgraded to a "B" rating as of March 6, 2009.

b. Defendant Credit Rating Agencies rate CFC as follows: Moody's assigns CFC an "A2" rating, S&P assigns CFC an "A" rating, and Fitch assigns CFC an "A-" rating.

Egan Jones does something with respect to CFC that Fitch, S&P, and Moody's do not do – Egan Jones compares CFC's performance to the performance of a peer group.

540. Defendants Fitch, S&P, and Moody's conspired with CFC and CFC's management (Defendants List, Lilly and Petersen) to have CFC access the Federal fisc:

a. "by means of false statements or other corrupt or fraudulent conduct, *or in violation of any statute or applicable regulation*"; and

b. by means of assigning to CFC inflated and undeserving ratings that were necessary for CFC to access the REDLG program.

**PART EIGHT: Relator's Knowledge**

541. Relator's knowledge is based upon the following:

a. Analysis of CFC's Financial Statements;

b. Information available to Relator because of his former status as an ICC board member until October of 2007 which has made privy to non-public information including direct dealings with CFC's management[199];

c. Information available to Relator because of his knowledge of the ICC bankruptcy proceedings which is not disclosed to the investing public;

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[198] SEC Release No. 57031.

[199] E.g., Relator negotiated the term sheet for the ICC Loan.

d. Information available to Relator about the CoServ Loan because Relator stumbled across a web site[200] that is no longer available which had many of the CoServ documents related to the CoServ reorganization[201];

e. Information developed from Relator's analysis or other information from other sources which was delivered by Relator to one or more Defendants[202]; and

f. Information available from CFC's SEC filings.

542. The CoServ Loan Fraud and the ICC Loan Fraud are the only two loans for which the Relator has access to reliable information from sources other than CFC.

**COUNT ONE**

**THE FEDERAL FALSE CLAIMS ACT 31 U.S.C. 3729(a)(1)**

543. Relator repeats and repleads and hereby incorporates each and every one of the foregoing allegations set forth in paragraphs 1-542, inclusive, as though fully set forth herein.

544. Defendants CFC, Lilly, List and Petersen, and each of them knowingly participated in a fraudulent course of conduct (and perpetuated a pre-existing fraudulent course of conduct) with the intent to:

(a) Prior to the 2008 Farm Bill, induced and caused Farmer Mac to (i) invest in CFC's Corporate Debt Obligations and (ii) purchased loans from CFC in violation of Federal regulations intended to secure Farmer Mac's safety and soundness;

(b) After the 2008 Farm Bill, induced and caused Farmer Mac into providing

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[200] http://www.gardere.com/Bankruptcy/BCCatDetail.asp?CatID=93&CaseID=42

[201] For a list of those documents *see* http://web.archive.org/web/20030526084856/http://www.gardere.com/Bankruptcy/BCCatDetail.asp?CatID=93&CaseID=42

[202] E.g., Relator delivered the April 6, 2009 Bankruptcy Hearing Transcript as well as other information such as proof of Mr. Lilly lying to the AIG analyst to Fitch, S&P, and Moody's.

CFC with lines of credit when Farmer Mac has no intent to acquire loans (program investments) in contravention of Farmer Mac's statutory charter knowing that Farmer Mac had no express or implied authority to make such loans; thus, the loans were made in violation of statute; and

(c) Fraudulently induced and caused the USDA to approve and the FFB to purchase CFC's Bonds in contravention of Federal statutes and regulations.

545. Defendants NRECA and English knowingly assisted in causing the government to pay claims which were grounded in fraud and a fraudulent course of conduct by:

(a) Prior to the 2008 Farm Bill, induced and caused CFC to present to Farmer Mac and induced and caused Farmer Mac to (i) invest in CFC's Corporate Debt Obligations and (ii) purchased loans from CFC in violation of Federal regulations intended to insure Farmer Mac's safety and soundness;

(b) After the 2008 Farm Bill, induced and caused CFC to present to Farmer Mac and induced and caused Farmer Mac to providing CFC with lines of credit when Farmer Mac had no intent for Farmer Mac to acquire the loans (program investments) and CFC had no intent to sell the loan, in contravention of Farmer Mac's statutory charter knowing that Farmer Mac had no express or implied authority to make such loans; thus, the loans were made in violation of statute; and

(c) Fraudulently induce CFC to submit and for the USDA to approve and the FFB to purchase CFC's Bonds in contravention of Federal statutes and regulations.

546. Defendants CFC, Lilly, List, Petersen, NRECA and English (collectively, the "A-1" Defendants) accessed the Government fisc (Farmer Mac and FFB) by means of –

a. false statements;

b. by means of corrupt or fraudulent conduct; and

c. *in violation of any statute or applicable regulation* (directly violating Federal regulations and indirectly by violating SEC Regulations).

All three forms of prohibited conduct pursuant to the Senate Judiciary Committee's report on the False Claims Reform Act are involved in the False Claim.

547. The A-1 Defendants and each of them knew or should have known that Farmer Mac could not lawfully make the direct and indirect investments in CFC regardless of the passage of the 2008 Farm Bill; said law only authorizes the purchase of CFC loans.

548. As CFC operated and with knowledge of CFC's fraudulent Financial Statements, the A-1 Defendants and each of them knew or should have known that, in fact, CFC was not eligible for the REDLG Program.

549. The accessing of the Farmer Mac funding for CFC constitutes a False Claim within the meaning of section (a)(1) of 31 U.S.C. 3729.

550. The accessing of the REDLG program for CFC constitutes a False Claim within the meaning of section (a)(1) of 31 U.S.C. 3729.

**WHEREFORE,** with respect to Count One, Relator asks for:

I. Judgment against Defendants CFC, Lilly, List, Petersen, NRECA and English in an amount equal to three times the amount of the False Claim damages sustained by the United States as a result of Defendants' conduct;

II. A civil penalty of not less than Five Thousand Five Hundred Dollars ($5,500.00) and not more than Eleven Thousand Dollars ($11,000.00) for each violation of 31 U.S.C. 3729;

III. That Relator, as Qui Tam plaintiff, be awarded the maximum amount allowed pursuant to 31 U.S.C. 3730(d) and/or any other applicable provision of law; and

IV. Attorney's fees and costs according to proof.

**COUNT TWO**

**THE FEDERAL FALSE CLAIMS ACT 31 U.S.C. 3729(a)(2)**

551. Relator repeats and repleads and hereby incorporates each and every one of the foregoing allegations set forth in paragraphs 1-550, inclusive, as though fully set forth herein.

552. Defendants CFC, Lilly, List and Petersen, and each of them knowingly makes, uses, or causes to be made or used, a false record or statement with the intent to:

(a) Prior to the 2008 Farm Bill, induce Farmer Mac into (i) investing in CFC's Corporate Debt Obligations and (ii) purchase loans from CFC in violation of Federal regulations intended to insure Farmer Mac's safety and soundness; and

(b) Induce the USDA to approve and the FFB to purchase CFC's Bonds in contravention of Federal statutes and regulations.

553. Defendants NRECA and English knowingly assisted in causing the government to pay claims which were grounded in false record or statement by:

(a) Prior to the 2008 Farm Bill, inducing CFC to make, use, or cause to be made or used, a false record or statement to present to Farmer Mac and inducing Farmer Mac into (i) investing in CFC's Corporate Debt Obligations and (ii) purchase loans from CFC in violation of Federal regulations intended to secure Farmer Mac's safety and soundness; and

(b) Fraudulently induce CFC to make, use, or cause to be made or used, a false record or statement to submit to the USDA and for the USDA to approve and the

FFB to purchase CFC's Bonds in contravention of Federal regulations and statutes.

554. Defendants CFC, Lilly, List, Petersen, NRECA and English (collectively, the "A-2" Defendants) accessed the Government fisc (Farmer Mac and FFB) by means of false financial statements and false statements.

555. The A-2 Defendants and each of them knew or should have known that Farmer Mac could not lawfully make the direct and indirect investments in CFC regardless of the passage of the 2008 Farm Bill; said amendments to Farmer Mac charter only authorizes Farmer Mac to purchase CFC loans.

556. As CFC operated, the A-2 Defendants and each of them knew or should have known that, in fact, CFC was not eligible for the REDLG Program and was using false financial statements and false statements to procure said loans.

557. The accessing of the Farmer Mac funding for CFC constitutes a False Claim within the meaning of section (a)(2) of 31 U.S.C. 3729.

558. The accessing of the REDLG program constitutes a False Claim within the meaning of section (a)(2) of 31 U.S.C. 3729.

**WHEREFORE,** with respect to Count Two, Relator asks for:

I. Judgment against the Defendants CFC, Lilly, List, Petersen, NRECA and English in an amount equal to three times the amount of the False Claim damages sustained by the United States as a result of Defendants' conduct;

II. A civil penalty of not less than Five Thousand Five Hundred Dollars ($5,500.00) and not more than Eleven Thousand Dollars ($11,000.00) for each violation of 31 U.S.C. 3729;

III. That Relator, as Qui Tam plaintiff, be awarded the maximum amount allowed pursuant to 31 U.S.C. 3730(d) and/or any other applicable provision of law; and

IV. Attorney's fees and costs according to proof.

**COUNT THREE**

**THE FEDERAL FALSE CLAIMS ACT 31 U.S.C. 3729(a)(3)**

559. Relator repeats and repleads and hereby incorporates each and every one of the foregoing allegations set forth in paragraphs 1-558, inclusive, as though fully set forth herein.

560. On information and belief, Defendants Ernst, Deloitte, Johnston, Moody's, Fitch, and S&P knowingly conspired with Defendants NRECA, English, CFC, List, Petersen and Lilly in a fraudulent course of conduct (and perpetuated a pre-existing fraudulent course of conduct) to have CFC's false or fraudulent claim paid or approved by:

a. The USDA and the FFB under the guise of the REDLG program in contravention of Federal statutes and regulations; and

b. Farmer Mac even though the conspirators knew in order to make the payments Federal statutes and/or regulations would be violated.

561. On information and belief, Defendants Ernst, Deloitte, and Johnston sought to have the false claim by CFC paid or approved relying upon false and misleading Financial Statements because, without the Federal funds at subsidized interest rates CFC would financially collapse and Defendants Ernst, Deloitte, and Johnston complicity in the overt act of attesting of CFC's Financial Statements (past statements as well as statements used to obtain the Federal funds) would be exposed and Defendants Ernst, Deloitte, and Johnston would be accountable to holders of nearly $19 Billion in CFC fraudulently issued debt.

562. On information and belief, Defendants Fitch, Moody's and S&P sought to have

the false claim by CFC paid or approved relying upon their inflated ratings assigned (making CFC investment grade) because, without the Federal funds at subsidized interest rates CFC would financially collapse and Defendants Fitch, Moody's and S&P complicity in assigning inflated and undeserved ratings to CFC would be exposed and such Defendants would be accountable to holders of nearly $19 Billion in CFC fraudulently issued debt.

563. The conspiracy to access Farmer Mac funding constitutes a conspiracy to defraud the Government by getting a false or fraudulent claim allowed or paid within the meaning of section (a)(3) of 31 U.S.C. 3729.

564. The conspiracy to access the REDLG program constitutes a conspiracy to defraud the Government by getting a false or fraudulent claim allowed or paid within the meaning of section (a)(3) of 31 U.S.C. 3729.

**WHEREFORE,** with respect to Count Three, Relator asks for:

I. Judgment against the Defendants CFC, Lilly, List, Petersen, NRECA, English Ernst, Deloitte, Johnston, Moody's, Fitch, and S&P in an amount equal to three times the amount of the False Claim damages sustained by the United States as a result of Defendants' conduct;

II. A civil penalty of not less than Five Thousand Five Hundred Dollars ($5,500.00) and not more than Eleven Thousand Dollars ($11,000.00) for each violation of 31 U.S.C. 3729;

III. That Relator, as Qui Tam plaintiff, be awarded the maximum amount allowed pursuant to 31 U.S.C. 3730(d) and/or any other applicable provision of law; and

IV. Attorney's fees and costs according to proof.

**DEMAND FOR JURY TRIAL**

Relator requests a jury trial.

Dated: September 2, 2010.

UNITED STATES OF AMERICA, *ex rel*, John P. Raynor, as the Relator

By: _/s/____________________________

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