



Office of Inspector General Small Business Administration

May 2002 Update

Business Loan Programs

Audit Report of Borrowers with Prior Loan Defaults Issued. On May 28, 2002, OIG issued an audit report on Borrowers with Prior Loan Defaults. The objective of the audit was to determine if **Section 7(a) loans were inappropriately guaranteed for applicants who had previously defaulted on guaranteed loans resulting in a loss to the Government.** We performed the audit using a sample of 47 loans obtained from SBA's loan database by matching loans made between October 1995 and April 2001 to all purchased and liquidated loans. The audit identified that 166 of the loans were made to applicants with prior loan losses. Of those 166, 42 applicants received loan guarantees with prior losses. OIG could not verify that the remaining 124 loans were made to applicants with prior losses because the prior loan files no longer exist. OIG found that district offices were not adhering to the 10-year retention requirement for charged-off loan files. OIG identified 30 files destroyed between 3.4 years and 9 years after being charged off.

As a result of the ineligible loans, SBA was at risk for guarantees totaling about \$20.1 million and had honored guarantees totaling about \$2.3 million to borrowers with prior defaults. Additionally, one of the sample loans defaulted after the draft report was issued and is estimated to result in a loss of about \$667,500 to SBA. This loan has been referred to the Investigations Division.

OIG recommended that SBA establish procedures to require loan officers to identify applicants with prior loan losses, develop procedures to allow lenders to use the SBA database to identify applicants with prior loan losses, seek recovery from existing borrowers who

failed to disclose their prior loan losses, annotate loan files to identify borrowers with current loans who failed to disclose prior losses, and reiterate to district offices the requirements for retention of charged-off loan files.

Management did not believe that the cited condition was significant enough to warrant new procedures and was concerned that lender access to the SBA database would raise Privacy Act issues. Management agreed to seek recovery from borrowers whose current loans default and who failed to disclose prior losses, to annotate the loan database to alert SBA personnel of existing borrowers who failed to disclose prior losses, and to issue a Notice to field offices about retention of charged-off loans.

Arizona Businessmen Sentenced to Probation and to Pay Restitution. The secretary-treasurer of a Phoenix, Arizona, corporation was sentenced on April 15, 2002, to 5 years probation; he was also ordered (jointly with the president) to pay \$906,000 in restitution. The two men previously pled guilty to one count of **mail fraud** and two counts of **making a material false statement** in connection with a \$1 million SBA-guaranteed loan. The president and secretary-treasurer had been charged with submitting fraudulent documents to obtain the loan to buy two fast-food restaurants. A long time friend of the president allegedly assisted in the creation of a fraudulent \$400,000 promissory note. The note was created to give the impression that the president and secretary-treasurer, individually and through the corporation, had a greater debt obligation, which would justify a larger loan from the non-bank lender. At the loan closing, the friend received a check for \$150,000 from loan proceeds, allegedly to pay off the fraudulent note balance. The friend

subsequently endorsed the check to the president. OIG conducted this investigation jointly with the Federal Bureau of Investigation. This investigation was based on a referral from SBA/OIG's Auditing Division.

Chicago Loan Packager and Business Broker Indicted for Aiding Preparation and Filing of Fraudulent Tax Returns. A Chicago, Illinois, SBA loan packager and business broker was indicted on April 30, 2002, for allegedly **aiding the preparation and filing of fraudulent income tax returns** with the Internal Revenue Service (IRS). This fourth superseding indictment added the defendant's name to those previously charged, including a borrower, three attorneys, and a corporation, relating to an alleged conspiracy scheme to defraud SBA and a non-bank participating lender. The charges were in connection with the 1996 purchase of a defunct Antioch, Illinois, restaurant. The scheme included a false capital injection by the borrower that enabled him to obtain a 100 percent financed, \$1.25 million business loan and resulted in a fraudulent inflation of the sales price, exposing SBA and the non-bank participating lender to additional loss and reduced recovery potential. As part of the alleged conspiracy, the defendant participated in preparation and submission of a loan package to the non-bank participating lender that contained false and exaggerated claims of work and management experience, and included false income and personal financial statements. The defendant also hired an accountant (a now deceased friend) to prepare allegedly bogus tax returns for the borrower, which were used in the SBA loan package and later submitted to IRS. OIG initiated this investigation based upon referrals from SBA's Illinois District Office.

Three Texans Indicted for Conspiracy, Mail Fraud, and Wire Fraud. A Houston, Texas loan broker and two of his clients who were loan applicants were indicted on May 15, 2002. The indictment charged all three on one count of **conspiracy**, three counts of **mail fraud**, and one count of **wire fraud**. The three had been arrested during the previous month after allegedly devising a fraudulent loan scheme to finance the purchase of a motel. According to the indictment, the defendants submitted a loan application package with fraudulent personal financial statements and a false purchase contract that inflated the price of the motel from \$2 million to \$2.7 million. To satisfy the closing requirements, the defendants submitted fraudulent

copies of cashier's checks as proof of their required equity injection. All three defendants were arrested following the closing conference at the title company, prior to loan funding. This case was a joint investigation with FBI and was initiated based on a referral from the SBA Houston District Office.

Oregon Businessman Indicted for Making Material False Statements. A Portland, Oregon, businessman and guarantor of an SBA-guaranteed loan made to a restaurant was indicted on six felony counts by a Federal grand jury, on May 23, 2002. The indictment charged that he made **material false statements** on business loan applications to the SBA-participating lender regarding a loan for \$697,200, and a second loan for \$168,995. The indictment also charged that he made material false statements on a loan application to another SBA participating lender for a \$169,500 SBA-guaranteed loan, and that he made material false statements on a loan application to the first lender for the purchase of his residence totaling \$196,875. Additional counts of the indictment charged that he **used false Social Security numbers** to obtain the loans and that he **failed to disclose prior bankruptcies, judgments, other business interests, and previous criminal history**. He was arrested and arraigned in connection with these charges on May 28, 2002. This case was a joint investigation with FBI and was initiated based on a referral from the SBA Oregon District Office.

Former Illinois Contracting Company President Pleads Guilty to Making Material False Statement. The former President of an Aurora, Illinois, contractor pled guilty to one count of **making a material false statement** on May 24, 2002. The plea agreement was the result of an earlier criminal information that was filed on January 24, 2002, and relates to a \$400,000 SBA-guaranteed loan that was obtained in February 1997 by the defendant's company through an SBA participating lender. The purpose of the loan was to obtain working capital for her company. During the loan application process, she signed an affidavit stating that she was individually, and as a corporation, current on all Federal and state taxes. According to information gathered by the SBA Illinois District Office, at the time she signed this affidavit, she and the company had a tax debt totaling more than \$1 million. The sentencing for her is set for

September 4, 2002. This investigation was worked jointly with FBI and was initiated based on a referral from the SBA Illinois District Office.

Disaster Loan Program

North Carolina Businessman and Company Indicted for Mail Fraud and Wire Fraud. A Carolina Beach, North Carolina, businessman and his company were indicted on May 22, 2002, on one count of **mail fraud** and six counts of **wire fraud**. The indictment relates to two SBA disaster loans totaling \$617,200. The defendant who was also the former North Carolina Transportation Secretary, acting as attorney for his father, obtained the two disaster loans for damages associated with Hurricanes Bonnie (1998) and Floyd (1999). The investigation disclosed that during this time period, the principals, through the company, were operating an illegal gambling business that made it ineligible for the disaster loans. The defendant also fraudulently claimed that machinery and equipment were damaged by the storms. Further investigation disclosed that loan proceeds were used to pay off long-term, high interest, pre-disaster debt that violated the loan and authorization agreements, and that the loan proceeds were either mailed or electronically transferred to the account of his father. On December 21, 2001, the defendant's son pled guilty to a one-count criminal information for **money laundering** and agreed to testify against his father and grandfather in lieu of being indicted on SBA charges. Although the defendant's father was actively involved in the music company, he was not indicted due to an onset of Alzheimer's disease. The indictment also included 268 counts associated with money laundering and illegal gambling pertaining to the FBI's part of the case. OIG initiated this investigation based on a request by the FBI and the U.S. Attorney's Office.

Agency Management

Audit Report on Information Systems Controls – Fiscal Year 2002 Issued. OIG issued Cotton & Company's report on Information Systems Controls - Fiscal Year 2001, on May 8, 2002. As part of the annual financial statement audit, the auditors reviewed general controls over SBA's financial management systems to determine compliance with various Federal requirements. General controls are the policies and procedures that apply to all or a large segment of an

entity's information systems to help ensure their proper operation. The auditors concluded again, as they did in FY 2000, that **SBA made progress toward implementing an agency-wide systems security program, however, improvements are still needed.**

The report describes areas where controls can be strengthened, such as: (1) entity-wide security program controls; (2) access controls; (3) application software development and program change controls; (4) system software controls; (5) segregation of duty controls; (6) service continuity controls; and (7) review of mainframe operations. The report also provides recommendations for strengthening controls in these areas. The Chief Information Officer and Chief Financial Officer generally agreed with 15 of the 24 recommendations in the draft report; they did, however, disagree with eight recommendations and did not comment on one recommendation. An overriding concern was that the report did not give enough recognition to the progress SBA has made over the past several years toward achieving its goals of control and security over its information systems. Cotton & Company agreed that SBA has made significant improvements and modified the report appropriately to reflect those improvements. The Associate Administrator for Disaster Assistance generally agreed with the findings and provided comments that did not specifically address the recommendations affecting his office.

Inspection Report on Modernizing Human Capital Management Issued. OIG issued an inspection report on Modernizing Human Capital Management on May 31, 2002. The inspection focused primarily on: (1) delivery systems (especially automation); (2) human resources (HR) metrics; and (3) office structure. To identify "best practices" in these areas, OIG visited agencies moving ahead in HR automation, advisory services, and building metrics. The report provides **recommendations to assist SBA in repositioning its HR office and functions** such as SBA should: (1) review the business case for its HR information system in light of other agencies' implementation experiences and the Administration's new HR initiatives and consider available short term alternatives; (2) develop business case metrics to determine the cost effectiveness of implementing appropriate functional automation software and/or outsourcing or cross-servicing certain HR functions;

(3) develop a measurement system that conforms to OPM's Standards of HR Management Accountability and includes financial measures such as cost per employee hired; customer satisfaction measures, such as those associated with responsiveness and quality; workforce capacity measures, such as employee satisfaction and education; and process effectiveness, such as cycle time and productivity; and (4) ensure that relevant SBA HR activities, such as strategic advisory services, are incorporated into office operations, and the office plays a key role in the Agency's workforce planning and restructuring effort; a process is in place for working closely with line management; individual planning, policy, and operational responsibilities within the office are well-defined; and HR activities, metrics, and results are publicized to all concerned—HR staff, line managers, and the workforce. SBA's Office of Management and Administration agreed with the recommendations.

Office of Inspector General

SBA OIG's Semiannual Report to Congress for the reporting period of October 1, 2001, through March 31, 2002, is now available. You may access it electronically at: <http://www.sba.gov/IG/sar3-02.pdf>. If you would like a paper copy, please contact our office at 202-205-6580.

The activity Update is produced by SBA/OIG,
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OIG has established an e-mail address (oig@sba.gov) that we encourage the public to use to communicate with our office. We welcome your comments concerning this Update or other OIG publications. To obtain copies of such documents please contact:

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