



**U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416**

AUDIT REPORT
ISSUE DATE: March 29, 2002
REPORT NUMBER: 2-15

To: Patricia B. Rivera, District Director
Colorado District Office

Robert J. Seabrooks

From: Robert Seabrooks, Assistant Inspector General
For Auditing

Subject: Audit of a SBA Guaranteed Loan to Colorado Taco Corporation

Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to your office. Your response is synopsised in the report and included in its entirety at Attachment A.

The recommendation in this report is subject to review and implementation of corrective action by your office in accordance with the existing Agency procedures for audit follow-up. Please provide your management decision for the recommendation to our office within 30 days of the date of this report using the attached SBA Form 1824, Recommendation and Action Sheet.

Any questions or discussion of the finding and recommendation contained in the report should be directed to Garry Duncan, Director, Credit Programs Group, at (202) 205-7732.

Attachments

**AUDIT OF A SBA GUARANTEED LOAN TO
COLORADO TACO CORPORATION
COLORADO SPRINGS, CO
AUDIT REPORT NO. 2-15
MARCH 29, 2002**

This findings in this report are the conclusion of the OIG's Auditing Division based on testing of the auditee's operations. The findings and recommendations are subject to review, management decision, and corrective action in accordance with existing Agency procedures for follow-up and resolution. This report may contain proprietary information subject to the provisions of 18 USC 1905 and must not be released to the public or another agency without permission of the Office of Inspector General.

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BACKGROUND

The Small Business Administration (SBA) is authorized under Section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of government-guaranteed loans. SBA guaranteed loans are made by participating lenders under an agreement (SBA Form 750) to originate, service, and liquidate loans in accordance with SBA regulations, policies, and procedures. SBA is released from liability on a loan guarantee, in whole or in part, within SBA's exclusive discretion, if a lender failed to comply materially with SBA regulations, the Loan Agreement, or failed to make, close, service, or liquidate a loan in a prudent manner.

Heller First Capital Corporation (the lender) was a Small Business Lending Company authorized by SBA to make guaranteed loans under the Preferred and Certified Lenders Programs. Under the Preferred Lenders Program (PLP), lenders are permitted to process, close, service, and liquidate SBA guaranteed loans with reduced requirements for documentation to and prior approval by SBA. Under the Certified Lenders Program (CLP), SBA processes loan guarantee applications and servicing actions on a priority basis. The lender also made loans under SBA's Low Documentation Loan Program (LowDoc). Although this program streamlined the guarantee application process, participating lenders are expected to perform a loan analysis in a manner consistent with prudent lending practices. The analysis is included with the lender's request for a SBA guaranteed loan. The lender stopped making SBA guaranteed loans in February 2001 and was acquired by General Electric Capital Corporation on October 25, 2001.

Prior audits of early default loans found that the lender did not always materially comply with SBA rules and regulations. In a January 2000 response to one of the audits, the lender acknowledged that the loan, which closed in 1997, would not have been approved under its current underwriting and closing procedures. A few months later in response to a SBA PLP review, the lender admitted that combined growth in volume and processing locations across the country was not in the best interest of the lender or SBA's lending program. Consequently, certain regions exercised more discretion in both credit analysis and compliance with procedures than the lender would have liked.

Based on the lender's acknowledgement of the lack of controls over the SBA guaranteed loan process, the Office of Inspector General initiated an audit of 140 loans originated by the lender that were purchased by SBA between January 1996 and February 2000, to determine if the loans were processed correctly. The audit identified several loans that were originated, serviced, and/or liquidated in material non-compliance with SBA rules and regulations. One of these loans was to Colorado Taco Corporation and is the subject of this report.

In October 1995, the lender approved a loan [FOIA EX. 4], for \$450,000 to Colorado Taco Corporation (borrower) under the Certified Lenders Program. The purpose of the loan was to purchase \$170,000 of inventory and pay for leasehold improvements totaling \$280,000. The loan was originally for two restaurants, but only one was actually opened.

Therefore, only \$251,472 of the original loan amount was disbursed. [FOIA EX. 4]. SBA purchased the loan guaranty for \$194,804 on November 19, 1997.

AUDIT SCOPE AND OBJECTIVE

The objective of the audit was to determine if the lender originated, disbursed, and liquidated the loan purchased by SBA in accordance with SBA rules and regulations.

The subject loan was reviewed for compliance with 11 requirements found in SBA rules and regulations and the SBA-lender guarantee agreements. All identified lender deficiencies were evaluated to determine if it resulted in a material loss to SBA. A material loss was defined as exceeding \$25,000.

The audit was conducted during May and June 2000 in accordance with Government Auditing Standards.

RESULTS OF THE AUDIT

Finding 1. The Lender did not comply with Equity Injection Requirements

The lender did not ensure that the borrower injected the required amount of equity for the project. The authorization and loan agreement (A&LA) required the lender to obtain evidence that the principal injected \$255,000 of equity into the business prior to the first loan disbursement. Eleven days after loan approval, the borrower submitted an accounting of equity injection expenditures for the project totaling \$447,331. The expenditures were for construction, franchising fees, equipment, and other items. A review of documentation contained in the lender's loan file showed that only \$191,503 of the expenditures submitted by the borrower qualified as equity injection. The following table lists the expenditures that did not qualify as equity injection.

Expenditure	Amount	Reason not Equity Injection
Restaurant Equipment	\$61,521	The invoice was unpaid when submitted to lender. Lender subsequently paid the vendor with loan proceeds by joint payee check.
Leasehold Improvements	\$141,807	Lender used loan proceeds to reimburse borrower for this expense.
Franchising Fees	\$30,000	Borrower reimbursed principals for the franchise fee.
Development Fee	\$22,500	Borrower reimbursed principal for payment of the development fee.
Total Unqualified Expenditures	\$255,828	

As a result of eliminating the unqualified expenditures from equity expenditures reported by the borrower, the equity injection shortfall is \$63,497.

Injection Expenditures Submitted by Borrower	\$ 447,331
Less Unqualified Expenditures (see chart above)	\$ <u>255,828</u>
Actual Equity Injection	\$ <u>191,503</u>
Required Injection per A&LA	\$ 255,000
Less Actual Amount Injected	\$ <u>191,503</u>
Equity Injection Shortage	\$ <u>63,497</u>

RECOMMENDATION

We recommend that the Colorado District Office take the following action:

1. Seek recovery of \$63,497 from General Electric Capital Corporation on the guaranty paid to Heller First Capital, less any subsequent recoveries, for loan number 8748993010.

District Office Response

[FOIA EX. 5]

OIG Evaluation of District Office Response

The District Office comment is responsive to the audit recommendation.

Lender Response

The lender agreed that there was a short fall of evidence for equity injection, but did not agree that SBA rules and regulations prohibited the use of loan proceeds for leasehold improvements incurred prior to the loan approval date. Accordingly, the lender recommended that the SBA district office limit the amount of recovery on the guarantee paid to the \$63,497 shortfall in the equity injection.

OIG Evaluation of Lender Response

The restriction on using loan proceeds for prior expenditures is contained in the SBA Settlement Sheet (SBA Form 1050). Loan proceeds may only be used to reimburse the borrower for authorized, evidenced expenditures made after the loan approval date or as otherwise directed in the A&LA. The A&LA for this loan did not authorize payment of prior expenditures. However, since the primary purpose of the loan was for leasehold improvements and the lender stated that the prior leasehold expenditure reimbursed with loan proceeds should not have counted towards the equity injection, we have removed the finding on prior expenditures from this report.



U.S. SMALL BUSINESS ADMINISTRATION
COLORADO DISTRICT OFFICE
721 19TH STREET, SUITE 426
DENVER, CO 80202-2517

Appendix A
Page 1 of 2

DATE: March 28, 2002
TO: Robert Seabrooks, Assistant Inspector General, Small Business
Administration
THRU: [FOIA EX. 6]
SUBJECT: Colorado Taco Corporation DBA ZuZu Handmade Mexican
Food
8 748993010

The SBA/OIG Auditing Division, in its December 10, 2001 report, cited Heller First Capital for closing deficiencies related to the subject loan.

Finding 1. Heller did not comply with equity injection requirements.

The Authorization required \$255,000 of equity injection be made in the business. The borrower, as per the audit, injected only \$191,503.

Finding 2. Loan proceeds disbursed in violation of SBA requirements.

Heller reimbursed the borrower for \$141,807 in unauthorized leasehold improvement expenditures that were incurred prior to loan approval and submitted as evidence of the borrower's equity injection.

Colorado District Office review of the SBA/OIG findings.

Finding 1. A review of the file by the District Office confirmed the Authorization required an equity injection of \$255,000 and the borrower injected only \$191,503.

Finding 2. The lender is at fault for not requesting a modification of the Authorization to change the use of proceeds. The lender's presentation for approval breaks down the use of proceeds as follows: Leasehold 310M, equipment 180M, Franchise fee and development costs 112M, furniture and fixtures 40M, inventory 8M, start up expenses (pre-open lease, utilities, etc.) 127M, and working capital 73M for a total of 850M. The original use of loan proceeds were \$280M for leasehold improvements and \$170M for equipment. However, the borrower started making lease payments of \$3910 per month on the Denver location starting January 1, 1995. The note was signed November 22, 1995. It is unknown when the leasehold improvements began. The OIG audit reveals \$447,331 of injection expenditures were submitted by the borrower.

[FOIA EX. 5]

Recommendation

The lender did not monitor the cash injection requirement. The difference between the amount required by the Authorization and the actual cash injection is \$63,497. [FOIA EX. 5]

[FOIA EX. 5]

Heller Financial, Inc.
500 West Monroe Street
Chicago, Illinois 60661
312.441.7000



[FOIA]
[EX. 6]

Via First Class Mail

March 12, 2002

Robert Seabrooks, Assistant Inspector General
Garry Duncan, Director
Credit Programs Group
U. S. Small Business Administration
Office of the Inspector General
409 3rd St. SW
Mail Code 4112
Washington, DC 20416

Re: Audit of SBA Guaranteed Loan to Colorado Taco Corporation, loan number 878993010

Dear Sirs:

I have received your draft report concerning the SBA Guaranteed Loan to Colorado Taco Corporation, and I would like to discuss the findings concerning the loan.

First, Heller would agree with the finding that the proof of equity injection had a shortfall of \$63,497 because loan disbursements were used to pay for \$141,807 in leasehold improvements that had been included in the equity injection calculation. However, we do not agree that the SOP or the Loan Authorization place any limits on when the leasehold improvements were incurred (whether before or after the Loan Authorization). Setting a limit requiring that the leasehold improvements be incurred after the Loan Authorization is not consistent with the realities of small businesses and small business lending. A small business owner usually can not afford any extended period of time in which he is incurring lease expenses without having his business open while his loan is being processed. It is therefore common place for the small business owner to incur such expenses while his loan is being processed and expect them to be paid by or reimbursed from his loan proceeds. There is no dispute that the Loan Authorization authorized the payment of leasehold improvements or that the leasehold improvements were actually made.

We would therefore recommend that the SBA district office compromise with the lender and agree that the amount of repayment be limited to the \$63,497 in equity injection shortfall.

Sincerely yours,

[FOIA EX. 6]

Appendix C

AUDIT REPORT DISTRIBUTION

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Deputy Associate Administrator for Capital Access.....	1
General Counsel.....	2
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Associate Administrator for Field Operations	1
Office of Chief Financial Officers Attn: Jeff Brown.....	1
General Accounting Office	1