



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

AUDIT REPORT
ISSUE DATE: June 22, 2004
REPORT NUMBER: 4-25

To: James Rivera
Associate Administrator for Financial Assistance

From: Robert Seabrooks [FOIA Exemption 6]
Assistant Inspector General for Auditing

Subject: Audit of a SBA Guarantied Loan to [FOIA Exemption 4 & 6]

Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to your office. Your response has been synopsised in the report and included in its entirety at Appendix 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-[FOIA Exemption 2].

Attachments

AUDIT OF A SBA GUARANTIED LOAN TO

[FOIA Exemption 4 & 6]

[FOIA Exemption 4 & 6], Texas

AUDIT REPORT NO. 4-25

JUNE 22, 2004

The finding in this report is the conclusion of the OIG's Auditing Division based on testing of the auditee's operations. The finding and recommendation is 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.

**AUDIT OF A SBA GUARANTIED LOAN TO
[FOIA Exemption 4 & 6]
[FOIA Exemption 4 & 6], Texas**

Table of Contents

	<u>Page</u>
BACKGROUND	1
AUDIT OBJECTIVE AND SCOPE	2
RESULTS OF AUDIT	3
Finding and Recommendation	
The Lender did not Originate the Loan in Material Compliance with SBA Requirements.....	3
APPENDICES	
A. Management Comments	
B. Audit Report Distribution	

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 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 guaranty, in whole or in part, within SBA's exclusive discretion, if a lender failed to comply materially with SBA regulations, the Loan Agreement, or did not make, close, service, or liquidate a loan in a prudent manner.

Heller First Capital Corporation (lender) was a Small Business Lending Company authorized by SBA to make guaranteed loans under the Preferred Lender Program (PLP). The lender was allowed to process, close, service, and liquidate SBA loans with reduced requirements for documentation and prior approval by SBA. Heller stopped making SBA loans in February 2001, and was acquired by General Electric Capital Corporation in October 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 they admitted in response to a SBA PLP review that combined growth in volume and processing locations across the country was not in the best interest of their 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 loan process, the Office of Inspector General (OIG) initiated an audit of all loans originated by the lender and purchased by SBA. The loans included those purchased from January 1996, through February 2000. The audit identified 25 loans that were originated, serviced, and/or liquidated in material non-compliance with SBA rules and regulations. One of these loans to [FOIA Exemption 4 & 6] is the subject of this report.

In June 1996, the lender approved an Eligible Passive Company (EPC) loan (number [FOIA Exemption 4 & 6] for \$234,000 to [FOIA Exemption 4 & 6] (borrower) to assist [FOIA Exemption 4 & 6] (operating company) using PLP procedures. The purpose of the loan was to purchase a building and land for \$210,000 and \$24,000 for building improvements. The loan was disbursed on July 19, 1996. The borrower filed Chapter 7 bankruptcy on August 5, 1996; only 17 days after the final disbursement and 26 days before the due date of the first payment. SBA purchased the loan guaranty for \$177,166 on April 14, 1997.

AUDIT OBJECTIVE AND SCOPE

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 guaranty agreements. All identified lender deficiencies were evaluated to determine if a material loss to SBA resulted. A material loss was defined as exceeding \$25,000. The audit was conducted in Dallas, Texas, in accordance with generally accepted Government Auditing Standards.

RESULTS OF AUDIT

The Lender did not Originate the Loan in Material Compliance with SBA Requirements

The lender circumvented SBA requirements by making a PLP loan to a borrower in full knowledge that the president of the operating company had a criminal history. The lender also did not properly verify equity injection or resolve questionable character issues. As a result, SBA made an improper payment when it honored the guaranty for \$177,166.

The loan was not eligible for processing under PLP procedures

The lender processed the loan under PLP procedures knowing that the loan application was modified to avoid a criminal history background check of the former president who, after selling his stock, became the vice president and associate of the operating company. SOP 50 10 3, provides that if principals answer “yes” to any criminal history questions on SBA Form 912, the loan is ineligible for PLP origination and must be processed under regular 7(a) procedures. SBA, not the lender, determines if the application should be approved based upon the circumstances of the criminal activity. An associate¹ with a criminal history must provide details regarding the activity in a separate exhibit to their Form 912 so SBA can determine if the activity warrants decline of the application. In accordance with 13 CFR 120.110, a business with an associate who is incarcerated, on probation, on parole, or has been indicted for a felony or a crime of moral turpitude is ineligible for a SBA business loan.

When the borrower applied for the loan as an EPC, the application showed that the president owned 40 percent of the operating company and the secretary owned 60 percent. Each owner signed the loan application and completed a Statement of Personal History (SBA Form 912), as required under SBA procedures. The president answered yes to two of the three questions regarding criminal history, which prohibited the lender from processing the loan under PLP procedures. Instead of halting the loan application process and processing the loan under regular 7(a) procedures so that SBA could perform a criminal history background check, the lender permitted the president to sell his shares of the operating company to the secretary. After the transaction, the borrower submitted a second loan application signed only by the secretary and without a Form 912 for the former president.

The ownership change, however, did not eliminate the need to submit a Form 912 on the former president. The stock sales agreement provided that the selling party (president) would be permanently employed as Vice President of Operations and would retain his current annual salary. Under SBA rules, this made the former president an associate and key employee of the operating company and as such, required to submit a Form 912 with the loan application.

¹ 13 CFR 120.10 (2) defines an associate of a small business as an officer, director, owner of more than 20 percent of the equity, or key employee of the small business. For purposes of this definition, an association commences six months before the date of the loan application to SBA and continues for the length of the loan.

As a result of the lender's imprudent actions, SBA was denied the opportunity to conduct a criminal background check on the former president to determine if the loan qualified for a SBA guaranty.

Equity injection was not verified

The lender did not verify if the borrower provided the required equity injection before the loan was disbursed. The Authorization & Loan Agreement (A&LA) required the lender to obtain evidence that the borrower injected at least \$26,000 into the purchase of the business property. Evidence was to be in the form of funds in escrow or funds brought to closing. The closing statement showed the borrower deposited \$5,000 and received a refund of \$96, thereby leaving an injection of only \$4,904. The lender, however, violated the terms of the AL&A by accepting a copy of a \$24,000 invoice marked "paid" from a construction company to "*build out interior – metal stud walls, insulation, sheet rock, electrical, T-Bar ceiling and bed walls,*" as evidence of the remaining equity injection. Other documents indicated that the borrower did, in fact, plan to build approximately 2,000 square feet of finished office spaces. The invoice alone, however, was not sufficient evidence to identify the source of the payment and there was no other evidence, such as a cancelled check or a bank statement, to show that payment came from the borrower's equity.

Furthermore, an appraisal completed soon after the borrower defaulted on the loan indicated that while there was evidence that some minor "build out" work had been completed, there were no finished office spaces. Consequently, in addition to the lack of evidence regarding the source of the payment, the validity of the work completed under the invoice is questionable. The lender should have verified the source of the payment before accepting the invoice as evidence of equity injection.

Borrower had questionable character

The impact of the borrower's unpaid Federal payroll taxes was not given proper consideration by the lender during loan origination. Pursuant to 13 CFR 120.150, the character, reputation, and credit history of the applicant, operating company (if applicable), its associates, and guarantors must be considered when reviewing a loan application. Timely payment of payroll taxes is a strong indication of borrower character. At the time of loan application, the balance sheet for the operating company showed unpaid Federal payroll taxes from 1995 through the first quarter 1996 totaling \$73,620. The lender, however, did not question the borrower about the unpaid taxes to determine their current status.

Non-payment of payroll taxes is a strong indication of a potentially serious character flaw that, depending on the circumstances, would warrant denial of a loan application. Not only does it reflect a possible lack of integrity, since a portion of payroll taxes are "held in trust" for the taxing authority; excessive payroll tax liabilities may be a sign that a business is experiencing financial difficulty. Also, failure to pay taxes may impact the operation of the business and thus, repayment ability, since taxing authorities have the power to close a business or levy bank accounts for unpaid taxes.

Summary

The loan was not processed in accordance with SBA requirements, the lender did not evaluate the borrower's character as required and SBA was denied the opportunity to assess the borrower's criminal history. As a result, the loan was made to a borrower with questionable character and criminal history without required SBA oversight and approval. Thus, SBA made an improper payment when it purchased the guaranty for \$177,166.

RECOMMENDATION

We recommend that the National Guaranty Purchase Center take the following action:

1. Seek recovery of \$177,166 from General Electric Capital Corporation on the guaranty paid, less any subsequent recoveries, for loan number [FOIA Exemption 4 & 6].

Management Comments

The Office of Financial Assistance agreed to seek full recovery of the guaranty purchase proceeds from the lender.

Evaluation of Management Comments

Management's comments are responsive to the audit recommendation.



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

Appendix A

Redacted for FOIA

DATE: June 15, 2004

TO: Robert G. Seabrooks, Assistant Inspector General for Auditing

FROM: James W. Hammersley, Acting JAA/PM
FOIA Ex. 6

SUBJECT: Audit of SBA Guaranteed Loan
Loan: Ex. 4 + 6 (EPC), Ex. 4 + 6 (OC) PLP
Ex. 4 + 6
Lender: GE Capital (loan originated by Heller First Capital Corp.)
St. Louis, MO

We have received the Office of Inspector General (OIG) March 17, 2004, memorandum and accompanying draft audit report for this loan that recommends full recovery of the guaranty payment of \$177,166.27, less any subsequent recoveries. The basis for the OIG recommendation is the failure of the lender to originate the loan in material compliance with SBA requirements.

We have reviewed this case and agree that the loan was not eligible for processing under PLP procedures due to the loan application being modified to avoid a criminal history background check of the former president who, after selling his stock, became the vice president and associate of the operating company. SBA policy provides that if principals answer "yes" to any criminal history questions on SBA Form 912, the loan is ineligible for PLP origination and must be processed under regular 7(a) procedures. However, this loan was processed PLP nonetheless.

We also noted your concern that the lender did not verify the borrower's required equity injection before the loan was disbursed. We do not agree that the failure to pay payroll taxes is per se evidence of poor character. Your report does not provide sufficient evidence to reach a conclusion of poor character due to non-payment of payroll taxes.

We have requested that the lender repay the guaranty purchase proceeds. If the lender refuses to do so, we will seek a legal opinion from OGC with respect to the possibility of pursuing enforced collection against the lender.

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