



**US SMALL BUSINESS ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL  
Washington, DC 20416**

<b>AUDIT REPORT</b>
<b>ISSUE DATE:</b> August 10, 2004
<b>REPORT NUMBER:</b> 4-36

**TO:** James E. Rivera  
Associate Administrator, Office of Financial Assistance

**FROM:** Robert G. Seabrooks [FOIA Ex. 6]  
Assistant Inspector General for Auditing

**SUBJECT:** Audit of an Early Defaulted Loan to Midwest Rotary Maniforms Company

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.

Any questions or discussions of the finding and recommendation contained in the report should be directed to Garry Duncan, Director, Credit Programs Group, at 202-205-[FOIA Ex. 2].

Attachments

**AUDIT OF**  
**AN EARLY DEFAULTED LOAN TO**  
**Midwest Rotary Maniforms Company**  
**Caro, Michigan**  
**AUDIT REPORT NO. 4-36**

**The finding in this report is the conclusion of the OIG's Auditing Division based on testing of SBA 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 AN  
EARLY DEFAULTED LOAN TO  
MIDWEST ROTARY MANIFORMS COMPANY**

**TABLE OF CONTENTS**

	<b><u>Page</u></b>
<b>BACKGROUND .....</b>	<b>1</b>
<b>AUDIT OBJECTIVE AND SCOPE.....</b>	<b>1</b>
<b>RESULTS OF AUDIT.....</b>	<b>2</b>
<b>Finding and Recommendation</b>	
The Lender Made a Loan to an Ineligible Borrower .....	2
<b>APPENDICES</b>	
A – Management Response	
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 guaranteed loans. SBA loans are made by participating lenders under an agreement 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 Authorization, or did not make, close, service, or liquidate a loan in a prudent manner.

First International Bank (lender), a UPS (United Parcel Service) company was authorized by SBA to make guaranteed loans under the Preferred Lenders Program (PLP). PLP lenders are allowed to process, close, service, and liquidate loans with reduced requirements for documentation and prior approval by SBA.

In December 2000, the lender approved a \$1.1 million SBA loan (number 4135964007) as part of a \$5.35 million loan package to Midwest Rotary Manifolds Company dba Data-Com Graphics II, Inc. (borrower) using PLP processing procedures. The purpose of the SBA loan was to refinance existing debt for a working capital loan. The borrower manufactured long run business forms and was primarily a trade manufacturer. The lender disbursed \$4.97 million of the \$5.35 million loan package in January 2001. The borrower defaulted in October 2001, with the loan transferred to liquidation two months later. SBA then purchased the loan guaranty in January 2002, for \$740,000.

## **AUDIT OBJECTIVE AND SCOPE**

The audit objective was to determine if the early default was caused by lender or borrower non-compliance with SBA requirements. We reviewed SBA and lender loan files and interviewed district office and lender personnel. We interviewed officials of the Michigan Department of Treasury, Tuscola County, Michigan Treasurers' Office and the Treasurer of Almer Township, Michigan. The loan was judgmentally selected for review as part of the Office of Inspector General's ongoing program to audit SBA loans charged off or transferred to liquidation within 24 months of origination (early default). The audit was performed during January 2003 through November 2003 in accordance with generally accepted Government Auditing Standards.

## **RESULTS OF AUDIT**

### **FINDING The Lender Made a Loan to an Ineligible Borrower**

The lender approved a \$1.1 million SBA guaranteed loan to an ineligible borrower. The borrower's credit history included delinquent taxes and a lack of credit worthiness. The lender's actions resulted in an improper payment of \$740,000 when it paid the loan guaranty.

#### **Delinquent Federal debt**

The lender disbursed an SBA guaranteed loan to a borrower with an outstanding IRS tax debt of \$409,000. On January 23, 2001, two days prior to loan disbursement, the lender discovered that the borrower had this debt. The credit memorandum was then amended to require full payment of the tax debt within 10 days after the loan closing. The principals of the business were required to loan the required funds to satisfy the tax debt. There was no evidence that the debt was paid. OMB Circular A-129 states that individuals with outstanding delinquent Federal debts are ineligible to receive Federal financial assistance.

#### **Borrower lacked creditworthiness**

The lender was not prudent in evaluating the borrower's creditworthiness. A review of the loan file revealed several discrepancies involving credit issues. According to Title 13 of the Code of Federal Regulations (CFR) Part 120.150(a), the applicant for an SBA loan must be creditworthy and loans must be so sound as to assure repayment. In making this determination the character, reputation, and credit history of the applicant (and the operating company, if applicable), its associates, and guarantors will be considered. The lender disbursed loan proceeds, even though the following deficiencies involving credit decisions were identified:

- A Dun and Bradstreet report, dated August 4, 2000, showed that the borrower and one of its affiliates, [FOIA Ex. 4], were involved in a lawsuit and were slow in making payments.
- The business had an accounts payable balance of \$2.06 million, as of January 2001. More than \$1.8 million of these debts to 79 vendors were over 120 days past due.
- In addition to the \$409,000 of Federal withholding taxes mentioned above, the borrower owed over \$300,000 in undisclosed delinquent state and county taxes. These delinquent taxes are listed in the following table.

## DELINQUENT TAXES OWED AS OF CLOSING DATE

Payee	Type of Tax	Amount
State of Michigan	State Tax Lien	\$ 100,000
State of Michigan	Business Tax	\$ 122,424
Tuscola County Treasurer	Personal Property Tax	\$ 80,265
<b>Total</b>		\$ 302,689

The borrower and its affiliates, therefore, lacked the ability or willingness to pay debts in a timely manner.

Additionally, interviews with officials of the State of Michigan - Department of Treasury revealed that, as of August 2003, the borrower still owed a majority of the \$100,000 Michigan State Tax Lien and the entire \$122,424 Michigan Business Tax plus interest and penalties.

### CONCLUSION

The lender's actions in making a loan to a borrower with delinquent Federal withholding taxes, coupled with discrepancies regarding credit issues, placed unnecessary and unacceptable risks on SBA. In accordance with 13 CFR, Section 120.354 (a) (3) SBA is released from liability on a loan guaranty (in whole or in part, within SBA's exclusive discretion) if the lender's improper action or inaction placed SBA at risk.

### RECOMMENDATION

We recommend that the Associate Administrator, Office of Financial Assistance take the following action:

- 1.A Recover \$740,000 paid to the lender to purchase the guaranty on loan number 4135964007.

### Management Comments

The Associate Administrator, Office of Financial Assistance (AA/OFA) stated that the lender should have the opportunity to provide documentation and further support for its decision to make the loan with delinquent taxes and an open lawsuit. Therefore, prior to taking any actions toward recovery of the guaranty purchase funds, the lender will be requested to provide a response within 30 days. At that time, OFA will analyze all data received from the lender and provide a reply with regard to the audit finding.

The AA/OFA disagreed with the section of the finding that stated that the loan was made to an ineligible borrower because of an outstanding IRS tax debt. He noted that 31 USC 3720B specifically exempts "a debt under the Internal Revenue Code of 1986" from being a reason to prohibit the Agency's guaranty of a loan.

## **Evaluation of Management Comments**

We will evaluate action to recover the balance of the amount recommended during the audit follow up process.

Regarding 31 USC 3720B, we agree that a loan guaranty cannot be denied solely due to an outstanding IRS tax debt. This statement has been removed from the final report.

A further review of the IRS tax debt, however, disclosed other factors that show the lender was not prudent in approving the loan. Prior to disbursing the loan proceeds, the lender discovered that the borrower had delinquent Federal tax debt of \$409,000. When applying for the loan, however, the borrower did not disclose the debt. The lender, therefore, should have identified that the borrower exhibited a lack of character by excluding the tax debt from the loan application.

As a result of this discovery, the lender required the principals to loan the business the required funds to pay the taxes within 10 days of loan closing (SBA loan proceeds were not to be used to pay the taxes). There is no evidence, however, that the lender verified that the taxes were actually paid. During our review, we discovered that the tax debt had, in fact, not been paid.

We maintain our position that the lender's actions place unnecessary and unacceptable risk on SBA.



WASHINGTON, D.C. 20416

DATE: July 21, 2004

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

FROM: James W. Hammersley, Acting AA/PM

SUBJECT: Draft Audit of SBA Guaranteed Loan  
Loan: Midwest Rotary Manifolds Company  
PLP 41359640-07  
Lender: First International Bank (UPS Capital Business Credit)

We have received the Office of Inspector General (OIG) June 22, 2004, memorandum and accompanying draft audit report for this loan that recommends recovery of \$740,000 from the lender that was paid at the time of guaranty purchase. The basis for the OIG recommendation is that the lender improperly approved the eligibility of an applicant with delinquent taxes, coupled with other discrepancies regarding credit issues. The OIG contends that the lender's actions placed unnecessary and unacceptable risk on SBA.

We note that SBA policy does not prohibit the Agency's guaranty of a loan to a borrower with delinquent taxes; in fact, the use of loan proceeds to pay delinquent income taxes (but not withholding taxes) may be permitted (SOP 50 10(4)(E), paragraph 11f). We also note that 31 USC ¶ 3720B (referenced in the audit report) specifically exempts "a debt under the Internal Revenue Code of 1986." Further, OMB Circular A-129 states that the processing of a federal loan may continue when a debtor satisfactorily resolves a delinquent federal debt, such as through a repayment plan. In this regard, the audit report states that the lender amended the credit memorandum to require full payment of the tax debt within 10 days after the loan closing date through a \$500,000 loan to the business from the principals.

We feel that the lender should have the opportunity to provide documentation and further support for its decision to make the loan with delinquent accounts payable, an open lawsuit and delinquent state and county taxes. Therefore, prior to taking any actions toward recovery of the guaranty purchase funds, we will request the lender to provide a response within 30 days. OFA will analyze all data received from the lender, and then we will provide a further reply with regard to the audit findings.



**AUDIT REPORT DISTRIBUTION**

Deputy Associate Administrator  
Capital Access..... 1

General Counsel.....3

Associate Administrator for  
Financial Assistance..... 1

Associate Administrator for  
Field Operations..... 1

Office of Chief Financial Officers  
Attn: Jeff Brown ..... 1

Government Accountability Office..... 1