



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

AUDIT REPORT
ISSUE DATE: September 17, 2004
REPORT NUMBER 4-43

To: James Rivera
Associate Administrator, Office of Financial Assistance

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

Subject: Audit of an Early Defaulted Loan to [FOIA Ex. 4]

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-[FOIA Ex. 2].

**AUDIT OF
AN EARLY DEFAULTED LOAN TO**

[FOIA Ex. 4]

Rhome, TX

AUDIT REPORT NO. 4-43

September 17, 2004

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
[FOIA Ex. 4]
Rhome, TX**

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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 loans are made by participating lenders under an agreement (SBA Form 750) to originate, service, and liquidate loans in accordance with Administration rules and regulations. SBA is released from liability on the guaranty, in whole or in part, if the lender fails to comply materially with any of the provisions of the regulations, the loan authorization, or did not make, close, service, or liquidate the loan in a prudent manner.

The Washington Mutual Bank is a financial institution authorized by SBA to make guaranteed loans under the Preferred Lenders Program (PLP). Preferred lenders are allowed to process, close, service, and liquidate SBA loans with reduced requirements for documentation and prior approval by SBA. In February 2001, Washington Mutual acquired Bank United (lender) and a number of SBA loans originated by Bank United in its capacity as a PLP lender.

In February 2000, the lender approved a \$980,000 SBA loan (number [FOIA Ex. 4]) to [FOIA Ex. 4] (borrower). The proceeds were for the purchase of a convenience store/gas station in Rhome, Texas. Zions First National Bank of Salt Lake City, Utah, held the senior lien position on this property with a \$1,110,000 loan. The balance of the project was to be funded by an owner's equity injection of \$425,000 and a \$150,000 standby agreement from the seller. Loan proceeds were disbursed in March 2000. The loan was placed in liquidation status in July 2001. The SBA reached agreement with the lender in August 2002 to adjust the guaranty from 75 percent to 30 percent.

AUDIT OBJECTIVE AND SCOPE

The audit objective was to determine if the early loan default was caused by lender or borrower noncompliance with SBA's requirements to originate, close, and liquidate the loan. 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). We reviewed and analyzed information in the lender's loan file. The audit was performed in accordance with generally accepted Government Auditing Standards.

RESULTS OF AUDIT

FINDING Prudent Lending Procedures were not used to Process a Loan

The lender did not use prudent lending procedures to process a Section 7(a) loan to the borrower. The lender did not:

- Verify the borrower's equity injection;
- require a standby agreement for the injection;
- question the borrower's lack of managerial experience;
- properly account for use of loan proceeds;
- require a guarantor; nor
- obtain an appraisal that met the required estimate.

Consequently, SBA made a \$293,823 erroneous payment when it repaired the guaranty.

Lender requirements for making SBA loans

SOP 50 10 (4), Subpart "D", provides the loan processing responsibilities of PLP lenders. Lenders are responsible for all decisions regarding eligibility and creditworthiness, as well as confirming that loan closing decisions are correct and comply with all requirements of law and SBA regulations.

Equity injection not verified

The authorization and loan agreement required the lender to obtain evidence prior to disbursement that the borrower injected at least \$425,000 into the business. The only evidence to support the equity injection was the settlement sheet from the title company and a letter from the borrower's father. The lender did not obtain canceled checks, proof of wire transfers, or other evidence of the injection.

The lender's February 3, 2000, credit analysis stated that the equity injection would come from \$350,000 cash on hand and \$50,000 from the collection of an account receivable. The remaining \$25,000 was to be documented with either an updated personal financial statement showing available liquid assets or a gift letter. The borrower's personal financial statement indicated that he had \$350,000 cash on hand. A document in the loan file contradicted the statement that the borrower would make the injection from cash on hand. Rather, a statement signed by the borrower's father, dated March 2, 2000, stated that he and the borrower were partners in a second business that was being sold. The sale proceeds would then be used to inject the required \$425,000.

There was no documentation verifying that the borrower was an owner of the second business or that it had been sold. In addition, the lender had not verified that the sale proceeds were deposited in the borrower's account. Since the borrower's personal financial statement indicated that he had the cash on hand, proceeds from a sale would not have been needed for the injection. The lender neither noted this contradiction nor determined why there were conflicting sources.

A prudent lender would have obtained more substantive evidence of equity injection than a letter from the borrower's father and a closing statement that did not indicate whether the borrower actually injected \$425,000. As a result, SBA had little or no assurance that the equity injection was actually made.

Standby agreement for the equity injection not obtained

If, as stated by the borrower, the equity injection was to come from the sale of a business owned by the borrower and his father, the lender did not obtain a standby agreement for the funds. Since the father was not a principal of the SBA loan, his share of the sale would have to either be gifted or loaned to the borrower. There was no documentation to support a gift, hence, the funds would be considered loaned.

According to SOP 50 10 (4), borrowed funds are deemed equity injection only when the lender of the borrowed funds agrees to a standby agreement of principal and interest until the SBA loan is paid in full, or the applicant can demonstrate repayment ability from a source other than cash flow of the business. The borrower was unable to meet either of these requirements. Therefore, the father's portion of any funds received from the sale of the business could not be considered equity injection.

Questionable managerial experience

According to 13 CFR 120.171, the lender must consider the borrower's experience and depth of management when examining credit criteria. The lender's credit analysis showed the borrower had three years of convenience store/gas station experience and ten years of deli/food management experience. The loan file also contained documents indicating the borrower was 19 years old. Despite the likelihood that the borrower could not have the stated management experience, the credit analysis showed this experience as one of the strengths of the business. To further demonstrate a lack of experience, the borrower tax returns showed reported earnings of \$647 for 1997 and \$1,463 for the 1998. Based on the borrower's age and such small earnings, the lender should have questioned the borrower's experience to manage a \$2 million business.

Accounting for the use of proceeds

The lender did not fully account for the use of proceeds. The authorization and loan agreement required that the proceeds be used to purchase an existing business (\$915,000) and for working capital (\$65,000). The settlement sheet provided by the lender showed that the title company received \$932,053 from the lender on behalf of the borrower toward the purchase of the business. Additionally, the sheet indicated that the remainder of the loan (\$47,947) was held in a deferred fund by the lender. There was no documentation in the loan file regarding the actual use of the funds. Also, SBA Form SF 1050 was left blank in the area that provided the information concerning how much was disbursed, when and to whom it was disbursed, and for what purpose. As a result, it was not known how these funds were used.

Guarantor not obtained for the loan

The lender did not apply the same underwriting standards as the first lien holder. Prudent business practice would dictate that the SBA loan be held to the same underwriting standards as that of a companion loan. The holder of the companion piggyback loan, Zions National Bank, required a second guarantor. Since the borrower was 19 years old and the loan was not fully collateralized, the requirement of a second guarantor appeared to be a prudent decision. Therefore, the lender should have included the same requirement for the SBA loan.

Appraisal amount less than required

The lender did not ensure that the property appraisal met the loan authorization requirement. The loan authorization required that the property be appraised with a real estate market value of at least \$2,050,000. The appraisal obtained by the lender opined that the market value of the real estate was \$1,650,000, \$400,000 less than required. No justification, for disbursing a loan with a lower than required appraisal amount, existed in the loan file.

Potential SBA Loss

A defaulted loan balance of \$979,410 was transferred to liquidation in July 2001. The SBA reached agreement with the lender in August 2002, to decrease the guaranty from 75 percent to 30 percent due to the following deficiencies: i) the going concern appraisal was faulty; ii) the bank did not require additional guarantors as did the first lien holder; iii) nearly \$48,000 in proceeds were unaccounted for; iv) the owner appeared to have limited managerial experience; and v) the equity injection was questionable and may have never existed. The SBA repurchased the guaranty for \$293,823.

We concluded that the repair of the guaranty based on the analysis provided in this report supports the fact that the lender was in material noncompliance with SBA rules and regulations in originating and closing this loan. As a result of the lender's malfeasance, a full denial of the guaranty is justified that would result in a recovery of \$293,823.

RECOMMENDATION

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

1. Recover \$293,823 paid to the lender to repair the guaranty on loan number [FOIA Ex. 4].

Management Comments

The Office of Financial Assistance agreed that there were problems in the lender's handling of the loan origination process, but were concerned that the terms of the settlement may impair further attempts at recovery. OGC will be requested to provide a legal opinion with respect to the effect of the settlement on further recovery efforts from the lender.

OIG Comments

We will evaluate the actions taken by SBA to address the recommendation during the audit follow-up process.



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

Appendix A

Redacted for FOIA

Date: September 10, 2004
To: Robert G. Seabrooks, Assistant Inspector General for Auditing
FOIA Ex. 4
From: James W. Hammesley, Acting AA/BM
Subject: Draft Audit of an Early Defaulted Loan to
Washington Mutual Bank (originally Bank United)

Ex. 4

We have received and reviewed the Office of Inspector General (OIG) August 5, 2004, memorandum and accompanying draft audit report for this loan that recommends full recovery of the balance of the guaranty payment (\$293,823). The basis for the OIG recommendation is that the lender had substantial deficiencies in originating the loan.

While we agree that there were problems in the lender's handling of the loan origination process, we are concerned that there was already a settlement effectuated with the lender in connection with the purchase at the reduced percentage of 30% as compared with the original guaranty percentage of 75%. The terms of the settlement may impair further attempts at recovery. Consequently, we have requested that the Dallas District Office send the loan file to Headquarters and we will request a legal opinion from OGC with respect to the effect of the settlement on further recovery efforts from the lender.

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