



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

AUDIT REPORT
ISSUE DATE: November 24, 2003
REPORT NUMBER: 4-02

To: Lavan D. Alexander, District Director
Dallas/Fort Worth District Office

/S/ Original Signed

From: Robert Seabrooks, Assistant Inspector General
For Auditing

Subject: Audit Report-Early Defaulted Loan to FOIA Ex. 4

Attached is a copy of the subject audit report. The report contains one finding and one recommendation. A response from your office indicated agreement with the recommendation, but stated you had a concern about one element of the finding. Your response has been synopsized in the report and included as an appendix.

The finding in this report is the conclusion of the Office of Inspector General, Auditing Division. The finding and recommendation are subject to review and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution. Please provide your management response for the recommendations to our office within 30 days of the date of this report using the attached SBA Form 1824, Recommendation and Action Sheet. The completed form should be sent to:

Audit Manager
SBA OIG/Atlanta Field Office
233 Peachtree Street, NE, Suite 1803
Atlanta, Georgia 30303

Should you or your staff have further comments or questions, please contact Garry Duncan, Director, Credit Programs Group, at (202) 205-7732.

Attachments

Redacted for FOIA

AUDIT REPORT

EARLY DEFAULTED LOAN TO FOIA Ex. 4

FOIA Ex. 4

AUDIT REPORT NUMBER 4-02

NOVEMBER 24, 2003

This 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 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.

**AUDIT OF
EARLY DEFAULTED LOAN TO** FOIA Ex. 4
FOIA Ex. 4

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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 750) to process, 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.

Bank United (lender) was 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 guaranteed loans with reduced requirements for documentation and prior approval. In February 2001, the lender and a number of SBA guaranteed loans it processed were acquired by Washington Mutual Bank, FA, also a PLP lender.

On FOIA Ex. 4, SBA Loan Number FOIA Ex. 4 was approved in the amount of \$1 million to [FOIA Ex. 4] using PLP processing procedures. The loan was part of a financing package of about \$2.8 million that also included a non-SBA companion loan of about \$1.2 million and an equity injection of \$590,000 to purchase a convenience store/gas station (the station) from [FOIA Ex. 4]. In June 2000, FOIA Ex. 4 (the refiner) sold the station to the seller for \$1.5 million as part of a bulk disposal of stations and, on the same day, the seller sold the station to the borrower. The station never operated under the seller's ownership. The SBA guaranteed loan provided \$880,000 for the purchase of the business, \$75,000 to acquire inventory, and \$45,000 for working capital. The loan was disbursed in full in June 2000 and the borrower defaulted 8 months later in February 2001. The loan was transferred to liquidation status in June 2001 with a principal balance of \$1,002,950.

AUDIT OBJECTIVE AND SCOPE

The audit objective was to determine if the lender and borrower materially complied with SBA's requirements when originating, closing, and liquidating the loan. The loan was judgmentally selected for review based on its dollar value and location as part of the Office of the Inspector General's ongoing program to audit SBA loans charged off or transferred to liquidation within 24 months of origination (early default). We reviewed SBA's and the lender's loan files for compliance with requirements found in SBA's rules and regulations and the loan authorization. We also interviewed SBA, lender, and other personnel. Our audit work was conducted in Atlanta, Georgia, between April and June 2003 in accordance with Government Auditing Standards.

RESULTS OF THE AUDIT

FINDING The Lender did not Comply with SBA Guidance for Eligibility and Repayment Ability

The lender made a loan that did not meet SBA's requirements for size (as a result of affiliation), change in ownership, and repayment ability as addressed in Title 13 of the Code of Federal Regulations (CFR), Part 120 and SOP 50 10(4). After the loan defaulted, the lender agreed to a reduced guaranty payment as a result of deficiencies identified by the Dallas/Fort Worth District Office (district) in the areas of adequate borrower equity, business valuation determination, and the real property appraisal. Because of these noncompliances and others identified by the auditors, SBA should deny liability on the guaranty in full in accordance with Part 120.524 of 13 CFR. The SBA should, therefore, recover the \$376,106 improper payment made to honor the reduced guaranty.

The business was not small based on a borrower affiliation

SBA requires that a business be small in order to obtain an SBA guaranteed loan. Size is determined based on attributes of the applicant and its affiliates. Part 121.103(g) of 13 CFR and SOP 50 10(4), Subpart A., chapter 3, section 3(g) states that an affiliation may arise through excessive restrictions upon the sale of a franchise interest. The SOP cites instances where provisions in franchise agreements have been found to either give the franchisor so much control over the operations of the franchisee or to so restrict the opportunity of the franchisee to have the benefit of profits or the risk of loss from the operations that the franchisee and franchisor were considered affiliates.

] E

FOIA Ex. 5

When the seller acquired the subject business from the refiner, the two concerns entered into an Option to Purchase Agreement which imposed restrictions upon subsequent purchasers of the business. A Fuel Sales Agreement was executed when the seller sold the business to the borrower. These two agreements included restrictions concerning debranding and repurchase rights, franchise requirements, gasoline allocations by the seller, and the control and removal of brand name signs. Details of the restrictions are as follows:

- The Option to Purchase Agreement gave the refiner the option to purchase the real property at an amount that was 20 to 30 percent less than the property's fair market value if the property was debranded. This restrictive provision was placed into land records and was binding on the borrower for a period of 10 years.
- The Fuel Sales Agreement contained the following restrictive statements.
 - "The seller entered into this Agreement in reliance on Buyer's personal qualifications and Buyer's representations to Seller of Buyer's desire to operate a retail motor fuel outlet and willingness to comply with all franchise requirements of the refiner." The agreement further stated that the Buyer's failure to comply with the refiner's and Seller's standards in the areas of retailing, appearance, customer service, and product quality are grounds for damages, non-renewal, and

termination of the agreement. We could not examine the franchise requirements, as they were not found in the lender's file. Therefore, we could not determine if they were in the best interest of the borrower.

- "The amount of gasoline or other motor fuels to be sold at the premises shall be subject to Seller's right to allocate supplies of available products as provided by the refiner, * * *.
- "All signs and poles bearing the business name * * * or brand name furnished by seller shall remain the property of seller and may be changed or removed at any time by seller without notification or consent of buyer."

The aforementioned provisions could restrict the opportunity for the borrower to have the benefit of profits or the risk of loss from operations and, therefore, resulted in an affiliation between the borrower and refiner. At the time of the sale, the refiner was classified as "other than a small business concern" because it exceeded the small business size standard of 100 employees for a petroleum refiner. As a result of the affiliation, the borrower was "other than small" and ineligible for an SBA guaranteed loan.

Change in ownership not based on reasonable need

The lender disbursed loan proceeds of \$1 million to finance a change in ownership that did not satisfy SBA's reasonable need requirement. Subpart B, chapter 1, section 3a. of SOP 50 10(4) states that 7(a) loans are eligible to accomplish a total change of ownership providing there is a reasonable need for such change of ownership. The SOP further provides the following as examples of reasonable need:

- (1) The change of ownership will preserve the existence of a small business; and
- (2) The change of ownership will promote the sound development of a small business.

Documents in the lender's file stated that the change in ownership would preserve the existence of the existing station. However, the station was operated by the refiner, which was other than a small business. The refiner sold the station to the seller. The documents reported that the seller purchased the business with no intention of entering the retail gasoline business. The business never operated under the ownership of the seller and was sold to the borrower on the same day as its acquisition. The change of ownership, therefore, did not preserve the existence of a small business because, prior to its purchase by the borrower, the business was owned by a business concern that was "other than small."

The change in ownership also did not promote the sound development of a small business because contractual relationships with the seller and the refiner potentially threatened the ability of the borrower to make a profit, as well as its sound development. A change in ownership that creates opportunities for others to benefit, all to the detriment of the profitability and sound development of a small business, does not meet SBA's reasonable need test and, therefore, is not consistent with SBA's policies and procedures.

Repayment ability not determined properly

The lender used projections that were not realistic when determining the borrower's ability to repay the loan. As indicated earlier, the business never operated under the seller's ownership and, therefore, historical financial statements of the seller did not exist. Additionally, we found no evidence that the refiner provided the seller with historical financial statements. The refiner did provide the seller with documentation showing actual gasoline volume data and convenience store sales, revenue, and gross margin data for January 1997 through March 2000. The seller made this financial information available to the lender who relied upon the 1999 information as the basis for repayment ability projections and business valuations. We noted that the data for calendar year 1999 contained a disclaimer stating that it should in no way be used as an indicator of the borrower's performance.

Subpart A, chapter 4, section 1.d. of SOP 50 10(4) states that projections may be used when there is a lack of historical financial data. It also requires that realistic projections be used and tested against industry averages and historical operations to assess feasibility. Per the SOP, significant variations must be explained. The SOP further states in chapter 6, section 4.f., that financial information relied upon to demonstrate repayment has to be verified.

The lender's projections, which were based on the 1999 data from the refiner, were not realistic when compared against industry averages from the National Association of Convenience Stores (NACS). The lender's projected gasoline sales and convenience store product sales exceeded the industry averages by more than 100 and 150 percent, respectively. In addition, the lender's projections significantly exceeded the historical convenience store product sales and gross profit margin data provided by the refiner. The lender's loan file did not include an explanation for the significant variances nor evidence that the refiner's data was verified. The following table demonstrates a comparison between the lender's projections, the refiner's data, and industry averages.

COMPARISON OF LENDER'S PROJECTIONS TO THE REFINER DATA & INDUSTRY AVERAGES				
	Refiner's Data 1999	NACS 1999 Industry Averages	Lender's Projections 2000	
			Projection	Industry Average Ratio
Monthly Gallons of Gasoline Sold	238,100	110,500	214,290 ¹	94%
Rate	Not Available	\$1.14	\$1.30	12%
Annual Gasoline Sales (\$)	Not Available	\$1,515,000	\$3,342,924	121%
Annual Convenience Product Sales	\$878,356	\$856,000	\$2,200,000	157%
Gross Profit Margin Convenience Products	\$257,430	\$257,100	\$401,780	87%
Operating Expenses	Not Available	\$399,400	\$623,302	56%

¹ Lender's model discounted the refiner's gallons sold by 10 percent and used resulting figures as a basis for computing gasoline and convenience products sales.

Projections based on the industry averages showed that the borrower's repayment ability was questionable. In addition, it appeared that the business valuations performed by the appraiser were based on the same unverified calendar year 1999 data used to compute the lender's projections. The district, in its post-purchase review, considered the valuations faulty and overstated.

District post-purchase loan review

As a result of its post-purchase review, the district determined that the lender did not process or close the loan in substantial accordance with the terms and conditions of the Loan Authorization (including use of proceeds). The district also stated that it had knowledge to suggest negligence, fraud, or misrepresentation as follows:

- "In effect, the loan was 100 percent financed. This lack of due diligence resulted in the making of a loan with inadequate equity, causing the business to fail."
- "The bank's failure to recognize or address weaknesses in the appraisal resulted in the financing of an overpriced business acquisition and directly contributed to the borrower's failure."
- "The loan appears to have been used to finance the back end of a flip."
- "The source of the owner's equity injection is questionable and may never have existed."

The district and the lender agreed on a 50 percent repair action in August 2001 and on June 18, 2003, the loan was charged off with a loss to SBA of \$376,106. In our opinion, the district should have denied liability for the guaranty as a result of the deficiencies identified during its review and should have referred the loan to the Office of Inspector General as a result of the suggested fraud and misrepresentation. Additionally, the eligibility and repayment ability deficiencies identified during the audit add to the lender's inappropriate actions and further emphasize the need for SBA to deny liability for the guaranty and recover funds paid to the lender.

RECOMMENDATION

We recommend that the District Director, Dallas/Fort Worth District Office, take the following action:

- 1A. [FOIA Ex. 5]

Management Comments

The District Director stated that his office reviewed the draft report and concurred with the recommendation but had concerns with the IG's position on "Repayment ability not determined properly" and requested that the recommendation to FOIA Ex. 5 be submitted to central office for final decision. He also stated that it should be noted that this early default was forwarded to the IG on June 22, 2001.

Evaluation of Management's Comments

Only the Administrator or his delegate can deny liability on the guaranty for a Section 7(a) guaranteed loan. Therefore, the district director [FOIA Ex. 5]

Appendix A

Management Comments

From: Alexander, Lavan D.

Sent: Thursday, November 13, 2003 3:25 PM

To: Norwood, Betty W.

Cc: Montes, Joseph O.

Subject: Draft Report-Early Defaulted Loan to FOIA Ex. 4

The Dallas District Office has reviewed the draft report on subject loan. The report listed one finding that stated "The lender did not comply with SBA Guidance for Eligibility and Repayment Ability." The Dallas office concurs with your recommendation but has concerns with your position on "Repayment ability not determined properly." Therefore we are requesting [FOIA Ex. 5]

Also, it should be noted that this early default was forwarded to the IG on June 22, 2001. If additional information is needed, please let me know.

Lavan D. Alexander
District Director
817-684-5502

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