



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

<b>AUDIT REPORT</b>
<b>Issue Date: December 23, 2003</b>
<b>Number: 4-04</b>

**TO:** Elaine F. Guiney, District Director  
Massachusetts District Office

**FROM:** /S/ Original Signed  
Robert G. Seabrooks  
Assistant Inspector General for Auditing

**SUBJECT:** Audit of an SBA Guaranteed Loan to Concord Wire Company

Attached is a copy of the subject report. The report contains one finding and one recommendation. Based on the response received from your office the draft report was modified. The final report only discusses the lender's allowing a creditor to accept payments contrary to a standby agreement. Your response is included at Appendix A.

The finding in this report is the conclusion of the Office of Inspector General's 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 to the recommendation within 30 days from the date of this report using the attached SBA Forms 1824, Recommendation Action Sheet.

If you have any questions about the issues contained in the report, please contact Garry Duncan, Director, Credit Programs Group, at (202) 205-7732.

Attachments

**AUDIT OF AN SBA GUARANTIED LOAN TO  
CONCORD WIRE COMPANY  
WORCESTER, MASSACHUSETTS**

**AUDIT REPORT NUMBER 4-04**

**DECEMBER 23, 2003**

**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 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 SBA GUARANTIED LOAN TO  
CONCORD WIRE COMPANY  
Worcester, Massachusetts**

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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. Participating lenders make SBA loans 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, or service the loan in a prudent manner:

First International Bank (lender) acquired by UPS Capital Company in August 2001 was authorized by SBA to make guaranteed loans under the Preferred Lender Program (PLP). Under PLP, the lender processes, closes, services, and liquidates loans with reduced requirements of documentation and prior approval by SBA.

We selected a group of SBA loans originated by the lender from October 1, 1999 to September 30, 2002 that had been charged off or were in liquidation status. In November 1999, the lender approved an SBA loan (number 342347402) for \$800,000 to the borrower under PLP procedures. The purpose of the loan was to refinance a revolving credit line and term debt of \$700,000, purchase equipment for \$75,000, and provide \$25,000 in working capital. The loan was disbursed in December 1999. SBA purchased the loan guaranty for \$514,294 in June 2002.

## **AUDIT OBJECTIVE AND SCOPE**

The audit objective was to determine if the early loan 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. 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 November 2002 through March 2003 in Glendale, California. The audit was conducted in accordance with generally accepted Government Auditing Standards.

## RESULTS OF AUDIT

### **Finding – The Lender did not Comply with SBA Loan Requirements**

The lender originated a loan to Concord Wire Company, Inc. (borrower) in material non-compliance with SBA regulations. Specifically, the lender's inaction allowed a creditor to accept payments contrary to the terms set forth in a standby agreement. As a result, SBA made an improper payment of a portion of the guaranty totaling \$105,000.

### **Payments made by the borrower were contrary to the terms of the standby agreement**

The borrower made monthly payments to a creditor totaling \$105,000 that was contrary to the terms set forth in a standby agreement. The loan authorization required the borrower to prepare a standby agreement for two loans of \$270,000 and \$75,000, respectively. The \$270,000 loan was used to buyout the 60 percent principal of the borrower business. The \$75,000 loan was for working capital.

SOP 50 10 11 states that an agreement of company creditors to subordinate their claims against the business should be obtained if it is determined that such subordination is necessary to improve a borrower's equity position or to assure the repayment of the SBA loan. Additionally, principal and/or interest payments may be allowed on this subordinated debt, or may be suspended for the term of the loan. In either case these conditions must be set forth in the standby agreement.

The loan authorization and the standby agreement provided that the creditor was to accept payments on the debt unless notified otherwise by the lender. Payments could be accepted only if cash generated by the business exceeded a debt coverage ratio of 1.25 to 1. The actual debt coverage (.91 to 1) at loan origination was less than the required ratio that would allow payments to the standby creditor. The lender indicated it was aware the debt coverage ratio was below the required threshold and thought it was understood that the creditor would receive no payments until operations improved. The creditor accepted borrower payments because the lender failed to notify him that the debt coverage ratio was less than the required ratio. Consequently, the \$105,000 paid to the creditor further degraded the debt service coverage and negatively affected the borrower's ability to sustain operations.

### **Recommendation**

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

1. Seek a repair of \$105,000 from the lender for an improper payment made by the borrower to a standby creditor for loan number 342347402.

## **Management Comments**

The District office stated that SBA did not make an “erroneous guaranty payment” because the secondary market holder was paid as required. The District agreed that the standby creditor should not have received payments and that the bank was at fault for not notifying the creditor to stop taking payments.

The District took issue with the two additional sections of the draft report, i.e. the affiliation relationship and the delinquency associated with debt refinancing. The full text of SBA comments is included in appendix A of this report.

## **OIG Evaluation of Management Comments**

We consider management’s response to the finding on payments made by the borrower to a standby creditor responsive. We have modified the report to reflect management’s concern that fault should lie with the lender and not the creditor. Based on comments concerning the affiliation relationship and the delinquency associated with debt refinancing, these sections were removed from the report.

**DATE:** September 8, 2003

**FROM:** Robert H. Nelson  
Lead Loan Specialist

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

**THRU:** Robert F. Coen  
Deputy Director

**SUBJECT:** Early Default Loan to Concord Wire  
34234740

This memo is in response to the 7/28/03 memo to Elaine Guiney, District Director of the Massachusetts District Office from Robert G. Seabrooks. The finding of the audit is that the lender, now UPS Capital, is in material non compliance with SBA regulations as the lender's inaction allowed a creditor to accept payments totaling \$105,000 contrary to the terms set forth in the standby agreement; the lender did not disclose to SBA a possible affiliated relationship; and the lender did not appropriately consider refinanced debt delinquency. The audit finds that the SBA made a \$514,294 erroneous payment. The recommendation of the audit is that the District Office requests the lender to return to guaranty payment.

The District Office response is as follows:

This office did not make an "erroneous guaranty payment". We paid the secondary market holders as we are required to do.

**Payments received by a creditor were contrary to the terms of the standby agreement**

The district office notes that the finding that "Payments received by a creditor were contrary to the terms of the standby agreement" is incorrect. The payments received by the standby creditor were received in accordance with the standby. The fault was in the Bank's not notifying the standby creditor to stop taking payments. As worded, there is an implication of wrongdoing on the part of the standby creditor which would mean that the bank could sue to recover erroneous payments which is not the case. As part of the prudent servicing of the loan, the bank should have informed the borrower and standby creditor that no payments were to be made on the standby debt as the debt service coverage ratio was not at the level to support debt payments on the standby obligation. This should have been a closing item as the DSC was not 1.25x's as of loan closing. The district office believes that a "repair" to the extent of \$105,000 is appropriate to compensate for this lack of action on the part of the lender to appropriately service the loan.

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 Concord Wire  
 September 8, 2003

**Possible Affiliation Relationship not disclosed to SBA**

The affiliation issue is a technical issue in that the bank actually did recognize that there was a potential affiliation and should have brought that to the attention of SBA rather than checking no in that box of the PLP application. The problem here is whether that is sufficient for a denial recommendation. Affiliation is only an issue for size purposes. If together with Weiler, the business still qualified as small, then the business would still have been eligible, and SBA's consideration of the affiliation would have been moot anyway.

**Imprudent evaluation of Delinquency of debt refinancing**

While the District Office agrees that the lender should have been aware of the extent of the delinquency as part of its refinance, it is not prohibited from refinancing delinquent debt on a PLP basis as long as the debt is not its own. There was a \$10,000 late fee that was paid as part of the refinance package. The lender should have requested an itemization as to how the \$21,684 was calculated and later reduced to \$10,000. The question is "does this rise to the level of denial of liability". The delinquency of the refinanced debt issue seems to be less an underwriting deficiency than an adverse change issue. According to the bank they knew that the loan was delinquent because the line had matured and had not been paid. The bank reviewed August statements and found no significant interest accruals which led them to believe that the loan was in relatively good standing at that time. This indicates that their underwriting was reasonable and prudent, but when it came to closing, the loan payoff statement indicated a significant late fee. A case can be made that at this time the bank was put on the alert to investigate the extent of the borrower's delinquency and that such an investigation should have triggered the adverse change language in the loan authorization and led to the bank's pulling the plug on the loan which would have avoided the subsequent loss. This reasoning presumes that the undisclosed delinquency was of such a magnitude as to warrant pulling the loan. This District Office opinion is that this lack of due diligence on the part of the bank does not warrant a denial. Projected DSC in the bank's analysis was 1.53x's. Based upon the pro forma projections, the business would have had the ability to repay the late fee and delinquency on the line of credit. Also, at this point, there is no clear basis for the late fee that was assessed and the amount may have been just a late fee on the past due principal as the bank line of credit was matured.

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Robert H. Nelson	Date
Lead Loan Specialist	

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Anne Rice Hunt	Date
Supervisory Economic Development Specialist	

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Philip A. Vitiello	Date
District Counsel	



Report Distribution

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