



**U.S. SMALL BUSINESS ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL  
WASHINGTON, D.C. 20416**

<b>AUDIT REPORT</b>
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<b>Issue Date: July 15, 2005</b>
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<b>Report Number: 5-21</b>
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**To:** James E. Rivera  
Associate Administrator for Financial Assistance

/S/ original signed  
**From:** Robert G. Seabrooks  
Assistant Inspector General for Auditing

**Subject:** Audit of a SBA Guaranteed Loan to L.I.C. Auto Sales, Inc.  
dba King Bear

Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to you. Your response and the response of the lender have been synopsized and included in the report.

The recommendation in this report is subject to review and implementation of corrective action by your office in accordance with 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 Action Sheet.

Should you or your staff have any questions, please contact Garry Duncan, Director, Credit Program Groups, at 202-205-[FOIA Ex. 2].

Attachment

cc: Acting IG

**AUDIT OF A SBA GUARANTIED LOAN TO  
L.I.C. AUTO SALES, INC. DBA KING BEAR**

**Long Island City, New York**

**REPORT NUMBER 5-21**

**The finding in this report is the conclusion of the Office of Inspector General's Auditing Division based on testing of SBA 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 A SBA GUARANTIED LOAN TO  
L.I.C. AUTO SALES, INC. DBA KING BEAR  
Long Island City, New York**

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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 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.

Banco Popular North America (lender) is authorized by SBA to make guaranteed loans under the Preferred Lender Program (PLP). A PLP lender is permitted to process, close, service, and liquidate SBA loans with reduced requirements for documentation and prior approval by SBA. During an on-going review of the guaranty purchase process at the National Guaranty Purchase Center (Center) in Herndon, Virginia, we identified a problematic loan made by the lender to L.I.C. Auto Sales, Inc. dba King Bear (borrower), which is the subject of this audit report. The loan was part of a sample selected from a universe of 7(a) loan purchase requests processed at the Center by Headquarters personnel from the Office of Financial Assistance (OFA).

On June 25, 2002, the lender approved an SBA loan (number 548-698-4009) to the borrower for \$430,000 using PLP procedures. The purpose of the loan was to purchase \$185,000 of equipment and \$55,000 of inventory, make \$85,000 of leasehold improvements, and provide \$105,000 of working capital. The final loan disbursement occurred on February 24, 2003. The borrower defaulted on August 12, 2003, less than six months after the final disbursement. SBA purchased the guaranty for \$308,960 on June 29, 2004.

## **AUDIT OBJECTIVE AND SCOPE**

The objective of the audit was to determine if the lender originated, serviced, and liquidated the purchased loan in accordance with SBA rules and regulations. During the audit we examined loan files maintained by SBA and the lender and interviewed SBA officials in OFA. The audit was conducted during February and March 2005, in accordance with Government Auditing Standards.

## RESULTS OF AUDIT

### **Finding 1 The Lender did not Follow SBA Loan Servicing and Liquidation Requirements**

In servicing and liquidating the loan, the lender did not: (i) verify the full amount of the equity injection, (ii) secure collateral, and (iii) properly accrue interest. As a result, SBA erroneously paid the lender \$308,960 when it purchased the guaranty.

#### ***Equity Injection was not verified***

The lender did not verify that the borrower injected the required amount of equity into the business before the loan was disbursed. The loan authorization required the lender to obtain evidence that at least \$100,000 was injected into the business prior to the first disbursement. The lender provided documentation showing \$106,480 was injected into the business, but only \$24,080 could be verified.

The source of equity funds was not adequately documented for a \$25,000 cashier check and a \$32,400 down payment. The lender claimed that a \$25,000 cashier's check deposited into the borrower's checking account was a gift from his father-in-law, but the only evidence that it was a gift rather than a loan was a statement signed by the borrower. According to SBA, this was insufficient evidence that the check was equity injection and not a loan. A \$32,400 down payment for the purchase of a franchise was also claimed as equity injection. Although the purchase agreement showed \$32,400 was received from the borrower in the form of cash or certified check, there was no evidence of the source of the payment. Consequently, the lender had no assurance that the funds were not borrowed and required to be repaid with business funds or loan proceeds.

Another \$25,000 equity injection was provided in the form of a loan from a business previously owned by the borrower. According to SOP 50 10(4), borrowed funds may be deemed equity only if: (i) the lender of the funds agrees to a formal standby of payment until the SBA loan is paid in full, or (ii) the borrower can demonstrate repayment ability from a source other than the cash flow of the business or from reasonable withdrawals or salary. There was no standby agreement for this loan found in the lender's loan files nor was there evidence that the lender performed the necessary analysis to determine if the borrower had the capacity to repay the loan from other sources. There was, however, evidence that the borrower was repaying the loan from the cash flow of the business which violated equity requirements.

As discussed above, \$24,080 of the \$106,480 claimed equity injection was verified as required but the remaining \$82,400 was unsupported. Since only \$100,000 of equity injection was required, the amount determined to be unsupported and not verified was \$75,920 (\$100,000-\$24,080), or 76 percent, of the required equity.

### ***Collateral was not secured***

The lender did not follow prudent lending procedures to assess and secure all available collateral after the borrower defaulted on the loan. In accordance with the loan authorization, collateral securing the loan included all rights, titles, and interest of the debtor in and to all property of every description, including inventory. Documentation in the loan files showed the borrower's used car inventory was to be taken as collateral to secure this loan. SOP 50 51, chapter 8, paragraph 7, required the lender to enforce recovery when it determined there was no longer any reasonable possibility that the borrower would repay the loan in an orderly manner. The lender was required to prepare a comprehensive and detailed report containing an inventory of assets and an assessment of their condition. Additionally, the lender was required to secure the collateral.

After two missed loan payments, the lender contacted the borrower and learned that the business had been abandoned. The lender immediately performed a site visit on September 17, 2003 and found the premises had been vandalized and most of the inventory and equipment had been removed, except for a few items of office equipment, steel lift supports, and several used cars which were still parked in the lot with for sale signs. The lender abandoned the office equipment and steel lift supports because the cost of recovery would have exceeded the value, however, they did not take prudent measures to assess the value of the remaining used car collateral and protect it from further loss. When the lender returned for a second site visit on January 30, 2004, the cars had been removed from the lot. Consequently, there was no recovery from collateral on the loan.

An accurate liquidation value cannot be established for the collateral because the lender did not assess and secure the used car collateral found during the first site visit. Based on the lender's credit memorandum prepared at the time of loan origination, the liquidation value of the borrower's inventory was \$25,000. Thus, the loss to SBA was increased by as much as \$18,750 ( $\$25,000 \times 75\%$  SBA guaranty) due to the lender's failure to protect and secure the collateral.

### ***Excessive interest accrued***

The lender's certified transcript showed that interest was accrued and paid on the entire loan amount of \$430,000 from September 12, 2002, through July 12, 2003. The settlement sheets, however, showed that \$397,600 was not disbursed until September 17, 2002, and the remainder of the loan was disbursed on February 24, 2003. Therefore, interest should not have begun to accrue on the first disbursement until September 17, 2002, and on the full amount of the loan until February 24, 2003. Due to the lender's error, excess interest of \$1,399 was accrued from September 12, 2004, through February 24, 2003. As a result, the principle loan balance shown in the transcript submitted to SBA with a guaranty purchase request was overstated by \$1,399.

## ***Conclusion***

Since the subject loan defaulted early and the deficiencies discussed above are significant and represent actions contrary to SBA requirements, we concluded that the lender's imprudent actions were the principal reasons for taxpayers incurring the loss on the loan. Therefore, a full denial of liability is warranted.

## **RECOMMENDATION**

We recommend that the Associate Administrator for Financial Assistance take the following action:

1. Seek recovery of \$308,960 from the lender on the guaranty paid for loan number 548-698-4009.

## **Lender Response**

The lender agreed there was some deficiencies but did not believe they warranted full denial. The lender's responses to specific sections of the draft report are synopsized below and the entire response (less attachments) is included as Appendix A.

### *Equity Injection was not verified*

The lender stated that the borrower's personal financial statement indicated the borrower had the necessary equity available for injection. The lender agreed, however, that the \$25,000 loan from the borrower's previously owned business could not be verified as equity injection because there was no standby agreement. They also agreed that the \$25,000 gift should not have been accepted as equity injection since the gift statement was not signed by the giver. The lender stated there was no evidence in their file of a cancelled check for the borrower's \$32,400 down payment for the purchase of the franchise. Instead, the lender relied on the fully executed contract between the borrower and the franchisor as evidence of the equity injection. The lender stated they had an established relationship with the seller and had no reason to question the validity of the cash received by them. The lender agreed to refund \$43,520 to SBA for the amount of equity injection that was not properly documented.

### *Unsupported use of proceeds*

The lender provided an escrow agreement that reflected the release of \$15,000 on January 30, 2003 due to the presentment of licenses. The lender also provided copies of an invoice and disbursement check to support the \$55,000 disbursement for inventory.

*Collateral was not secured*

The lender stated that as a matter of practice, they do not place liens on motor vehicle inventory and that their security agreement did not include this inventory. Therefore, the lender claimed they would not have been able to sell the motor vehicles if they had secured them. Furthermore, they stated that the only other remaining collateral items were abandoned because the cost of recovery would have exceeded the value.

*Excessive interest accrued*

The lender acknowledged the excess interest accrued and agreed to refund SBA \$1,399 for this deficiency.

**Evaluation of Lender Response**

The lender's response provided some new information to justify minor revisions to the audit report. It was not sufficient to materially modify or withdraw our finding and recommendation. Therefore, we continue to recommend full recovery on the guaranty. An evaluation of the lender's responses to the specific sections of the draft report is summarized below.

*Equity Injection was not verified*

The availability of funds based on the borrower's personal financial statement is not sufficient evidence of an equity injection. Simply showing that equity funds were available is not evidence they were injected into the business. The purchase agreement showing that a \$32,400 down payment was received from the borrower in the form of cash or certified check is also not adequate evidence of equity injection because it does not substantiate the source of the funds. Without establishing the source, the nature of the funds can not be determined. The lender's relationship with the seller is not adequate evidence that the down payment was not borrowed and required to be repaid with business funds or loan proceeds.

The report was revised to reflect the additional information provided by the lender with regards to the \$25,000 gift and the \$32,400 down payment.

*Unsupported use of proceeds*

The documentation provided by the lender was sufficient to address this issue. Accordingly, this section was removed from the report.

*Collateral was not secured*

The used car inventory was a major part of the borrower's inventory in which the lender took a security interest. According to SBA regulations, the lender was required to



secure all available used car collateral. Internal lender policy does not take precedence over SBA policy; therefore, the lender contributed to the loss on the loan because they did not secure the collateral in accordance with SBA policy.

The report was modified to reflect that the lender abandoned other collateral because the cost of recovery would have exceeded the value.

*Excessive interest accrued*

The lender's comments and planned actions were responsive to this issue.

**SBA Management Response**

OFA agreed to seek full recovery of the \$308,960 guaranty paid on this loan. OFA's responses to specific sections of the draft report are synopsisized below and the entire response is included as Appendix B.

*Equity Injection was not verified*

OFA stated that availability of funds reflected on the borrower's personal financial statement was not sufficient to verify funds were actually injected into the business. They agreed there was insufficient evidence to determine whether the cashier's check for \$25,000 and the \$25,000 check from the borrower's previously owned business were equity injections or loans. OFA believes there was sufficient evidence that the lender verified the \$32,400 down payment for the purchase of the franchise was equity injection. As a result, they determined there was a \$43,520 shortfall in the verification of equity injection, rather than the \$75,920 shortfall computed by the OIG. OFA concluded, however, that the equity injection shortfall warranted full recovery based on the SBA policy that when a business experiences an early default and equity injection has not been verified, SBA assumes the business failed due to insufficient working capital/equity. As a result, OFA agreed with the recommendation to seek full recovery of the purchase amount disbursed in the amount of \$308,960.

*Unsupported use of proceeds*

OFA stated that the lender satisfied the documentation issue regarding the use of proceeds questioned in the draft report.

*Collateral was not secured*

OFA stated that the used motor vehicles were a major inventory item. Since the lender took a security interest in the borrower's inventory, OFA concluded that the lender was obligated to properly perfect its interest and subsequently secure the inventory for recovery on the loan. OFA stated that internal bank policy does not have precedence over SBA policy and requirements. Accordingly, when the lender made the choice to

adhere to its internal policy and did not secure/sell the remaining used car inventory, it contributed to the loss on the loan.

*Excessive interest accrued*

OFA agreed that the principal amount of the loan should have been reduced by \$1,399 at the time of the guaranty purchase.

**Evaluation of SBA Management Response**

OFA's comments regarding the unsupported use of proceeds, unsecured collateral and excessive interest accrual were responsive to the issues presented in our draft report. Furthermore, OFA's plan to seek full recovery of the guaranty purchase due to a \$43,520 shortfall in the verification of the required equity injection is responsive to our recommendation.

We disagree with OFA that the \$32,400 down payment was adequately documented as an equity injection. The purchase agreement between the borrower and franchisor showed \$32,400 was injected into the business in the form of cash or certified check, but it did not substantiate that the cash came from borrower equity. Without verifying the source, the lender had no assurance that the down payment was not comprised of borrowed funds which had to be repaid, thereby making it ineligible for equity injection under SBA procedures.



Banco Popular North America  
9600 W. Bryn Mawr Ave.  
Rosemont, IL 60018  
Telephone: (847) 994-6936  
Facsimile: (847) 994-6914

May 19, 2005

Stephen Seifert  
SBA Office of Inspector General  
1145 Herndon Parkway  
Suite 900  
Herndon, VA 20170

RE: L.I.C. Auto Sales dba King Bear  
SBA Loan #PLP 548 698 4009

Dear Mr. Seifert:

Enclosed you will find the bank's draft response to the draft audit report conducted by the Office of Inspector General on the above referenced loan. We have carefully considered our response and await feedback upon your review and consideration.

Should you have any questions, please contact me.

Sincerely,

[FOIA Ex. 6]

Genny J. Maguire  
Loan Workout Officer

/pm  
C  
Encl.

L.I.C. AUTO  
BPNA'S RESPONSE TO THE  
I.G. AUDIT FINDINGS

I.G. CONCLUSIONS – Since the subject loan defaulted early, the deficiencies discussed are significant and represent actions contrary to SBA SOP requirements by the lender, we concluded that the lender's imprudent actions were the principal reason for taxpayers incurring the loss on the loan. Therefore, a full denial of liability is warranted.

I.G. RECOMMENDATION – Seek recovery of \$308,960 from the lender on the guarantee paid for loan number 548-698-4009.

BPNA CONCLUSIONS – The loan went into default a year after the initial funding. In our review of the IG findings we conclude there were some deficiencies however, we do not feel these deficiencies warrant a full denial of the guaranty. Our review of the file reflects an honest effort by bank officers to take prudent measures to follow SBA SOP requirements. Some of these measures would not be acceptable within our current organization structure but at the time, our field officers made judgment calls based on their understanding of the SBA SOP requirements for cash injection, etc. Unfortunately, the officers involved in the origination of this loan are no longer with the bank. Also, at the time this loan went into default, the bank was in the process of transitioning the SBA workout files from the regions into Rosemont. The transition of the New York files was completed January 2004. Although we have made every effort to locate all the files and documents relating to this loan, we feel some documentation may have been lost.

BPNA RECOMMENDATION – Based upon our review, the bank is prepared to accept a repair equal to the cash injection that was not properly documented in our files in the amount of \$43,520. In addition the bank is prepared to refund excess interest accrued in the amount of \$1,399.

EQUITY INJECTION WAS NOT VERIFIED

I.G. The lender did not verify that the borrower injected the required amount of equity into the business before the loan was disbursed. The loan authorization required the lender to obtain evidence that at least \$100,000 was injected into the business prior to the first disbursement. The lender provided documentation showing \$106,480 was injected into the business, but only \$24,080 could be verified during the audit.

The source of funds was not documented for a \$25,000 cashier check deposited into the borrower's checking account and a \$32,400 down payment to purchase a franchise. Consequently, the lender had no assurance that the borrower was not required to repay these amounts with business funds or loan proceeds. Another equity injection of \$25,000 was provided in the form of a loan from a business previously owned by the borrower. According to SOP 50 10(4), borrowed funds may be deemed equity only if: (i) the lender of the funds agrees to a formal standby of payment until the SBA loan is paid

in full, or (ii) the borrower can demonstrate repayment ability from a source other than the cash flow of the business or from reasonable withdrawals or salary.

There was no standby agreement for this loan found in the lender's loan files and the lender did not perform the necessary analysis to determine if the borrower had the capacity to repay the loan from sources other than the cash flow of the business or from reasonable withdrawals or salary. Furthermore, there was evidence that the borrower was repaying the loan from the cash flow of the business. As a result of the above, \$75,920 or 76 percent of the required equity was unsupported and could not be verified.

BPNA response:

[FOIA Ex. 6] personal financial statement dated 5/21/02 lists liquid assets of \$191,000 comprising of \$41,000 in cash & savings in addition to \$150,000 in IRA or retirement accounts. The authorization required \$100,000 of equity injection in the form of franchisor fee and inventory. The PFS would seem to indicate the guarantor had the necessary equity injection.

The form of cash injection was as follows:

- There is evidence of a \$25,000 deposit on 9/16/02 to the Bank of NY checking account #6903945948 for cashier's check drawn on NEB and made payable to LIC. The closing attorney provided a copy of the check with the statement funds were gifted from the father-in-law.
- Also there is a letter from King Bear Auto Service Centers verifying receipt of check #143 dated 4/23/02 drawn on account at The Bank of NY in the amount of \$24,080 as payment from [FOIA Ex. 6].
- Another check from On-Site of New York, Inc. in the amount of \$25,000 dated 4/22/02 made payable to King Bear Automotive Service Center. This check appears to have been drawn on a business line of credit at The Bank of New York. This company was previously owned by guarantor [FOIA Ex. 6] and was taken over by his son. There is a statement in file from the borrower stating the assets and accounts of On-Site were taken over by his son, [FOIA Ex. 6].
- The contract for sale stated the buyer had received \$32,400 upon execution of the agreement however there is no evidence in file of the cancelled check. The bank relied on the fully executed contract. The bank had an established relationship with the seller as we had funded several previous King Bear franchises in the past. There was no reason for the bank to question the validity of the cash received by the seller at the time the contract was executed.

All together there is \$106,480 in cash injection. Admittedly the bank could have obtained a standby letter from On-Site of New York, Inc. for the \$25,000. The bank did recognize the evidence provided prior to the initial funding was not adequate and sought



to obtain clarification. An escrow agreement was entered into and a portion of the loan proceeds were held back. The borrower then provided the bank with a copy of the \$25,000 cashier's check with the statement funds were gifted from the father-in-law. By today's standards the bank would not have accepted this as it was signed by [FOIA Ex 6] and not the father-in-law.

### UNSUPPORTED USE OF PROCEEDS

I.G. Upon signing the SBA Form 1050, "Settlement Sheet," the lender certified that loan proceeds were used in accordance with the loan authorization, and that disbursement was made by issuance of joint payee checks, except for checks for cash operating capital, cash to reimburse the borrower for evidenced expenditures made after the loan approval date, or as otherwise directed by the loan authorization.

According to the settlement sheets and supporting documentation, \$15,000 of the loan proceeds were disbursed to an attorney to be held in escrow until the borrower received new licenses for a repair facility and used auto dealer. There was no evidence that the licenses were obtained or the funds were ever disbursed to the borrower. This \$15,000 disbursement was included in SBA's calculation of the guarantee purchase amount and therefore, may have resulted in an overpayment to the lender. The settlement sheets also showed that \$55,000 was disbursed to King Bear Auto Service Center, Inc. for inventory without any support. Consequently, \$70,000 of loan disbursements was not properly supported.

BPNA response.

The authorization required use of proceeds as follows:

1. \$185,000 to purchase equipment
2. \$85,000 to make leasehold improvements to the building
3. \$105,000 for working capital
4. \$55,000 to purchase inventory

We have a settlement sheet dated 9/12/02 for disbursement of \$397,600 as follows:

\$250 to Banco for packaging fee  
 \$9675 to banco for guaranty fee  
 \$6282.25 to Victor Gardenstein for legal fee  
 \$2500 to Urban & Salatto for legal fee  
 \$15,000 to Victor Gardenstein for escrow to be held until licenses obtained for repair facility and Used auto dealer.  
 \$71,292.75 to L.I.C. auto for working capital  
 \$237,600 to King Bear Auto Service Center, Inc. for purchase of franchise  
 \$55,000 to King Bear Auto Service Center, Inc for inventory

We have a settlement sheet dated 2/24/03 for the remaining \$32,400 to L.I.C. Auto Sales, Inc. dba King Bear for working capital that is supported by cancelled checks.

The closing attorney was able to provide the bank with a copy of the escrow agreement dated 9/12/02. The agreement reflects the release of the \$15,000 from escrow on 1/30/03 due to presentment of licenses. Neither our files nor the attorney's files contain copies of the licenses but the release was signed by bank officer, James Delaney. The closing attorney was also able to provide the bank with a copy of an invoice from King Bear Auto Service Centers, Inc. for the total amount of \$75,000 reflecting inventory consisting of tires and auto parts. This invoice supports the \$55,000 disbursement for inventory.

The escrow agreement also reflects the release of \$32,400 from escrow due to presentment of evidence of \$25,000 cash injection. This appears to have been the cashier's check with the statement funds were gifted from the father-in-law. The release was signed by bank officer, Mike Dee.

#### COLLATERAL WAS NOT SECURED

I.G. The lender did not follow prudent lender procedures to assess and secure all available collateral after the borrower defaulted on the loan. Collateral securing the loan included all rights, titles, and interests of the debtor in and to all property of every description, including inventory. Documentation in the loan files showed the borrower's used car inventory was to be taken as collateral to secure this loan. SOP 50 51, chapter 8, paragraph 7, required the lender to enforce recovery when it determined there was no longer any reasonable possibility that the borrower would repay the loan in an orderly manner. The lender was required to prepare a comprehensive and detailed report containing an inventory of assets and an assessment of their condition. Additionally, the lender was required to secure the collateral.

After two missed loan payments, the lender contacted the borrower and learned that the business had been abandoned. The lender immediately performed a site visit on September 17, 2003, and found the premises had been vandalized and most of the inventory and equipment had been removed, except for a few items of office equipment, steel lift supports, and several used cars which were still parked in the lot with for sale signs. The lender, however, did not take prudent measures to assess the value of the remaining collateral and protect it from further loss. When the lender returned for a second site visit on January 30, 2004, the cars had been removed from the lot. Consequently, there was no recovery from collateral on this loan.

Because the lender did not follow prudent lending procedures to assess and secure the remaining collateral found during the first site visit, an accurate liquidation value cannot be established. Based on the lender's credit memorandum, the liquidation value of the borrower's inventory was \$25,000. Thus, the loss to SBA was increased by as much as \$18,750 ( $\$25,000 \times 75\%$  SBA guarantee) due to the lender's failure to protect and secure the collateral.

BPNA response.

The inventory on this loan consisted of used cars and auto parts. As a matter of practice the bank does not place it's lien on M/V inventory. In addition, our security agreement did not give us a security interest in any M/V. Had we secured the M/V on the lot at the time of our first site visit, we could not have sold them. The other collateral items on site i.e. computer equipment and steel support were abandoned by the bank as the cost to recovery would have exceeded the value. The bank did take prudent measures to report the loss of the collateral to the Inspector General's Office on 9/18/03.

#### EXCESSIVE INTEREST ACCRUED

I.G. The lender's certified transcript showed that interest was accrued and paid on the entire loan amount of \$430,000 from September 12, 2002, through July 12, 2003. The settlement sheets, however, showed that \$397,600 was not disbursed until September 17, 2002, and the remainder of the loan was disbursed on February 24, 2003. Therefore, interest should not have begun to accrue on the first disbursement until September 17, 2002, and on the full amount of the loan until February 24, 2003. Due to the lender's error, excess interest of \$1,399 was accrued from September 12, 2004, through February 24, 2003. As a result, the principle loan balance shown in the transcript submitted to SBA with a guaranty purchase request was overstated by \$1,399.

BPNA response

The lender's transcript of account was compiled from the optical reports. This report reflects the disbursement occurred on 9/12/02. It appears the funds were disbursed to the closing attorney who in turn held the funds for disbursement. The bank acknowledges excess interest accrued as a result of the accounting for the disbursements for this loan.





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

Appendix B  
Page 1 of 3

**DATE:** June 14, 2005  
**TO:** Robert G. Seabrook  
Assistant to the Director General for Auditing  
**FROM:** James W. Hammersley [FOIA Ex. 6]  
Acting AA/PM  
**SUBJECT:** Draft Audit of SBA Guaranteed Loan to L.L.C. Auto Sales, Inc. dba  
King Bear

Set forth below is our response to your draft audit report on the above referenced loan. We have reviewed the response of Banco Popular North America to the audit findings and as a result conclude that one of the issues is non-material to the purchase. However, based on the other findings, we concur that SBA should seek full recovery of the purchase amount disbursed in the amount of \$308,960. Consequently, we will request the return of the funds from the lender, and if this proves to be unsuccessful we will request a legal opinion from the Office of General Counsel with respect to possible litigation for recovery of the funds.

The draft audit contends that the lender did not follow SBA loan servicing and liquidation requirements in that:

**(i) The lender did not verify the full amount of the equity injection**

The loan authorization required the lender to obtain evidence that prior to disbursement the borrower had injected at least \$100,000 cash into the business for payment of the franchise fee and purchase of inventory. The audit report states the lender provided evidence that \$106,480 was purportedly injected into the business, but that only \$24,080 could be verified.

**Lender Response:**

- The principal had liquid assets of \$41,000, as well as \$150,000 in a retirement account at the time of loan application, thereby indicating that the borrower had sufficient resources to meet the equity injection requirement.
- Copy provided of \$25,000 cashier's check drawn on NFB and made payable to LIC dated 9-16-2002.
- Letter from King Bear Auto Service Centers verifying the receipt of \$24,080.
- Check from On-Site of New York, Inc. in the amount of \$25,000 dated 4-22-2002 made payable to King Bear Automotive Service Center which appears to have been drawn on the business line of credit at the Bank of New York (the company was previously owned by principal). This company was taken over by Mr. [FOIA Ex. 6] son.
- Contract for sale stating that the buyer would present \$32,400 to seller upon execution of the contract agreement.

**OFA Response:**

The principal did, in fact, reflect the assets noted by the lender on his personal financial statement; however, the mere fact of the availability of funds is not sufficient to verify that the funds were actually injected into the business.

- There is insufficient evidence to determine whether the cashier's check for \$25,000 and the \$25,000 check dated 4-22-02 made payable to King Bear Automotive Service Center were equity injections or loans.
- Lender has provided verification that \$56,480 was paid to King Bear Automotive Service Centers toward the purchase of this franchise (\$24,080 plus \$32,400), leaving a shortfall of \$43,520 in the verification of the required equity injection.

SBA policy requires lender verification of equity injection. If the business experiences an early default and the injection has not been verified, the assumption is made that the business failed due to insufficient working capital/equity. This is considered a material deficiency. A repair in the amount of the equity injection that could not be verified is considered inappropriate under these circumstances.

**(ii) The lender did not exercise prudent controls over the use of loan proceeds**

OIG maintains that the lender did not confirm that the borrower had the appropriate licenses prior to allowing disbursement of \$15,000 held in escrow until the licenses were obtained. Additionally the IG indicates that funds in the amount of \$55,000 were disbursed to the seller/franchisor for inventory without any supporting documentation.

**Lender Response:**

- Lender does not have evidence that the business had the appropriate licenses - lender allowed disbursement of funds based on the business operating under the licenses of the franchise until such time as the licenses were issued.
- Lender has provided an invoice from the seller/franchisor in the amount of \$75,000 for inventory.

**OFA Response:**

- OFA has reviewed the documentation provided by the Lender and concludes that the lack of confirmation of the license is a deficiency; however, it is not considered a material deficiency since it was not a contributing factor to the failure of the business.
- Lender has satisfied the documentation issue regarding the inventory purchase.

**(iii) The lender did not secure loan collateral**

OIG asserts that lender did not secure the loan with the collateral indicated in the lender's credit memorandum. This collateral included used car inventory. Further, the lender made no attempt to secure the collateral once the business had defaulted. The lender's field visit revealed that the business location had been burglarized and vandalized and the lender still made no attempt to secure/protect the used car inventory remaining at the site.

**Lender Response:**

Lender states that as a matter of practice the bank does not place liens on motor vehicle inventory; that the security agreement did not include this inventory; and that the only other remaining collateral items were abandoned because the cost of recovery would exceed the value of the collateral. The lender did refer this case to the IG's office at that time.

**OFA Response:**

In this instance, the used motor vehicles were a major inventory item and the lender took a security interest in the borrower's inventory; therefore, the lender was entitled and obligated to properly perfect its interest and subsequently secure the inventory for recovery on the loan. Internal bank policy does not have precedence over SBA policy and requirements. When lender made the choice to adhere to its internal policy and did not secure/sell the remaining used car inventory, it contributed to the loss on the loan.

**(iv) The lender did not properly accrue interest**

OIG states that the lender overcharged the amount of interest due by \$1,399 since it charged interest on funds that were in an escrow account at the closing attorney's office and had not been disbursed to the borrower.

**Lender Response:**

Lender concurs with the OIG findings regarding the overcharge of interest to the borrower.

**OFA Response:**

OFA concurs with OIG findings regarding the overpayment by SBA at the time of guaranty purchase of \$1,399 (the principal amount of the loan should have been reduced by this amount).

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