



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

<b>AUDIT REPORT</b>
<b>ISSUE DATE: September 28, 2005</b>
<b>REPORT NUMBER: 5-26</b>

**To** James Rivera  
Associate Administrator for Financial Assistance

**From:** /s/ **Original**  
Robert G. Seabrooks  
Assistant Inspector General for Audit

**Subject:** Audit of a SBA Guaranteed Loan to [FOIA Ex. 6]

Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to you. Both your and the lender's response 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 days 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 Programs Group, at 202-205-[FOIA Ex. 2].

Attachment

**AUDIT OF A SBA GUARANTIED LOAN TO**

**[FOIA Ex. 6]**

**Otego, New York**

**September 28, 2005**

**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 GUARANTIED LOAN TO  
[FOIA Ex. 6]**

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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.

During an on-going audit of the guaranty purchase process at the National Guaranty Purchase Center (Center) in Herndon, Virginia, we identified a problematic loan made by the National Bank of Delaware County (lender) to [FOIA Ex. 6] (borrower) that is the subject of this audit report. The loan was part of a sample selected from a universe of 7(a) guaranteed loan purchase requests processed by the Office of Financial Assistance (OFA).

The loan was processed as a regular 7(a) guaranteed loan; therefore, SBA determined that the borrower met SBA's eligibility and credit requirements as part of loan approval. The lender, however, was required to service and liquidate the loan in accordance with SBA regulations, policies, and procedures.

The loan (number [FOIA Ex. 6]) was approved on June 19, 2001, for \$435,000. The purpose of the loan was to purchase land, buildings, and machinery and equipment for \$185,000 and inventory for \$250,000. Due to a decrease in the value of inventory purchased, the amount disbursed on June 29, 2001, was \$375,000. The remaining \$60,000 was never disbursed. The borrower defaulted on November 29, 2001, only 5 months after disbursement, thus this loan is considered an early default loan under SBA policy. On February 21, 2002, the borrower filed Chapter 11 bankruptcy which was converted to Chapter 7 on February 6, 2004. SBA purchased the guaranty for \$255,088 on July 12, 2004. According to the lender, the borrower also defaulted on the loan due to a lack of working capital, management experience, and management controls.

## **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 discussed the loan with SBA and lender officials. The audit was conducted during April and May 2005, in accordance with Government Auditing Standards.

## RESULTS OF AUDIT

### **Finding 1     The Lender did not Verify Equity Injection**

The lender disbursed the loan without ensuring that the borrower made the equity injection, as required by program regulations and the loan authorization. As a result, SBA made a \$255,088 erroneous payment when it honored the loan guaranty.

The loan authorization required the lender to obtain evidence that the borrower injected at least \$87,000 into the business prior to disbursement of the loan. The authorization permitted the borrower to use cash from personal resources or from a loan that was standby debt. Any such debt was required to be covered by a standby agreement with no payment permitted until the borrower paid the SBA loan in full. Furthermore, in accordance with SOP 50 10 4, Subpart A, Chapter 6, Paragraph 7, SBA approval was required for any modification to the terms and conditions of the loan authorization.

#### Prior Approval not Obtained for Loan Modification

According to the lender, the borrower injected only \$60,723 of the required \$87,000 into the business because the loan amount was reduced. The lender assumed the previous loan officer obtained SBA approval for a lesser injection amount. There was no evidence to support this claim in either the lender or SBA files.

#### Source of Equity Injection not Verified

The source of the \$60,723 injection was a \$50,000 unsecured personal note to the principal and a down payment of \$10,723 by the principal for the purchase of business assets. Neither amount of the equity injection was verified via documentation.

The lender claimed that \$50,000 from a personal note it made to the principal more than two months prior to SBA loan approval was injected into the business. There was no evidence, however, of a required standby agreement or evidence that the \$50,000 was injected into the business.

The lender also did not verify the source of the \$10,723 down payment shown on the sales statement for the purchase of the business assets. Based on the borrower's July 1, 2000, financial statement, the principal did not have sufficient funds available for the down payment. Thus, the lender had no assurance that the borrower was not required to repay the \$10,723 with business funds.

As a result of the above imprudent lender actions, the entire amount of the \$87,000 equity injection was not verified prior to disbursement as required by the loan authorization. SBA Policy Notice 5000-831, 7(a) Loan Guaranty Purchase Policy, provides that for early default or early problem loans where a significant cash injection is not documented by a lender, a direct link between business failure and the lack of injection should be assumed and a full denial of liability may be appropriate. An early

default is defined as a business failure that occurred prior to or within 18 months from the date of final disbursement. Since the lender could not prove that the borrower made the required equity injection and the injection was significant (20 percent of the approved loan amount), a full denial of the \$255,088 guaranty is warranted.

## **RECOMMENDATION**

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

1. Seek recovery of \$255,088, less any subsequent recoveries, from the lender on the guaranty paid for loan number [ FOIA Ex. 6 ].

## **Lender Response**

The draft report contained two deficiencies, use of proceeds and verification of equity injection for two loans made to the borrower. The lender disagreed with both deficiencies and did not believe that denial of the liability is warranted.

The lender provided additional information regarding the use of proceeds deficiency.

The lender also stated that the borrower injected more than the \$87,000 required by the loan authorization. According to the lender it had provided information to SBA that showed the borrower injected \$60,723. This amount consisted of a \$50,000 note from the lender payable to the principal and \$10,723 down payment. Additionally the lender provided a copy of an operating agreement showing that the borrower's initial capital contribution was \$29,500. Consequently, the lender concluded that the borrower injected a total of \$90,223 which exceeded the amount of the required injection.

## **Evaluation of Lender Response**

The use of proceeds issue was deleted from the report based on additional information for the use of proceeds deficiency which resolved this issue.

The lender did not provide any evidence that the borrower injected the \$50,000 proceeds from the note into the business or that the borrower actually contributed capital of \$29,500 as indicated in the operating agreement. Consequently, there is no assurance that the borrower actually made the required equity injection.

## **SBA Management Response**

SBA did not agree with the finding regarding the use of proceeds. Based on additional documentation provided by the lender SBA agreed that the proceeds were used in accordance with the loan authorization.

SBA agreed that the lender did not verify that the loan proceeds from the \$50,000 note were injected into the business account. SBA indicated that it would consider the \$29,500 capital contribution as equity injection if the lender can substantiate that it was actually paid into the company. SBA has requested, in writing, that the lender provide appropriate documentation showing the infusion of the \$29,500 into the business. If the lender cannot provide evidence that the borrower actually paid the \$50,000 and \$29,500 into the company prior to disbursing the loan, SBA agrees with the recommendation for full recovery of the guaranty, less any recoveries remitted after the guaranty was paid.

### **Evaluation of SBA Management Response**

Based on the additional information provided, we agree with SBA's position that the use of proceeds for loan number [FOIA Ex. 6] was proper. Therefore, the finding was deleted from the report.

SBA's response to request full recovery of the guaranty paid if the lender cannot substantiate that the proceeds from the \$50,000 note and the capital contribution of \$29,500 were paid to the borrower's business account is responsive to our recommendation.



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Appendix A  
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August 15, 2005

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

RE: [redacted]  
SBA Loan [redacted]

Dear Mr. Seifert:

This letter is in response to the SBA audit on the above referenced loans. The National Bank of Delaware County is not in agreement with the recommendation that it refund \$177,159 on loan [redacted] or \$255,088 on loan [redacted]. First we would like to bring to your attention to a letter dated September 12, 2002 from Patricia K. Estelle, Loan Specialist with the SBA, which was the result of their findings at the bank in 2002. The SBA Review Team reviewed all our SBA loans including the two loans in question and as you will note they found that the bank was "Substantially in Compliance" and that most of the deficiencies are relatively minor. A copy of the letter and the report is enclosed for your review. If we would have been made aware that we had issues as outlined in the letter dated July 20, 2005 we may have been able to get the answers from Mr. [redacted], who in 2002 was cooperating with the bank, and we would be able to better document the files and provide you with written documents instead of assumptions.

The conjecture that there were two separate businesses is incorrect. There is only one business, [redacted] which the loans were used to purchase the Walton and Otego locations from [redacted]. A copy of the "Incumbency Certificate" is enclosed to verify this statement.

We would like to address each loan separately as was done in the draft report. First is loan number [redacted]. The purpose of this loan was for [redacted] to purchase the real estate and the inventory from [redacted] and that is what transpired. The inventory was purchased from [redacted] on November 24, 2000 with a note granted by the bank to [redacted] for \$173,793, a copy of the check payable to [redacted] is enclosed supporting this statement. Why the inventory had to be purchased at this time is not documented in the file, but if the bank would have known that this was a concern we could have gotten an answer from Mr. [redacted] as to

FOIA Ex. 6



why the transaction took place the way that it did. We believe Mr. [ ] wanted to open his business in Walton prior to the transfer of the real estate and [ ] and the borrower were in agreement. We assume that Mr. [ ] wanted to have the sales from the holiday season and if he had to wait for the real estate closing, which happened on January 21, 2001, his Walton business would have started in one of the slowest sales months of the year. When the loan closed in January of 2001 the note for the inventory was paid and the real estate was purchased which was the reason for the SBA guaranteed loan. We do not know if the loan officer had verbal conversations with the SBA about the action that was taken, however we do not see where the action taken would have changed the outcome on this loan. Furthermore, we do not find anything in the authorization that stated that the inventory could not be purchased prior to the closing of the SBA loan. The bank has liquidated the inventory and those funds have been applied to the loans and a foreclosure sale on the Walton real estate is scheduled for August 18, 2005. If the bank did not have a first position on the inventory the bankruptcy court would not allowed us to liquidate the inventory and keep the funds for the loans. Therefore, based on the above information the bank believes it complied materially with the loan authorization on this loan and disagrees with returning the \$177,159.

On loan [ ] the SBA authorized the National Bank of Delaware County to grant a \$435,000 loan to [ ] and would provide a SBA guaranty of 75%, however the bank only granted a loan of \$375,000, and on July 3, 2001 and a letter was sent to the SBA by [ ], the originating loan officer, advising the SBA of the change. A copy of the July 3, 2001 letter is enclosed.

The purpose of the loan was to purchase land, buildings, machinery and equipment and inventory and that is what the funds were used for. A requirement of the \$435,000 authorization was that Mr. [ ] injected a sum of \$87,000 or 20% of the loan amount. The bank has provided the SBA information that shows \$60,723 was injected into the business by Mr. [ ] or 16% of the \$375,000. \$50,000 was in the form of an unsecured personal note granted to Mr. [ ] by the National Bank of Delaware County. It needs to be noted that Mr. [ ] defaulted on the \$50,000 note and the bank has a judgment against Mr. [ ] In reviewing the files at our attorney's office we found a copy of the "Single-Member Limited Liability Company Operating Agreement for [ ] that shows a capital contribution by Mr. [ ] of \$29,500. A copy of this agreement is enclosed for your review. Based on this new information there was a capital contribution of \$90,223 greater than the \$87,000 requirement, or 24% of the amount borrowed. The National Bank of Delaware County is willing to sign a stand-by agreement and any proceeds collected on its note will be applied to this SBA loan. It is unfortunate that the original loan officer did not document the files as to what was done at the time of this loan being granted. As stated before if present management would have been made aware that this was an issue by the findings

[ ] of the SBA in 2002 we may have been able to document the files from our meetings with Mr. [ ] and would have obtained more information as to where he got the \$10,723 from and would have had him sign a statement about the reason for the \$50,000 personal note. We do not agree with your findings that Mr. [ ] did not inject the \$87,000, when in reality it is our belief that Mr. [ ] injected more than the \$87,000.

The loan officer of our bank when these loans were granted is no longer employed at the bank. We agree that he did a poor job in documenting his actions and it makes it difficult to get you documented information. We can only provide you with the information we have. We have no idea if there were verbal conversations or other written documents sent to the SBA for any of the actions taken when these loans were granted. The present management depended on the audit of the SBA Lender Review Team findings in 2002 that stated there were no major issues in our SBA guaranteed loan portfolio. We believe that both of these loans failed because of the lack management controls, inexperience management, and the additional debt the borrower took on after these loans were closed.

We believe that we have supported our position as to why we do not agree with the findings that states the National Bank of Delaware County should refund the \$177,159 on loan number [ ] or the \$255,088 on loan number [ ] We are sorry that the information about the \$29,500 capital injection was not brought to your attention earlier, however this new information does support that the total capital injection was made. Please contact me should you have questions or if you need additional information and thank you for your attention in this matter.

Sincerely,

Richard A. Bryden  
Vice President

File



U.S. SMALL BUSINESS ADMINISTRATION  
WASHINGTON, DC 20416

Appendix B  
Page 1 of 2

DATE: September 20, 2005  
TO: Garry L. Duncan, Director, Credit Programs Group  
FROM: Walter C. Intlekofer, Director, Portfolio Management Division, OFA [ ]  
SUBJECT: Response to Draft Audit of [ ]

This is further response to your Draft Audit dated July 20, 2005 on the above loan, recommending recovery of the guaranty payment of \$255,088, less any subsequent recoveries on the loan. This response is based on the additional information your office provided with respect to this early default loan.

The basis for the OIG recommendation is that the loan authorization required the lender to verify that the borrower had injected \$87,000 into the business prior to loan disbursement, in the form of cash or standby debt. The lender provided a \$50,000 loan to the principal of the business for the injection but failed to execute a standby agreement. The closing statement also reflects \$10,723 contributed by the principal but the OIG questions the source of this contribution.

**Lender Response to Audit** – The lender provided a copy of a note reflecting that a loan in the amount of \$50,000 was made to the principal of the business. Approximately \$450 was paid on the principal of this loan at the time of loan default, and the lender has indicated a willingness to execute a standby agreement and to apply any proceeds collected on this note in the future to the SBA loan (the bank has obtained a judgment against Mr. [ ] on the defaulted loan). The closing statement reflecting \$10,723 received from the borrower was submitted as verification of equity injection, as well as the Limited Liability Company Operating Agreement indicating that the initial capital contribution by the sole member (Mr. [ ]) was \$29,500. This agreement is dated March 10, 2000.

**OFA Response** – The lender asserts that it did lend the principal the \$50,000 to inject into the business, and the fact that there was no standby agreement was a deficiency; however, SBA was not materially harmed by the deficiency in view of the fact that only \$450 principal was paid on the loan. However, and more importantly, the lender did not verify that the \$50,000 loan proceeds were injected into the business account for [ ]

The \$29,500 can be considered as part of the equity contribution to the LLC if the lender can substantiate that the \$29,500 was actually paid into the company. In this regard, we have written the lender and requested appropriate documentation, but have not yet received a response.

FOIA Ex. 6

**Summary** – We understand that the lender has indicated that it cannot verify that the proceeds from the \$50,000 loan were actually paid into the borrower's business account. Further, we do not yet have any verification from the lender that the \$29,500 equity contribution to the LLC was ever made. We do note that SBA did not issue comprehensive guidance to lenders regarding verification of equity injections until 2002, over a year after this loan was closed. However, prudent lending practice would have dictated that the lender verify that both the \$50,000 and \$29,500 were actually paid into the LLC prior to disbursing the loan. Consequently, if the lender cannot do so, we agree with the recommendation in the draft audit that full recovery of the guaranty purchase disbursement, less any subsequent recoveries remitted to SBA, is appropriate.

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