AUDIT OF AN SBA GUARANTEED LOAN TO

[Exemption 6]

DBA L & L LEGAL ASSISTANCE

San Francisco, California

Audit Report Number: 7-09

January 9, 2007

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

AUDIT REPORT
Issue Date: January 9, 2007
Report Number: 7-09

To: Janet A. Tasker
Acting Associate Administrator for Financial Assistance

/S/ original signed
From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Audit of an SBA Guaranteed Loan to [Exemption 6]
dba L & L Legal Assistance

The purpose of this memorandum is to notify you of a $141,689 improper payment that should be recovered. During our audit of the guarantee purchase process at the National Guaranty Purchase Center, we identified a problematic loan [Exemption 2] made by Heller First Capital Corporation to [Exemption 6] dba L & L Legal Assistance (borrower). We reviewed the loan to determine if it was originated, serviced and liquidated in accordance with Small Business Administration (SBA) rules and regulations. The audit was conducted during June 2006 in Herndon, Virginia, in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

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. If a lender fails to comply materially with SBA regulations, the loan agreement, or does not make, close, service, or liquidate a loan in a prudent manner, SBA has exclusive discretion to release itself from liability, in whole, or in part, on the loan guarantee.

Heller First Capital Corporation was authorized by SBA to make guaranteed loans under the Preferred Lender Program (PLP). As a PLP lender, Heller was authorized to process, close, service and liquidate SBA loans with limited documentation and review by SBA. On October 25, 2001, GE Capital Small Business Finance Corporation acquired Heller. GE Capital became responsible for all decisions regarding SBA loans made by Heller. GE Capital was unable to locate its loan file for the subject loan and therefore, our audit scope was limited to a review of only the documentation in the SBA loan file.

On November 11, 1999, using PLP procedures, the lender approved a $200,000 loan to the borrower for the purchase of an existing business and working capital. The lender made four loan disbursements between December 13, 1999, and February 18, 2000, and the borrower defaulted on April 1, 2001, less than 14 months after the last disbursement. Thus, the loan is considered an early default loan under SBA policy. The borrower filed Chapter 7 bankruptcy on January 2, 2002. The National Guaranty Purchase Center completed its purchase review in October 2004, and accepted a $4,500 repair due to the lender's over disbursement of the loan. Although the National Guaranty Purchase Center originally recommended an additional $67,000 repair for the lender's failure to verify a portion of the required equity injection, it eventually acquiesced on this issue and purchased the guarantee on December 22, 2004, for $141,689.

The Lender Did Not Verify Borrower Equity Injection

The lender did not verify that the borrower injected $66,150 or 57 percent of the required equity injection into the business. The loan authorization required the lender to obtain evidence that the borrower injected at least $117,000 in cash into the business prior to the first loan disbursement. Policy Notice 5000-831, *7(a) Loan Guaranty Purchase Policy,* states that verifying equity injection requires documentation, such as a copy of a check along with evidence that the check was processed (e.g., a business bank account statement dated prior to the first loan disbursement). According to the lender, the borrower injected $149,919 into the business: $50,850 for the acquisition of the business per the settlement statement and $99,069 in working capital per bank statements. There was adequate support documenting that $50,850 was injected for the acquisition of the business, however, the additional $99,069 injection of working capital was not supported. While SBA's loan file contained a personal investment statement for the borrower showing $99,069 in investments, there was no evidence that any of these funds were deposited into the business bank account. As a result, only $50,850 of the required equity injection was supported, leaving a balance of $66,150 that could not be verified.

The borrower closed the business less than 14 months after the last loan disbursement, due to a lack of cash flow, demonstrating the importance of the equity injection. Policy Notice 5000-831 states that if there is an early default loan and a significant cash injection is not properly documented, a direct link between business failure and the lack of equity injection should be assumed, and a full denial of liability may be appropriate.

The Lender's Repayment Ability Calculation is Questionable

The lender's cash flow analysis was unsupported and contained unexplained anomalies. As a result, the borrower's loan repayment ability was questionable.

Standard Operating Procedure (SOP) 50 10(4) provides that the most important consideration in the loan making process is the ability to repay a loan from the cash flow of the business. The SOP also states that the best evidence of repayment ability is sufficient cash flow from prior operations. If historical cash flow does not indicate repayment ability, a realistic projection must be used.

Historical cash flow for 2 of the 3 years prior to the sale of the business showed insufficient cash available to service the borrower's debt. Furthermore, the net income reported for the first 7 months of the year of sale did not align with the net income amounts reported for the prior 3 years. The annualized net income figure for the year of sale was 69 percent higher than the highest amount of net income reported during the 3 previous years, and there was no explanation for the increase. As this was an early default loan, the lender was required to submit supporting financial information to SBA with its purchase package. While the lender submitted IRS transcripts to support the net income reported in the prior 3 years, it did not provide financial statements to support the cash flow adjustments made each year or the interim figures reported for the year of sale. As the lender did not provide this required information and has since misplaced its loan file, we were unable to determine the accuracy of the lender's credit analysis depicted below.

Lender's Cash Flow Analysis
Historical Data Adjusted for SBA Loan
(Dollars in Thousands)

Description	Year Ended				Auditor 12/31/99 Annualized
	12/31/96	12/31/97	12/31/98	Interim 7/31/99	
Net Income	$30	$146	($1)	$144	$247
Balance sheet Withdrawn/Distribution	($30)	($73)	($29)	$0	$0
Depreciation	$4	$7	$10	$3	$5
Interest	$2	$13	$1	$2	$3
Other	$59	$263	$34	$3	$5
Draw Required	($58)	($58)	($58)	$34	($58)
Cash Available for Debt Service	**$7**	**$298**	**($43)**	**$186**	**$202**
Debt Service	$33	$33	$33	$33	$33
Cash Available after Debt Service	**($26)**	**$265**	**($10)**	**$153**	**$169**

Because the lender's cash flow analysis showed that the business generated insufficient cash for 2 of the 3 prior years to service the borrower's debt and the significantly higher net income in 1999 was not supported, the borrower did not adequately demonstrate repayment ability at the time his loan was made.

The Lender Did Not Inventory and Assess the Collateral

The lender did not inventory and assess the collateral in accordance with SBA policy. SOP 50 10(4) required the lender to accurately calculate and justify the real value of the collateral at loan origination. A listing attached to the Commercial Security Agreement executed at loan origination showed that the collateral for the loan consisted of five copiers, eight desks, nine computers with unix network capabilities, two computers and printers, three facsimile machines, proserve software, nine cameras, and miscellaneous office equipment and supplies. The only items that had values assigned, however, were the proserve software which had a fair market value of $30,000 and the office supplies which were valued at $3,000. The credit memorandum indicated that the collateral had a fair market value of $34,000, but it did not identify any individual items or show the basis for the assigned collateral value. As a result, there is no assurance the value assigned to the collateral at origination was appropriate and, since values were assigned to only two of the items listed on the attachment to the Commercial Security Agreement, it appears the collateral was undervalued.

In April 2001, the principal informed the lender that he could no longer afford to lease the space where the business operated and did not need the existing business assets, as he planned to operate the business without the assets from his home. He offered to assist in the liquidation of the assets.

The lender performed a site visit on May 3, 2001. While the lender noted that the copiers were missing during the site visit, it did not inventory the collateral or assess its condition. SOP 50 51 2 states that when a site visit is made, the lender must prepare a comprehensive and detailed report containing an inventory of assets and an assessment of their condition. Without an inventory, there is no way to determine what other collateral was missing or the condition of the remaining collateral. The remaining collateral was appraised by an independent appraiser, however, and assigned a liquidation value of $900 to $1,200. A schedule attached to the appraisal described the collateral as "all business collateral including: furniture, fixtures, shelving, computer software/hardware." There was no mention of the copiers, fax machines or cameras, and pictures taken by the appraiser did not show these items. Based on the estimated $1,000 to $1,200 removal cost versus the appraised value of the remaining collateral, the lender abandoned it. There was no evidence the lender attempted to locate the copiers or any other missing collateral. As a result, the loss to SBA on this loan increased.

Due to the materiality of the lender's deficiencies in verifying the borrower's equity injection and in inventorying and assessing the collateral for this early default loan, a full recovery of the $141,689 paid to purchase the guarantee is warranted.

Recommendation

We recommend that the Acting Associate Administrator for Financial Assistance:

1. Seek recovery of $141,689, less any subsequent recoveries, from GE Capital on the guarantee paid.

Lender Comments

The lender did not provide a written response to the draft report, however, it sent a check to SBA for the full recommended recovery amount in settlement of the guarantee.

Agency Comments

SBA Management agreed with the findings and recommendation.

Office of Inspector General Response

The lender's repayment of the guarantee and SBA Management's comments were sufficient to address the findings and recommendation.

Appendix I

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