

**AUDIT OF AN SBA GUARANTEED LOAN TO
IROM CNC MACHINING, INC. AND IROM
IMAGING, INC.**

Report Number: 7-17

March 12, 2007



Memorandum

U.S. Small Business Administration
Office of Inspector General

To: Janet A. Tasker
Acting Associate Administrator for Financial Assistance
/S/ original signed
March 12, 2007

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Audit of an SBA Guaranteed Loan to IROM CNC Machining, Inc. and IROM Imaging, Inc.
Report No. 7-17

The purpose of this memorandum is to notify you of a \$77,683 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 Corp. (lender) to IROM CNC Machining, Inc. and IROM Imaging, Inc. (borrowers). We reviewed the loan to determine if it was originated, serviced and liquidated in accordance with Small Business Administration (SBA) rules and regulations and interviewed lender and SBA officials as necessary. The audit was conducted during July 2006, in Chicago, Illinois, in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

BACKGROUND

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 Corp. was authorized by SBA to make guaranteed loans under the Preferred Lender Program (PLP). As a PLP lender, Heller First Capital Corp. was permitted to process, close, service and liquidate SBA loans with limited documentation and review by SBA. In October 2001, GE Capital Small Business Finance Corp. acquired Heller. GE Capital became responsible for all decisions regarding SBA loans made by Heller.

On July 12, 2000, using PLP procedures, the lender approved a \$750,000 loan to the borrowers to refinance \$500,000 of existing debt and provide \$220,000 for working capital and \$30,000 for closing costs.

The loan was closed and fully disbursed on August 17, 2000. The borrowers defaulted on June 1, 2001. Thus, this loan is considered an early default loan in accordance with SBA policy. The borrowers, however, continued to make sporadic payments after the default and the last payment was made on March 4, 2004. On May 4, 2004, GE Capital Small Business Finance Corp. requested that SBA purchase the guarantee from the secondary market. On May 21, 2004, SBA purchased the guarantee for \$325,180. After purchase, proceeds from the sale of collateral reduced the loan balance to \$103,577. SBA's guarantee share is \$77,683.

The National Guaranty Purchase Center completed the post purchase review on May 17, 2005. Although the center's legal counsel concluded that SBA was legally obligated to honor the guarantee, the conclusion was subject to facts not yet disclosed or liquidation actions not yet completed, either of which could provide the basis for a full or partial recovery from the lender. Legal counsel cited missing documentation related to the sale of collateral, bankruptcy filings and discharges, and questioned the application of the last loan payment. The guarantee, however, was never repaired or denied.

RESULTS IN BRIEF

We found that the lender did not originate and service the loan in accordance with SBA's policies. IROM CNC Machining, Inc. did not pay its payroll taxes timely, which should have been considered a character issue during loan origination. Furthermore, the lender did not identify that there were two 50-percent shareholders of IROM CNC Machining, Inc., and as a result, did not obtain the guarantee of or a *Statement of Personal History* from the second shareholder as required. The lender also inappropriately disbursed \$7,500 for a broker fee charged to the borrower. Lastly, the lender calculated the default date incorrectly

and accrued \$111,237 of excess interest. Due to the materiality of the deficiencies identified on this loan, we recommended recovery of the \$77,683 guarantee paid.

THE LENDER DID NOT ORIGINATE AND SERVICE THE LOAN IN ACCORDANCE WITH SBA'S POLICIES

Questionable Character of Borrower

Although the principal certified that all taxes were current, the historical and interim financial statements showed that IROM CNC Machining, Inc. was not paying its payroll taxes timely and was not questioned about this by the lender. According to 13 CFR 120.150, an applicant must be creditworthy as demonstrated by the character, reputation, and credit history of the applicant. As explained in Standard Operating Procedure (SOP) 50 10 4, consideration of character includes whether the principals have historically shown the willingness and ability to pay their debts. It specifically states that the willful failure of principals to pay income taxes is a character issue for consideration.

As of July 31, 1999, IROM CNC Machining, Inc.'s financial statements showed a payroll tax expense of \$24,621 with payroll taxes payable of \$28,857 on \$344,565 in wages and salaries. As of March 31, 2000, payroll taxes payable had increased to \$90,064, while wages and salaries for the same period decreased to \$174,492. The inverse relationship between payroll taxes payable and the amount of wages and salaries indicated that IROM CNC Machining, Inc. was not paying its payroll taxes as they became due. This should have been considered a character issue, especially since at least 50 percent of payroll taxes payable represented money withheld from employees.

Interestingly, less than one year after the loan was made, the IRS filed a \$68,792 lien against IROM CNC Machining, Inc. for non-payment of payroll taxes between July 2000 and March 2001 and filed another \$29,031 lien in November 2003. These are strong indications that the borrowers did not have adequate working capital to pay their operating expenses as well as the required loan payments. If this deficiency had been identified by the lender, the borrowers may have been deemed ineligible for the SBA loan.

Loan Not Properly Guaranteed

SOP 50 10 4 also requires that those holding at least a 20-percent ownership interest in the applicant business, personally guarantee the loan and provide a SBA Form 912, *Statement of Personal History*. The lender's PLP Checklist and the principal's Form 912 reported that the principal owned 100 percent of IROM CNC Machining, Inc. and IROM Imaging, Inc. The principal was the only guarantor on

the loan and the only one to complete a Form 912. Federal tax returns for IROM CNC Machining, Inc. covering the 3-year period preceding the loan (July 31, 1996 through July 31, 1999), however, showed there were actually two shareholders, each with a 50-percent ownership interest. As a result, the lender should have required the other shareholder to guarantee the loan and provide a Form 912. The additional guarantor may have made additional loan payments or provided additional liquidation proceeds, which could have reduced the loss on this loan to SBA. Also, there was no assurance that borrowers would have qualified for an SBA guaranteed loan because of character issues that may have been identified on the Form 912 for the additional owner.

Lender Made an Improper Loan Disbursement

The borrower was inappropriately charged a \$7,500 broker fee that was paid with loan proceeds. On August 17, 2000, the lender disbursed \$7,500, or one percent of the loan amount, to Associated Enterprises, Ltd. and IROM CNC Machining, Inc. under a joint payee check. The lender's internal closing statement and an attachment to the SBA Form 1050, *Settlement Sheet*, identified the disbursement as a broker fee.

SOP 50 10 4 prohibits lenders or their associates from charging an applicant any commitment, bonus, broker, commission, referral or similar fee. This deficiency was not detected during the post purchase review and as a result, SBA made a \$7,500 improper payment when it honored the guarantee.

Over Accrual of Interest

The lender incorrectly applied to interest a portion of loan payments that were received after the loan should have been transferred to liquidation status. SBA did not identify this deficiency during the guarantee purchase process and as a result, the lender received \$111,237 of excess interest.

SOP 50 51 2 states that a PLP lender should place a loan in liquidation status when a loan payment is 60 days or more past due. A loan can be returned to servicing when at least three monthly payments have been made as agreed. All proceeds received while a loan is in liquidation status must be applied to the principal balance of the loan.

Further, the lender calculated, and SBA accepted, an incorrect loan default date of March 1, 2004. According to 13 CFR 120.523, the "earliest uncured payment default" is the date of the earliest failure by a borrower to pay a regular installment of principal and/or interest when due. Payments made by the borrower before a lender requests SBA to purchase the guarantee are applied to the earliest uncured payment default. If the installment is paid in full, the earliest uncured payment

default date will advance to the next unpaid installment date. We determined that the earliest uncured payment default date was June 1, 2001, based on the lenders transcript and other information included in the loan files. As a result, the lender should have transferred the loan to liquidation status on August 1, 2001. Additionally, since the borrower did not make three monthly payments as agreed after the date of default, all loan payments received after August 1, 2001, should have been applied to principal. Due to the lender's improper determination of the date of default, the lender continued to apply a portion of the loan payments received after August 1, 2001, to interest and the principal balance of the loan was overstated by \$111,237 at the time of purchase.

RECOMMENDATION

Due to the materiality of the deficiencies identified on this loan, we recommend that the Acting Associate Administrator for Financial Assistance:

1. Seek recovery of \$77,683 from GE Capital Small Business Finance Corp. on the guarantee paid by SBA.

LENDER COMMENTS

GE Capital agreed that the borrower's character was questionable and that the loan was not properly guaranteed. As a result, GE conceded to pay the recommended recovery amount. GE disagreed, however, that loan payments were inappropriately applied to interest and that the loan default date was miscalculated. GE stated that the borrower made an additional 23 payments after June 1, 2001, and does not believe SBA would expect a lender to liquidate collateral when a borrower could make an additional 23 payments. Nor do they believe the payments should have been viewed as liquidation proceeds and applied to principal. GE maintained that the correct default date was March 1, 2004.

GE also disagreed that the intellectual property rights collateral was inappropriately released. GE stated that the intellectual property rights were not considered collateral at origination and that the value of other collateral items was sufficient to cover the loan amount. As a result, GE does not believe it was required to seek SBA approval to release the intellectual property rights. GE's comments are included as Appendix I.

AGENCY COMMENTS

SBA concurred with the recommendation to seek recovery of \$77,683 from GE Capital, but questioned our finding regarding the borrower's application of payments to interest after default. SBA stated that this issue has been the subject

of much correspondence from the National Association of Government Guaranteed Lenders and participant lenders in view of the language in SBA's note, which specifies that borrower payments are to be applied to interest first and then principal. SBA stated that there is no distinction made with respect to payments made after default. In view of the lender's agreement to repay the guarantee, SBA stated this was a moot issue. SBA also set a target date of April 9, 2007 for recovering the guarantee paid to the lender.

OFFICE OF INSPECTOR GENERAL RESPONSE

GE's agreement to repay and SBA's agreement to seek recovery of \$77,683 is responsive to our recommendation. Based on GE's response, we removed the section regarding the inappropriate release of collateral from our final report. We did not, however, remove the section regarding GE's over accrual of interest. Although the borrower made an additional 23 payments after June 1, 2001, the payment amounts were not sufficient to "cure," or pay the June 1, 2001 installment in full. As a result, we continue to support our position that the earliest uncured payment default date was June 1, 2001.

We also continue to support our position that the loan should have been transferred to liquidation status on August 1, 2001 and loan payments received after this date should have been applied to principal. We acknowledge, however, that this is a grey area and that SBA's policies and procedures do not clearly specify how borrower payments received after default should be applied. Consequently, this issue will be the subject of a future audit.

We appreciate the courtesies and cooperation of Office of Financial Assistance representatives during this audit. If you have any questions concerning this report, please call me at (202) 205-[Exemption 2] or Robert Hultberg, Director, Credit Programs Group at (202) 205-[Exemption 2].

APPENDIX I. LENDER COMMENTS

February 15, 2007

Ms. Terry Settle
SBA Office of inspector General
1145 Herndon Parkway
Suite 900
Herndon, VA 20170

RE: **SBA Guaranteed Loan to Iron CNC Machining**
[Exemption 2]

Dear Ms. Settle:

GE Capital Small Business Finance Corporation acknowledges receipt of your memorandum dated December 19, 2006, wherein you recommend return of the SBA guaranty in the amount of \$77,683 from the above SBA loan originated by Heller Small Business Finance Corporation. Please note GE's following responses:

The Lender did not originate and service the loan in accordance with SBA's policies:

- Questionable character of the borrower: GE does not dispute the OIG's observations concerning the borrower's financial statements and resulting IRS tax lien for non-payment of payroll taxes.
- Loan not properly guaranteed: GE does not dispute the OIG's observations regarding the additional 50% shareholder in the business based on the federal tax return.

The Lender made an improper loan disbursement:

- Over accrual of interest: GE disagrees with the OIG's inconsistent observations regarding the default date and application of payments on this loan. Although it is true that SBA policy recommends that a loan be placed in liquidation after loan payments are 60 days past due, continued payment by the borrower, as noted by you, can alter the actual default date. Chronic delinquency does not necessarily imply default. GE was able to continue collection from the borrower after June 1, 2001 – thereby recovering an additional 23 payments before declaring default. We can hardly believe that SBA expects lenders to liquidate collateral when a borrower can continue to pay an additional 23 payments! Nor do we believe that these payments should be viewed as "liquidation proceeds" and applied to principal. We maintain that the correct date of default is March 1, 2004 – the last unpaid installment and the date at which it was determined that no further payments were likely – with our only recourse liquidation of the collateral. We do not agree that an adjustment is required in the application of the payments received prior to March 1, 2004.

Ms. Terry Settle; re: Irom Maching
February 9, 2007
Page 2

- Inappropriate release of collateral: Prior to releasing its interest in the intellectual property rights for \$150,000 in January, 2003, GE reviewed the collateral valuation per Heller's original credit write-up. It was noted that the intellectual property was not valued by Heller at loan inception. In addition, it was not specifically listed as collateral on any of the loan documents, including the SBA Loan Authorization. The collateral actually detailed and valued included the commercial real estate, residential real estate, equipment, machinery and inventory. Based on the values of these items, the collateral ratio was sufficient to cover the loan principal balance at that time we released the intellectual property. The borrower's initial request for release of the intellectual property was actually for \$50,000; however, GE required payment of \$150,000. Upon release of the intellectual property, the ratio for the remaining collateral increased from 112% to 146%. Inasmuch as there was no value placed on the intellectual property at origination, we did not see the release as being 47% of the total collateral value and accordingly, did not see a need to request SBA approval.

Conclusion: GE acknowledges that some of the financial information provided at loan origination may have served as a red flag to the character of the borrower and possible likely repayment on the loan. We disagree; however, that payment was improperly applied or that collateral inappropriately released. Nevertheless, we will concede to pay the requested \$77,683.

Sincerely,

GE Capital Small Business Finance Corporation
A Delaware Corporation

David V. Sierminski, Its Manager of Collections and Liquidations
314/205-[**Exemption 2**]

cc: Janet A. Tasker, Acting Associate Administrator for Financial
Assistance
Karen Rossetti, Chicago SBA
Walter Intelkofer, Washington D.C. SBA

APPENDIX II. AUDIT REPORT DISTRIBUTION

<u>Recipient</u>	<u>No. of Copies</u>
Associate Administrator for Capital Access.....	1
General Counsel.....	3
Deputy General Counsel.....	1
Office of the Chief Financial Officer Attention: Jeff Brown	1