



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

MEMORANDUM AUDIT REPORT

Issue Date: July 31, 1998

Number: 8-F-6-008-023

To: Jane P. Butler, Acting Associate
Administrator for Financial Assistance

Peter L. McClintock

From: Peter L. McClintock, Assistant Inspector General
for Auditing

Subject: Memorandum Audit Report - Defaulted
Loan made by Arkansas Capital Corporation

We reviewed an SBA guaranteed loan (Number 82321230) made by Arkansas Capital Corporation (lender) to Frugé Marine Enterprises, Inc. (borrower). The loan was selected for review because it defaulted within 12 months of origination. This report presents the audit results and recommends needed actions by your office.

BACKGROUND

Arkansas Capital Corporation is a privately-owned, non-profit corporation created by an Act of the Arkansas State Legislature to assist in the development and financing of small businesses within the State. The Act authorized this lender to borrow funds from the State Treasury to make loans to small businesses. Regular SBA lender status was received in 1990 and preferred lender status was granted in 1995. This loan was processed under Certified Lender Program procedures by Arkansas Capital Corporation and approved by SBA.

The SBA guaranteed loan was closed on September 1, 1995. The lender disbursed funds to the borrower on September 1 and 8, 1995. Loan proceeds were to be used to purchase a failed boat manufacturing business. The funds were to be used as follows:

- \$243,000 for equipment and inventory,
- \$200,000 to refinance bank notes, and
- \$57,000 for working capital.

The loan was placed in liquidation status two months after the proceeds were disbursed to Frugé, with SBA paying about \$420,000 to purchase the guarantee. Although the estimated value of the collateral securing the loan was \$700,000, SBA recovered less than \$30,000.

AUDIT OBJECTIVES AND SCOPE

The audit objective was to determine if the lender processed the loan in accordance with applicable SBA requirements.

The loan was selected for audit from a universe of loans approved during the period October 1993 to September 1995 that were greater than \$100,000 and defaulted within 12 months of origination. We examined documents in the district office and lender loan files and interviewed selected personnel. We also talked to a former loan officer for the lender and to a vendor with whom the borrower did business. Audit field work was accomplished between October 1996 and June 1997. The audit was conducted in accordance with Government Auditing Standards.

RESULTS OF REVIEW

FINDING Lender actions contributed to the default of a \$500,000 SBA loan

The lender did not process the Frugé loan in accordance with SBA requirements. The loan should not have been disbursed because of adverse information about the borrower which was known to the lender but not provided to SBA.

Adverse Borrower Information

The lender's analysis of information available during the processing of the Frugé loan should have precluded its disbursement. The following table presents a chronology of events for the loan.

DATE	EVENT
March 30, 1995	Loan application submitted to SBA with 1994 financial statements showing a loss of \$71,375.
April 5, 1995	Loan approved under CLP procedures by SBA. SBA letter sent to lender reinforcing tax return verification requirement and requiring the lender to notify SBA of any significant discrepancies between IRS data and the financial statements.
June 2, 1995	Lender requested verification of 1994 tax return from the Internal Revenue Service (IRS).
June 15, 1995	IRS responded "no record of 1994 tax return."
July or August 1995	Borrower provided copy of tax return for 1994 to lender showing loss of \$501,701.
August 31, 1995	Lender submitted second verification request to IRS. Request stated borrower provided copy of 1994 tax return indicated it was completed on July 7, 1995.
September 1, 1995	Loan was closed and initial disbursement was made.
September 8, 1995	Second and final disbursement was made.
September 11, 1995	Lender received IRS transcript of 1994 tax return confirming a loss of \$501,701, which agreed with the loss per borrower provided copy.

The loan defaulted and SBA subsequently purchased the guarantee for \$420,000.

Lender negligence in the loan approval process

The lender disbursed the loan before getting a tax return verification from IRS or comparing the borrower provided copy of the 1994 tax return to the financial statements. Therefore, the lender did not identify and provide SBA an explanation regarding the difference in the amount of loss per the financial statement and the tax return. Further, the lender (i) did not require the borrower to pay the guarantee fee within 90 days of loan approval, (ii) made a material misrepresentation (overstated value of the collateral), and (iii) failed to perform a proper credit analysis. The omissions by the lender were material to the guarantee decision and, according to the loan authorization and Title 13 CFR 120.524, should have been brought to SBA's attention.

- **IRS tax verification** There was no indication that the lender either compared the income tax return information with the business' financial statements or notified SBA of the discrepancy. The loan authorization document required the lender to obtain a tax verification from the IRS before disbursing the loan. This requirement was reinforced by SBA in a letter to the lender dated April 5, 1995, stating that the tax return for the borrower must be verified before disbursement. The lender did not comply with or request a waiver of this requirement.

The lender requested IRS verification of the 1994 tax return in June 1995. IRS responded that it had "no record of return for 1994." Another verification request was submitted to IRS on August 31, 1995. In the second request, the lender stated that "Our borrower has provided a copy of the 1994 return which indicates it was completed on July 7, 1995." On September 11, 1995, IRS provided a transcript of the 1994 tax return which confirmed the information on the copy of the borrower provided tax return. The IRS reply to the lender stated the verification was in response to "your inquiry of 8/31/95".

The 1994 IRS tax return verification, which was received by the lender three days after the final disbursement, showed a loss that was more than six times greater than the loss shown on the 1994 financial statements. According to SBA procedures, the lender should not disburse any funds until the tax verification has been received, reviewed, and any significant difference in profit or loss between the financial statements and the tax return explained.

- **Comparison of the borrower's financial statements and tax return** Even before the lender received IRS verification, it should have known there was a substantial discrepancy between the financial statement loss (\$71,375) and the tax return loss (\$501,701). While the exact date the borrower submitted the 1994 tax return to the lender is not known, the documentation does show that the lender had the tax return prior to the loan closing and the first loan disbursement made on September 1, 1995. Even a superficial comparison of the net loss reported on the financial statement with the tax return would have raised a red flag. A more thorough comparison of the assets and sales data on the two documents would have raised more red flags. The lender clearly should have realized there was a material discrepancy that required notification to and discussion with the SBA.
- **Guarantee fee payment** The lender did not require the borrower to pay the guarantee fee in accordance with the terms of the loan authorization agreement or request a waiver. The loan was approved April 5, 1995, with disbursements made on September 1 and 8, 1995. Although the guarantee fee was required to be paid within 90 days of the date of loan

approval, it was not received by SBA until September 12, 11 days after loan closing. The borrower paid the guarantee fee, which was submitted to the lender at closing, with an insufficient funds check. On September 26, the Progressive National Bank sent a hand written letter citing an enclosed cashier's check as a replacement for the insufficient funds check and requesting that the copy of the "bounced" check be returned for the bank's files.

Progressive National Bank was the borrower's business bank in Louisiana and received over \$85,000 for debt repayment when the first disbursement of loan proceeds was made September 1. Payment of the guarantee fee with a "bad" check was an indication the borrower was having financial troubles and that the borrower's character was questionable. If the lender had complied with the terms of the loan agreement and required payment of the guarantee fee before loan closing, indications of borrower financial problems may have been identified.

- **Value assigned to personal property collateral** The lender indicated in its SBA Form 4-I, Lender's Application for Guaranty or Participation, that personal property assets pledged as collateral had a market value of about \$1.5 million and a liquidation value of approximately \$700,000. This collateral was to be purchased from Tidecraft Company, which was a defunct boat builder. Since the collateral was to be purchased from a defunct business, the value of the collateral should have been established by an independent third party. The loan file contained three appraisal letters showing the value of the property. None of the letters, however, provided details of the appraiser's qualifications or provided a basis for the valuation.

Prior to approving the loan, the lender substituted collateral with equipment to be purchased from a different boat builder, Spirit Boats USA. When the value of this collateral was shown on the amendment to the SBA Form 4-I at less than the initial collateral, the lender obtained an estimate of the substituted collateral's value. The collateral, which was valued at \$600,000, was purchased for \$130,000 or about 20 percent of the appraised value. The appraisal of the collateral purchased was not made by an independent party and may not have been objective. The value was provided by one of the borrower's vendors who received approximately \$13,000 from the SBA loan disbursement. The purchase price, not the value provided by one of the borrower's vendors, was probably a better indication of the actual value of the collateral.

When the borrower filed for bankruptcy, the lender submitted a proof of claim for personal property collateral in the amount of \$100,000. The lender's attorney, in a letter to the lender regarding bankruptcy actions taken, stated that a proof of claim for \$100,000 was filed even though the lender had advised him that the collateral was not worth more than \$75,000. After the lender submitted its proof of claim, the borrower's premises were burglarized. One of the lender's employees estimated that about two-thirds of the personal property collateral disappeared. The remaining collateral was sold for about \$29,000.

- **Value assigned to real property collateral** The loan also had real estate collateral. This collateral was added to the loan when the borrower requested a modification to pay off a bank note (\$85,400) for which the lender was to receive a second lien position on real estate. The modification request listed a property mortgage of \$320,000, with an appraised value of \$659,400. The value of real estate can be established by three valuation methods—cost, income, and comparable sales. A complete appraisal would include all three methods. A limited appraisal would include only one method, which is normally comparable sales

unless another method is justified.

The method used to value the real estate collateral was based on the income approach, which relied on borrower submitted income and expense statements. The desirable method of real estate valuation would have been the comparable sales approach because the business had been in operation less than a year and the information used in the income approach was based on borrower provided financial information. An appraisal based on borrower financial information was suspect considering the borrower prepared financial statements provided to the lender showed a loss of about \$71,000 and the tax return for the same year showed a loss of over \$500,000. The tax return and appraisal were dated July 7 and 27, 1995, respectively. Although we do not know the exact dates the lender received the documents, the tax return was actually received, and the appraisal should have been received, before the loan was disbursed.

Lending officials stated that the property was probably worth about \$320,000. The opportunity for recovering an amount above the first lien (\$320,000) was unlikely since the property had been on the market for about five years. SBA officials stated that both they and the lender decided not to buy the first lien on the property due to the fact it had been on the market for a long time and there was a possibility of contamination.

- **Credit Analysis** The lender's credit analysis was inadequate because a borrower reported loss was not properly considered and projected sales were not supported.

The borrower provided business financial statements for 1994 with the loan application on March 30, 1995. A corresponding 1994 tax return to corroborate the financial statements was provided in July or August 1995. The 1994 tax return, prepared by a paid tax preparer, showed the business lost \$501,701 while the financial statements, prepared by the borrower, showed a loss of only \$71,375. As discussed above, the lender should have been aware of the difference between the loss reported on the financial statement and the tax return because the borrower provided a copy of the tax return before the first disbursement was made. Such a material discrepancy is misrepresentation of the business financial condition.

Projected sales for the borrower's second year of business showed an increase of 485 percent (from \$819,000 to \$4.8 million). The borrower's sales projection appeared unrealistic. The borrower's principals had limited experience in boat manufacturing and planned to take over the operations of a boat building business that failed in 1994. The lender stated the projection was considered reasonable because the borrower manufactured a good product and had a large backlog of orders. The sales projection included a \$5 million sales base of Tidecraft, a company that the borrower never assimilated due to a last minute decision to buy the equipment from another company. When the borrower did not purchase the assets of Tidecraft nor obtain exclusive rights to sell the product, the borrower lost its \$5 million sales base used in the sales projection. In addition, Tidecraft Company, which had ceased operations, began operating again in August 1995, a month before the loan was closed. The document-ation in the loan files was insufficient to support borrower sales projections. Specifically, there was no indication of the dollar volume of orders on backlog or an analysis of how the decision on the failure to obtain the assets of Tidecraft and its dealer network would affect projected sales.

Conclusion

The lender, Arkansas Capital Corporation, did not follow SBA requirements in processing this

loan. The lender's errors resulted in an SBA guarantee for a substandard loan which defaulted and resulted in substantial losses to the Federal Government. Title 13 Code of Federal Regulations §120.202.5 states that "SBA shall be released from obligation to purchase its share of the guaranteed loan unless the lender has substantially complied with all of the provisions of these regulations, the Guaranty Agreement, and the Loan Authorization, and has not failed to disclose material facts, and has made no material misrepresentations. . . ." (As of March 1, 1996, the provisions of §120.202.5 were included in §120.524). SBA should not have purchased this loan and should now recover the guarantee from the lender.

RECOMMENDATION

We recommend that the Acting Associate Administrator for Financial Assistance recover from the lender the amount of the guarantee paid for Loan Number 82321230.

SBA Management Response and OIG Evaluation

SBA Response

SBA agreed with the recommendation and has requested a legal opinion from the Office of General Counsel with respect to legal sufficiency to initiate litigation. [FOIA Exemption 5]. SBA's response is presented at Attachment 1.

OIG Evaluation

SBA has initiated action to implement the recommendation.

Auditee Response

The auditee (lender) disagreed with the report, stating that for the loan in question, it complied with SBA requirements and did not make any misrepresentations or omissions that caused SBA to approve a loan that should not have been approved (see Attachment 2). The lender stated that it had been defrauded by the borrower and requested that the OIG pursue all available avenues against the principals.

OIG Evaluation

Upon receipt of the response, we obtained additional information from the lender. Generally, the information obtained provided further support that the loan was not processed in accordance with SBA procedures and policies. The lender's comments and additional information were incorporated into the report, as appropriate. The lender's specific comments and our evaluation are summarized below.

a. Verification of tax return

Auditee Response

According to the lender, it proceeded with loan closing after receiving a tax verification indicating no receipts for 1993, which agreed with the information provided by the borrower, and that IRS had no record of a tax return on file for 1994. Tax verification for 1994 was received on or about September 11, 1994, after the loan was closed and disbursed.

OIG Evaluation

The report was revised to indicate that the lender had a copy of the 1994 tax return provided by the borrower before the initial disbursement on September 1, 1995. The amount of the loss shown on the copy of the tax return provided by the borrower (and confirmed by IRS verification after the loan was closed) was significantly larger than the loss shown on the financial statements for 1994. The lender should have compared the financial statements with the borrower provided tax return prior to closing. The loan should not have been disbursed until the IRS verification was received and SBA notified of the discrepancy on the financial statements and the tax return and the reason(s) for the difference.

b. Valuation of collateral

Auditee Response

Between the time the borrower filed for bankruptcy and the lender's subsequent control over the assets, there was almost total dissipation of the collateral. Due to this situation it is impossible to determine the liquidation value of the collateral. The lender believes that this lack of collateral available for liquidation is the reason for the significant loss on this loan.

OIG Evaluation

We agree that the disappearance of collateral and the bankruptcy diminished the amount received from the sale of collateral, but the report shows that the collateral was overvalued as well. Another factor that reduced the amount of the recovery during liquidation was that neither the lender nor SBA had a lien on the finished inventory. According to the loan authorization, the lender and SBA were to obtain a first lien on all inventory. When the borrower filed for bankruptcy, however, Progressive National Bank, the borrower's business bank, stated it had a first lien on finished boat inventory, and the lender had a first lien on only the raw material inventory. There was no evidence in the loan files that the lender objected to Progressive's assertion.

c. Lender's credit analysis

Auditee's Response

With respect to projected sales, the lender considered the company to be a going concern with good potential for buying the molds and operations from a company that had \$5 million in sales and an existing dealer network.

OIG Evaluation


Based on information obtained after the lender's response was received, the report was changed to show that the scenario used to project sales was no longer applicable when the borrower decided to purchase equipment from a different boat company.

* * * * *

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

DATE: June 30, 1998
TO: Pete McClintock, AIG/Auditing
FROM: Arnie Rosenthal, AA/BLS 
SUBJECT: Fruge Marine Enterprises, Inc.
Arkansas Capital Corporation

Yesterday, we received the SBA loan files on the above case from the Little Rock District Office, along with additional comments from the District Director.

We are requesting an opinion from the Office of General Counsel with respect to the sufficiency of the legal grounds to initiate litigation against Arkansas Capital Corporation. [

FOIA Exemption 5

]



February 13, 1998

Richard C. Benton
 Audit Manager-Dallas Field Office
 4300 Amon Carter Blvd # 116
 Fort Worth, Texas 76155

Dear Mr. Benton:

Arkansas Capital Corporation (ACC) has received your Draft Memorandum Audit Report on the defaulted SBA guaranteed loan made to Fruge' Marine Enterprises, Inc (Number 82321230). This memo is in response and in full accordance with your request.

Your background paragraph states that the lender is bound to abide by SBA regulations and procedure for loan origination, servicing and liquidation, and further requires the lender to review the borrowers eligibility, repayment ability, management qualifications, use of proceeds and adequacy of collateral. ACC wholeheartedly agrees and accepts that responsibility.

In the instant case we feel we have done exactly that and cannot accept that we have done any less than SBA required or expected. ACC denies without any equivocation there were omissions or misrepresentations made by ACC to have caused SBA to approve a loan it should not have. It is clearly a misstatement to say there was adverse information about the borrower that ACC had, but did not provide to SBA causing the loan to be approved. We are pleased to have this opportunity to respond and we feel the facts as they are developed during the various stages of the case will bear this out.

It must be noted Lender had no motive to obtain an SBA guarantee based on misrepresentations. Lender was not refinancing existing debt to itself, nor was anyone paid incentive dollars of any kind for completing this project. The support given this project was a group effort consisting of the local community bank and a bank in Louisiana. Both of the entities performed their analysis and reached the independent conclusion that this was a worthwhile loan.

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Adverse information at the time the loan was approved is a misstatement. Any negative information was well after the loan was approved. The tax liability for delinquent taxes was not discovered until August 1995 and again not known to us at the time of processing. The taxes according to the lien filed were delinquent less than 60 days when we submitted the application to SBA. The loan Authorization gives authority to the lender in "its sole discretion, that there has been no unremedied adverse change....". (See Authorization Paragraph 2(c))

In this case the problem of the tax lien that came to our knowledge during closing procedures was remedied by outside financing arranged by a Louisiana bank the day before the loan was closed and no loan funds were disbursed for that purpose.

Our closing department proceeded with closing after receiving a tax verification showing 1993 with no receipts (same as our presentation) and "we have no record of a return being filed for tax year(s) 1994" and on this basis closed the loan per the authorization. A tax verification for 1994 was later received on or about September 11, 1995 after the loan was closed and disbursed. At closing we did receive an insufficient funds check for the guaranty fee. We could not have known it was hot because we do not collect from the borrower until the loan is fully disbursed in accordance with SBA regulations. Again, any adverse information was quickly remedied, timely replaced with a Cashier's Check. The validity of the check did not affect closing and SBA was not notified because it was remedied and within our lender authority. The ultimate outcome of the loan was not affected by this ISF check.

The audit concludes that ACC made a material misrepresentation of the collateral. In our collateral analysis, we made a subjective judgement discounting the values and then went on in the narrative to state "lender realizes that the collateral, mostly molds, etc., will hold a low liquidation value" Regarding the market value of the molds the file contains letters stating their opinion as to the market value. These letters were by other firms in the business of manufacturing fiberglass products, one of the better sources you could find. They also stated useful life. At a later time after approval the assets to be acquired changed and we obtained a new valuation of molds by a fiberglass manufacturer that stated "These are some of the best molds I have seen in my 35 years of selling Polyesters". He reported the molds to have a value of \$500 to \$600 Thousand Dollars.

You reference Lender's submittal of a proof of claim for \$100,000 in personal property during the bankruptcy proceedings and imply this was Lender's actual estimate of value. The \$100,000 figure used was done, without Lender's knowledge, by Legal Counsel representing Lender in Bankruptcy proceedings. Lender was advised that the amount could be "modified at any time". Counsel used this strategy to insure Lender's position as a "majority player" as an unsecured creditor in the approval of any plan of reorganization". This was not to be contrived as a statement by Lender of its belief in the actual value of the collateral.

It appears a major contention in the audit is that Lender has misrepresented the value of the collateral. A partial basis for this point seems to be the small amount of recovery which occurred through liquidation. What is not considered is the fact that from the time the borrower filed for bankruptcy and lender's subsequent control over the assets, there was almost a total dissipation of the collateral by the borrower and/or others. Due to this situation it is impossible to determine what the value in liquidation would have been had lender the opportunity to liquidate. It is lender's belief this is the reason for the significant loss.

Borrower filed Chapter 11 bankruptcy on October 27, 1995 thus precluding lender/SBA from taking action. The filing was converted to a Chapter 7 on July 1, 1996. Around August 8, 1996. Lender requested SBA/IG assistance in determination of fraud by borrower's and hoped that assistance could be obtained in locating borrower's who were believed to have left the state. This was necessary in order to determine the location of the collateral and to pursue action against borrower's personal assets.

On the basis of the above lender requested, through SBA, assistance from the Inspector General in the hope that through it's powers the borrowers could be located and pursued with all means possible.

The report states the real estate was not appraised or a copy of the appraisal could not be located, which is incorrect. The file does contain an appraisal by a qualified, licensed, certified appraiser. However, we did not represent it to have much value on a contract for sale over and above the sellers carry back. This collateral was not represented to be a significant source of repayment. There was little equity in the purchase and we took a secondary lien interest for possible future benefit if the balance paid down.

Our credit analysis was criticized claiming we did not verify equity. Several field trips to the business were made during processing and closing. On each occasion we observed a viable operation with many boats in work in progress and numerous finished boats inventory. There was no evidence of anything less than what was reported to be. The financial statement indicated the equity and the personal financial statement reflected assets which were pledged to bank loans represented as used for equity injection along with other personal funds. It is noted that the Dun and Bradstreet report reflected a similar equity standing. Nothing in the Dun and Bradstreet report or personal credit report led us to believe otherwise than the statement we relied on as to financial standing. It must be remembered that the enterprise had been in operation a number of months before we processed the loan.

As to the projected sales, our observations were that the company was a going concern and had a good potential taking over the molds and operations from a company that had five million dollars in sales and an existing dealer network.

We estimate the breakeven point would have been about \$3.1 million. No one at SBA even questioned the projections in approving the loan. The company was producing a big ticket item of high quality and it is easy to believe they could reach the multi-million dollar sales level. The whole purpose of moving to a plant in Arkansas was that they were running out of room to produce, and the loan was providing assets for an expanded operations.

Assistance to this business had the support of our State Economic Development Commission who referred this case to us originally, plus the support by purchase of a participation by the local bank and the promised participation purchase by the Louisiana bank who had previous business dealing with the applicant. This all added creditability to the borrower.

The company quickly went down the tube and we do not know where the money went. We do know that when we went in to liquidation much of the molds and other assets were gone and we did not have much to liquidate. Although a couple of people did look at it with the idea to inject money into it and one person did so to the tune of about \$125,000. With several visits working with the bankruptcy court, during Chapter 11 proceedings, and others it came to the point that there wasn't much left to liquidate.

As reflected in the comments of this response there were no specific instances where we did not follow SBA requirements in the processing of this loan. Since we had received a no filing tax verification and had sole discretion regarding unremedied adverse actions, we duly remedied the tax liability. There is not a closing deficiency that effected the eventual outcome of the loan.

We categorically deny that omissions or misrepresentations to SBA by the lender occurred. Having been defrauded by the borrower and missing items, stolen or otherwise, we respectively hope that the Inspector General Office would use their vast interagency resources and locate these principals and pursue all available avenues for criminal and civil actions against the perpetrators. We would cooperate with the Inspector General and assist in funding a lawsuit for deficiency judgement if assets and principals can be located.

Specific documents addressing each point in this response have been shown to representatives of the District Office for verification. If you would like to review or have a copy of these documents they are available to you upon request.

Sincerely,



C. Sam Walls
Executive Vice President

Attachment 3

AUDIT REPORT DISTRIBUTION

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