

**AUDIT OF  
AN EARLY DEFAULTED LOAN TO**

[ FOIA EX. 4 ]

**AUDIT REPORT NO. 9-25**

**SEPTEMBER 24, 1999**

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FOIA EX. 4



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

<b>AUDIT REPORT</b>
<b>ISSUE DATE: September 24, 1999</b>
<b>Number: 9-25</b>

**To:** John M. Quinn, District Director  
San Francisco District Office

**From:** *Garry J. Duncan*  
for John E. Dye, Acting Assistant Inspector General  
For Auditing

**Subject:** Audit of an Early Defaulted Loan to [ ] Ex-4 ]

Attached is a copy of the subject audit report that contains one finding with two recommendations addressed to your office.

The recommendations in the report are subject to review and implementation of corrective actions by your office in accordance with existing Agency procedures for audit follow-up. Please provide your management response within 30 days from the date of this report by completing the attached SBA Forms 1824, Recommendation Action Sheet.

Any questions or discussion of the issues contained in the report should be directed to Garry Duncan at (202) 205-7732.

Attachment

FOIA Ex-4

**AUDIT OF  
EARLY DEFAULTED LOAN TO  
MAIN STREET ATHLETIC CLUB**

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**APPENDICIES**

- A – SBA Management Response
- B – Auditee Response
- C – Audit Report Distribution

## AUDIT SCOPE AND OBJECTIVE

This report provides the conclusions of an audit conducted on a SBA guaranteed loan (number [ Ex. 4 ]) made by Heller First Capital Corporation (lender) to [ Ex. 4 ] [ Ex. 4 ] (borrower). The loan was judgmentally selected for review as part of the Office of Inspector General's ongoing program to audit SBA guaranteed loans charged off or transferred to liquidation within 36 months of origination (early default).

The audit objective was to determine whether the early default was caused by lender or borrower non-compliance with SBA requirements. The SBA and lender loan files were reviewed and district office and lender personnel were interviewed. Audit fieldwork was accomplished between March and July 1999. The audit was conducted in accordance with Government Auditing Standards.

## BACKGROUND

The [ Ex. 4 ] loan was processed under PLP 7(a) origination and disbursement procedures for a borrower who [ Ex. 4 ] California area. The purpose of the loan was to repay long term debts, including a note due [ Ex. 4 ] and a note to a former partner. SBA provided the lender with a guarantee of 62.5 percent of the loan amount.

After the loan defaulted it was placed in liquidation status in September 1997. SBA purchased the guarantee one-month later for [ Ex. 4 ] After the sale of business assets, the loss to SBA was reduced to about [ Ex. 4 ]

The borrower used a second lien position (first lien held by Sumitomo Bank) on a [ Ex. 4 ] note payable he received from the sale of a prior business to secure the SBA loan. The lender's liquidation actions included acquiring the note from the first lien holder after concluding that the note's first lien position should be purchased from Sumitomo Bank. In October 1997, the Sumitomo Bank released its first lien position to the lender after receiving the amount the borrower owed [ Ex. 4 ]. The lender then began receiving monthly payments from the note in December 1997. In accordance with SBA operating practices, the lender applied 100 percent of the receipts to repay itself for the cost of obtaining a first lien position. The lender was fully reimbursed for the cost of acquiring the first lien in January 1999.

## RESULTS OF AUDIT

Our audit did not disclose any evidence that the loan default was caused by lender or borrower non-compliance with SBA requirements. The lender, however, was receiving payments from a note receivable used to secure the loan without remitting SBA's share of the collections.

**FINDING. Loan collateral receipts were not shared with SBA**

Funds collected from the collateral securing the loan were not remitted to SBA as required by the loan guarantee agreement. This occurred because the lender failed to establish an account for the note and subsequently lost track of both the note and its collections. As a result, there was no assurance that SBA's loss on the loan would be reduced by more than [ ex.4 ]

Paragraph 9 of the SBA Form 750 executed by the lender, requires that recovery of liquidated collateral be repaid to SBA in the same proportion as exists in the loan guarantee (62.5 percent). Starting in February 1999, the lender should have remitted [ ex.4 ] monthly as SBA's share of all remaining note payments. Our review disclosed that the lender had not shared any collateral note collections with SBA. After the auditor notified the lender in April 1999, the lender in May 1999 paid SBA [ ex.4 ] of the [ ex.4 ] currently owed for back payments.

The lender's Deputy General Counsel stated that their normal procedure was to establish a note receivable account when funds were to be collected from collateral. Most such accounts involve collections requiring only one or two payments. The Counsel stated that this note was very unique in that the collections would occur over eight years. Because of its uniqueness, an account was not established for either the note or its collection. Further contributing to losing track of the note and its collections was the centralization of lender loan processing activities from San Francisco to Chicago.

The SBA District Office also lost track of the note by not properly monitoring the lender's liquidation actions. Monitoring of liquidation actions should have begun when the lender informed SBA that monthly payments on the note securing the loan were being received and that full reimbursement for obtaining the first lien position was expected by February 1999.

In May 1999, the SBA San Francisco District Office verified the receipt of the lender's payment of [ ex.4 ] Although the District Office personnel acknowledged receipt of the payment, they were unaware of its purpose. No purpose was indicated in the Delinquent Loan Collection System.

SBA should now continue to receive payments of [ ex.4 ] per month until the note is paid off in 2006. Potential recovery by SBA through the year 2006 is [ ex.4 ] which would reduce SBA's loss to [ ex.4 ]

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Note: SBA's share of the monthly payment is computed as follows: total monthly note payment [ ex.4 ] times loan guarantee percentage (62.5) = SBA's share [ ex.4 ]

## **Recommendations**

We recommend the San Francisco District Office take the following actions:

- 1.A. Establish a repayment schedule with Heller First Capital Corporation to cover past due and future payments for the note securing Loan Number [ EX. 4 ]
- 1.B. Ensure lender payments to SBA are monitored and received until the note matures in 2006.

## **SBA Management Response and OIG Evaluation**

### **District Office Response**

The Assistant District Director for Financial Assistance, San Francisco District Office, agreed with our recommendations. The Assistant District Director further stated that a separate note receivable [ EX. 4 ] will be established in the Delinquent Loan Tracking System. The Delinquent Loan Tracking System will generate a regular past due report that shows when payments are past due. He also stated the District Office is meeting with the lender to determine the amount that should be remitted to SBA.

### **OIG Evaluation**

The actions taken by the District Office are responsive to our recommendations.

### **Auditees Response**

The lender's Deputy General Counsel reported she had no objection to the report and had agreed with the District Office's request to establish a note receivable so that payments by the borrower and payments by the lender to SBA can be closely tracked.



U. S. SMALL BUSINESS ADMINISTRATION  
SAN FRANCISCO DISTRICT OFFICE  
450 MARKET STREET, 6<sup>TH</sup> FL.  
SAN FRANCISCO, CA 94105-2402

Appendix A

**Date:** September 16, 1999

**To:** Mr. John E. Dye, Acting Assistant Inspector General  
U.S. Small Business Administration  
Office of Inspector General

**From:** Spencer Stratton Assistant District Director for Financial Assistance  
San Francisco District Office

**Re:** Audit of an Early Defaulted Loan to [ Ex. 4 ]  
SBA [ Ex. 4 ]

This responds to your request for our comments related to the I. G. findings and recommendations on the subject loan. I agree with your finding that the funds were not submitted to SBA in a timely manner as required by the 750 and SOP 50 51 (nor were status reports or wrap up report submitted which would have given this office notice of the purchased loan). It is of note that the lender did not advise the San Francisco Office of the purchase of the note and this was not discovered until after the I. G. reviewed the lender file .

I also agree that adequate SBA systems are not in place to monitor this kind of repayment situation and your recommendations that a repayment schedule be established to cover the past due and future payments so the receipt of funds may be tracked on a monthly basis. We have determined the best method of monitoring would be to establish a separate [ FOIA EX. 4 ] in the SBA system. That way if payments are not received each month the N/R will show up in the "Delinquent Loan Tracking System" regular past due account reports. It will also generate a "past due" notice directly to Heller that SBA did not receive the funds so they follow up on the account.

We are working with Heller to determine what is presently owing and what amounts should be remitted to SBA (which we must have in order to properly establish the N/R). We hope to accomplish this within the next week or so.

Also, we recently had a meeting with Heller officials from the Chicago Office to discuss these deficiencies and other servicing issues. They indicated, as did you, that the transfer of the servicing to Chicago complicated this problem. However, they are committed to making the necessary changes to correct the situation. Since our meeting, they lost two of their key servicing and liquidation staff. They are in the process of finding replacements but it seems experienced SBA staff have been difficult to find in the Chicago area.

Please call me at 415/744-8479 if you have any other questions.

Heller Financial, Inc.  
906 Circle 75 Parkway, Suite 900  
Atlanta, Georgia 30339  
Telephone: (770) 980-6016  
Facsimile: (770) 980-6215

Appendix B



**Heller Financial**

*Elizabeth A. Edelman  
Deputy General Counsel*

September 14, 1999

Mr. John E. Dye  
Acting Assistant Inspector General  
U.S. Small Business Administration  
Office of Inspector General  
Washington, D.C. 20416

Re: **Audit of an Early Defaulted Loan to [ ex. 4 ]**

Dear Mr. Dye:

I received (unfortunately slightly delayed) the draft Audit Report for [ ex. 4 ]  
[ ex. 4 ] As I explained in a voice mail to Garry Duncan, I have no  
objection to the report. Just for your reference, we value our relationship with the  
SBA and each of the district offices and want to work together to assure that in  
this loan (and for that matter, in all other loans) we're acting in concert with the  
SBA and that funds that are due and owing to them are paid promptly and timely.

The San Francisco SBA office has requested, and we have agreed, to establish  
a note receivable so that they can more closely track the payments on the  
Beldroe note and so there can be some control procedure in place if payments  
aren't made timely either to us or from us to SBA.

Please let me know if I can provide you with any other information.

Cordially,  
HELLER FINANCIAL, INC.

Elizabeth A. Edelman  
Deputy General Counsel

EAE:cpd

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