



## Office of Inspector General Small Business Administration

March 2001 Update

### *Business Loan Programs*

#### Audit Report Issued on Early Defaulted Loan.

OIG issued an audit report on an early defaulted loan for which the borrower defaulted 9 months after the first loan disbursement. The loan was judgmentally selected for review as part of OIG's ongoing program to audit SBA guaranteed loans that defaulted within 36 months of origination. The audit showed that both the lender and the borrower did not comply with SBA regulations contributing to the default. The lender neither ensured that over \$299,000 of equity was injected into the business, as required, nor followed its own policy for monitoring collateral. Also, the borrower provided misleading information to the lender regarding equity injections and use of loan proceeds. The district office concurred with the audit findings and recommendations. The lender did not provide a response to the draft report.

Audit Report Issued on Early Defaulted Loan. An audit report was issued on an early defaulted loan that was placed into liquidation status 14 months after approval. The objective of the audit was to determine if the early loan default was caused by lender or borrower noncompliance with SBA's requirements. The auditors found that the lender's noncompliance contributed to the loan default. The lender neither evaluated the credit history of the borrower nor informed SBA of adverse credit information. In addition, the lender did not disburse the loan proceeds prudently, report the disbursements accurately, or ensure the proceeds were used for authorized purposes. The lender

disagreed with OIG's conclusions. The district office agreed that the lender did not comply with SBA's policies and procedures when making and disbursing this loan, but did not believe the lender's actions warranted a total denial of liability by SBA. Instead, SBA stated that it will pursue appropriate action.

#### Texas Auto Body Shop Employee Sentenced to

Prison for Loan Scheme. An employee of an Irving, Texas, auto body shop was sentenced on March 1, 2001, to 37 months incarceration and ordered to pay \$506,203 in restitution to a non-bank participating lender and SBA. The former employee was previously convicted of one count of **conspiracy** and nine counts of **making material false statements** to the non-bank participating lender and SBA in connection with a \$350,000 SBA-guaranteed loan. In calculating the defendant's sentence, the judge included two additional SBA-guaranteed loans (for \$256,000 and \$390,000) in which he was also a major participant. The body shop's proprietor, the defendant's brother, is a fugitive currently residing in Bangladesh and, consequently, was unavailable for trial on the indictment in which the two were charged with submitting a falsified "copy" of a Federal tax return along with fraudulent documentation in support of capital injections and equipment purchases. OIG conducted this continuing investigation with the Department of Treasury's OIG for Tax Administration based on an anonymous referral.

SBA Office Recovers \$755,332 from Non-Bank Participating Lender. On March 7, 2001, SBA's Richmond District Office notified OIG that it had received a \$755,332 check from a non-bank participating lender to compensate SBA for purchasing its guaranty of a loan to a hospitality management company. This reimbursement resulted from a joint investigation conducted by OIG and the Federal Bureau of Investigation (FBI) involving another hospitality management company and the first company. Both companies received SBA-guaranteed loans from the non-bank participating lender in 1999. Subsequently, both loans defaulted and SBA purchased the guaranties. The preliminary investigation disclosed that both companies operated from the same property in Norfolk, Virginia, and that the same individuals guaranteed both loans. The loan applications, however, showed different business addresses. OIG immediately brought this information to the attention of SBA's Richmond District Office. SBA demanded that the non-bank participating lender reimburse SBA for purchasing its guaranty of the first company's loan.

Colorado Commercial Painting Company Owner Indicted for Lying and Bankruptcy Fraud. The owner of a commercial painting company in Berthoud, Colorado, was indicted on March 15, 2001, on three counts of **making false statements** to a federally-insured lender and two counts of **bankruptcy fraud**. OIG's joint investigation with FBI determined that the owner failed to disclose approximately \$250,000 in business debts and two pending lawsuits on her application submitted to the bank to obtain a \$100,000 SBA-guaranteed LowDoc loan. In addition, the owner allegedly used some of the loan proceeds for personal expenses instead of her authorized business debts. The investigation also disclosed that the owner failed to list numerous assets during her bankruptcy. OIG initiated this case based on a referral from SBA's Colorado District Office.

New Jersey Franchising Company President Sentenced. The president of a franchising company in Millstone Township, New Jersey, was sentenced on March 13, 2001, to 2 years incarceration, 1 year supervised release, and \$650,000 restitution to an investor in his franchising company. The president previously pled guilty to

**making a false statement** to influence an SBA participating lender to make a \$150,000 SBA-guaranteed loan to finance the sale of a pet store franchise in Tampa, Florida. The store's seller had allegedly signed and submitted a bill of sale that indicated a total price of \$225,000 and verified that he had received a \$75,000 cash injection from the buyers. In his plea, the president admitted submitting a letter to the participating lender corroborating that the \$75,000 cash injection from the buyers had been paid. In fact, the sale price was \$200,000 and the buyers had made a cash injection of only \$25,000. An undisclosed \$25,000 note between the seller and the buyers made up the difference. OIG continues the investigation with FBI based on a referral from SBA's South Florida District Office.

Advisory Memorandum on Character Determinations Issued. OIG issued an inspection advisory memorandum, *Timeliness of Formal Character Determinations on Loan Applicants*, which examined Office of Financial Assistance (OFA) efforts to prevent fraud and monetary loss by making any loan applicant who discloses a prior or pending criminal record subject to a formal character determination. Some district office officials have expressed concern that delays in this process can slow the processing of loan applications and thus place some prospective borrowers' businesses at risk.

Minimizing the time needed for this process requires prompt action by all parties involved, including the local SBA field office, OIG, FBI, and OFA. Accordingly, OIG recommended that OFA and OIG jointly prepare a procedural notice outlining: (1) all participating offices' responsibilities in terms of timeframes and required documentation, and (2) how e-mail will be used to provide advance notice of OFA's final decisions. The Office of Capital Access concurred that this report addresses its concerns.

## ***Government Contracting and Business Development***

Pennsylvania Construction Company Vice President Convicted of Conspiracy, False Claims, and Major Fraud. The vice president of a defunct

Philadelphia, Pennsylvania, construction company that had participated in SBA's Section 8(a) program was convicted by a jury on March 1, 2001, of one count of **conspiracy to defraud the Government**, nine counts of **false claims**, and one count of **major fraud against the United States**. On two additional counts of **making material false statements**, the defendant had waived his right to a jury trial and was found guilty by the judge after pleading *nolo contendere* (no contest). The two false statement counts related to the vice president's denying in the company's 1995 Section 8(a) application that he had a criminal history. In fact, he had been arrested seven times and convicted three times. The other charges on which he was tried related to alleged schemes to defraud SBA, the Department of the Navy, and the U.S. Department of Agriculture (USDA). These included falsely reported payments to subcontractors and false progress payment certifications. The company's president pled guilty on July 20, 2000, to all 15 counts on which he had been indicted. The company pled guilty on February 16, 2001, to all 14 counts on which it had been indicted. SBA/OIG joined the Naval Criminal Investigative Service (NCIS), the Defense Criminal Investigative Service, USDA/OIG, and the Department of Labor OIG in the investigation based on a referral from NCIS.

Former Section 8(a) Participant Plead Guilty to Obstruction of Federal Audit. The owner of a former Section 8(a) environmental research contractor pled guilty on March 9, 2001, in the U.S. Eastern District of Kentucky to one count of **obstruction of a Federal audit**. He admitted that, from 1993 to 1995, he had directed his staff to obstruct U.S. Environmental Protection Agency (EPA) auditors from attempting to determine the appropriateness of the company's billings under EPA contracts. The owner and five associates were previously indicted on charges of racketeering, racketeering conspiracy, money laundering, bank fraud, mail fraud, and obstruction of a Federal audit. A prosecution under the Racketeer Influenced and Corrupt Organizations Act involves allegations that a group of persons formed an "enterprise" that then engaged in a series of corrupt or illegal activities. In this case, the owner initially entered SBA's Section 8(a) program in Ohio as primary owner of a hazardous-waste cleanup

contractor. The indictment alleged that shortly after the company was "graduated" from the program, he obtained (in the name of his son and codefendant to conceal the owner's role) Section 8(a) status in Kentucky, and later in California, for another company he controlled. The indictment further alleged that another waste cleanup company purportedly headed by another of the owner's sons and codefendants fraudulently obtained Section 8(a) status in Kentucky. During the period these companies participated in the Section 8(a) program, they were awarded Federal contracts totaling more than \$150 million. The owner is scheduled to be sentenced on August 3, 2001. Among the conditions for the Government's dismissing other charges of the indictment is that he pay a \$2 million fine in this case, as well as another unpaid fine (which, with accrued interest, has grown to approximately \$950,000) assessed from a Federal criminal case in North Carolina in 1994. This matter was investigated by OIGs of EPA and the Department of Defense, with the assistance of SBA/OIG's Washington, DC, Field Office.

## ***Small Business Investment Company Program***

New York SBIC President Sentenced for Bank Fraud and Lying. The president of a New York, New York, small business investment company (SBIC) was sentenced on March 14, 2001, to 1 year incarceration, 5 years supervised release, and \$770,000 restitution to SBA. He previously pled guilty to **bank fraud** and **making material false statements**. From March 1996 through February 1997, he fraudulently obtained over \$750,000 in loans from the SBIC, as well as over \$250,000 in salary advances, while drawing an annual salary of \$150,000. He caused the SBIC's vice president to cosign the salary-advance and loan checks by falsely representing that the loans were permissible under SBA regulations. He falsely claimed that the SBIC's loan committee had approved the loans and advances and subsequently made the same false representations to SBA on several occasions, seeking the Agency's retroactive approval for the monies he had already received. He then used the fraudulently obtained funds for unauthorized purposes, including repayment of his personal

gambling debts and personal debts to the two other members of the SBIC's loan committee. The improper loans and advances, and his failure to make any repayment on them, caused a loss to SBA of over \$900,000 and forced the Agency to liquidate the SBIC in 1997. This investigation, conducted jointly with FBI, originated from a referral from SBA's Office of SBIC Operations.

## ***Agency Management***

Audit Report Issued on SBA's Planning and Assessment for Protecting SBA's Critical, Physical Infrastructure. An audit report was issued titled, "SBA's Planning and Assessment for Protecting SBA's Critical, Physical Infrastructure." Presidential Decision Directive (PDD) 63 calls for a national effort to ensure the security of the United States' critical infrastructures. Critical infrastructures are the physical and cyber-based systems essential to the minimum operations of the economy and Government. SBA has made progress toward implementing PDD 63 requirements, but its focus has been on protecting the Agency's critical, cyber-based infrastructure. In order to fully comply with PDD 63, the Agency needs to expand its infrastructure protection efforts to address its critical, physical infrastructure. SBA's current Critical Infrastructure Protection (CIP) Plan does not require protection of the Agency's physical Mission Essential Infrastructure (MEI). We recommended that the plan be revised to include milestones and responsibilities for identification of physical MEI, performance of vulnerability assessments, development of remedial plans, determination of resource requirements, and updating of policies and procedures as necessary. PDD 63 and related guidance call for agencies to establish effective CIP coordination with other applicable entities. To avoid duplication of key functions, we recommended that SBA coordinate its CIP efforts with the General Services Administration, which is responsible for the security of the Federal and leased buildings in which SBA operates. The Agency agreed with our recommendations and stated that it has already taken steps to address the issue.

Audit Report Issued on SBA's Information Systems Controls for FY 2000. OIG issued an

audit report on SBA's information systems controls. The report was based on the review of general controls over SBA's financial management systems performed by Cotton & Company LLP, as part of the audit of SBA's FY 2000 financial statements. General controls are the policies and procedures that apply to all or a large segment of an entity's information systems to help ensure their proper operation. They impact the overall effectiveness and security of computer operations, rather than specific computer applications. The objective of the review was to determine if those controls complied with various Federal requirements. The report concluded that while SBA has continued to make significant progress in implementing its information systems security program, further improvements are still needed. The report described areas where controls can be strengthened, such as: (1) monitoring, assessing, and measuring security program effectiveness; (2) restricting physical access to network servers; (3) documenting application development and software changes; (4) controlling changes to operating system configurations; (5) segregating incompatible duties; and (6) testing disaster recovery plans. The Agency generally agreed with the findings and recommendations.

Audit Report Issued on Results Act Performance Measurement for the Minority Small Business and Capital Ownership Development Program. OIG issued an audit report titled, "Results Act Performance Measurement for the Minority Small Business and Capital Ownership Development Program." The report concludes that SBA has not adequately implemented performance measurement requirements of the Results Act for the Section 8(a) Business Development (BD) program. SBA's definition of success for the Section 8(a) BD program contained in its FY 2001 Results Act Annual Performance Plan (Performance Plan) omitted the measures of success as defined by law. OIG auditors found that: (1) the performance plan lacked effectiveness and efficiency performance indicators for the Section 8(a) BD program; (2) the data contained in the SBA database for the program was generally accurate concerning which fiscal year that Section 8(a) BD program participants left the program; and (3) some performance data was unreliable or incorrectly described. OIG recommended that: (1) SBA define Section 8(a)

BD program success in accordance with the law; (2) include indicators in the Performance Plan that allow for a determination of how effectively and efficiently the Section 8(a) BD program is operating; (3) accurately describe and report performance goals and data; and (4) implement a system that ensures that termination requests of Section 8(a) firms are tracked through final resolution. The Agency took no exception to the audit results presented in the draft report.

## *Office of Inspector General*

OIG has established an e-mail address ([oig@sba.gov](mailto:oig@sba.gov)) that we encourage the public to use to communicate with our office. We welcome your comments on our publications, suggestions for possible audits, or referrals of possible incidents of waste, fraud, or abuse.

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