

**AUDIT OF AN EARLY DEFAULTED LOAN TO**

**GLT MANAGEMENT COMPANY**

**AUDIT REPORT NO. 0-09**

**MARCH 22, 2000**

**This finding in this report is the conclusion of the OIG's Auditing Division based on testing of the auditee's operations. The finding and recommendations are subject to review, management decision, and corrective action in accordance with existing Agency procedures for follow-up and resolution. This report may contain proprietary information subject to the provisions of 18 USC 1905 and must not be released to the public or another agency without permission of the Office of Inspector General.**



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

<b>AUDIT REPORT</b>
<b>ISSUE DATE:</b> <b>MARCH 22 , 2000</b>
<b>REPORT NUMBER: 0-09</b>

**To:** Robert Blaney, District Director  
Arizona District Office

**From:** *Garry J. Duncan*  
for Robert Seabrooks, Assistant Inspector General  
For Auditing

**Subject:** Audit of an Early Defaulted Loan to GLT Management Company

Attached is a copy of the subject audit report. The report contains one finding and two recommendations addressed to your office. Your comments and the comments of the lender have been synopsisized and included in the report. Your comments indicate that you agree with the audit results and that all options and potential remedies available to SBA in recovering the loan guarantee from the lender will be examined.

Since this report may contain proprietary information subject to the provisions of 18 USC 1905 and might comprise possible investigative work, the contents must not be released to the public or another agency without permission of the Office of Inspector General.

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

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

Attachments

**AUDIT OF  
EARLY DEFAULTED LOAN TO  
GLT MANAGEMENT COMPANY**

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- A-Management Response
- B-Lender Response
- C-Audit Report Distribution

## BACKGROUND

The Small Business Administration (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 guaranteed loans are made by participating lenders under an agreement (SBA Form 750) to originate, service, and liquidate loans in accordance with Administration rules and regulations.

On [ EX. 4 ] Commercial Capital Corporation (lender) approved loan number [ EX. 4 ] to GLT Management Company (borrower). The loan was made to refinance the purchase of [ EX. 4 ] Arizona. The refinanced loans and notes were held by a second lender (Capital Lending Corporation), the seller [ EX. 4 ] and a third party. The \$1 million loan was originated under regular 7(a) procedures (with a 75 per cent SBA guarantee) and disbursed in [ EX. 4 ] The borrower defaulted seven months after the loan was disbursed and then filed for bankruptcy. SBA paid the lender \$834,081, including interest, to purchase the guarantee.

## AUDIT SCOPE AND OBJECTIVE

This report provides the conclusions of an audit of a SBA guaranteed loan. 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 if the early loan default was caused by lender or borrower noncompliance with SBA requirements. The SBA and lender loan files were reviewed and district office and lender personnel were interviewed. The borrower and its bookkeeper were contacted and their records analyzed. The audit was conducted between April and September 1999 in accordance with Government Auditing Standards.

## RESULTS OF AUDIT

### **The Borrower was Ineligible for a SBA Guaranteed Loan**

The borrower defaulted because sufficient cash flow was not available to service business debts. The lender and SBA did not detect the inability to repay the loan because the borrower submitted financial statements that misrepresented its financial condition. The lender and SBA compounded the problem by violating loan origination requirements that required the lender to obtain the seller's historical financial data for the prior three years. As a result, SBA lost \$834,081 after the borrower defaulted.

FOIA EX. 4

## **Borrower Misrepresentation**

Our audit showed the borrower submitted interim financial statements that demonstrated it had the ability to repay the loan. Using the interim data, the cash flow projections showed the borrower could generate gross revenues of \$1.4 million and cash flow totaling at least \$343,100 per year. We found, however, that the interim statements overstated the borrower's actual revenues and cash flow.

## **Lender Loan Processing**

We found that the lender based cash flow projections on the borrower's partial year tax return and interim, unaudited, financial statements for the first eight months of 1996. Using the interim data, the cash flow projections showed the borrower had the ability to repay the SBA loan, i.e., available cash flow was calculated at \$343,100 per year.

## **Criteria for Verifying Historical Financial Data**

Standard Operating Procedure (SOP) 50 10 4, Subpart B, Chapter 1, required the lender to obtain the seller's historical financial statements for the last three years. If the lender had followed SBA requirements and obtained the seller's prior years financial data it would have discovered that the borrower's income projections were grossly overstated. The statements which were available from the original lender, Capital Lending Corporation, showed that the business' historical annual cash flow of \$110,900 would be insufficient to service debts of over \$183,900 per year.

## **SBA Loan Approval**

When a loan is originated under regular 7(a) procedures, the SBA district office should ensure that the lender has accurately calculated the business historical cash flow and the borrower's ability to repay the loan. We found the district office did not require the lender to obtain the seller's historical financial data for the last three years to support the borrower's ability to repay the loan. Had the district office required compliance with this rule, it would have determined the borrower lacked the cash flow needed to service the loan.

In addition, the district counsel expressed concerns about the lender and the loan application. The attorney stated that the loan application contained possible misrepresentations and misinformation and that the loan underwriting appeared grossly negligent. In addition, the attorney stated that if SBA accepted the information it would have no remedies in bankruptcy. According to the attorney, inappropriate lender actions included:

- Mislabeling  ex. 4  Arizona property as fee simple although the underlying documents revealed the ground was leased and only the building was purchased.

- Treating the real estate collateral as property eligible for 25-year financing although less than 12 years remained on the ground lease and no option existed for purchasing or extending the lease.

The district office overrode the attorney concerns and approved the loan guarantee.

### **Loss to SBA**

We concluded that the lender's noncompliance with SBA loan origination requirements allowed the borrower to obtain a loan that could not be repaid. As a result, SBA lost \$834,081 (\$748,078 to purchase the guarantee and \$86,003 for accrued interest).

### **Impact on the SBA Guarantee**

Section 120.524, Title 13 of the Code of Federal Regulations states that SBA is released from liability on a loan guarantee in whole or in part if:

- The lender has failed to comply materially with any of the provisions in the regulations or the loan guarantee agreement.
- In addition, SBA is released from the guarantee liability if the lender's improper action or inaction placed SBA at risk.

If SBA determines, after purchasing the guaranteed portion of a loan, that any of the above events occurred in connection with the loan, SBA is entitled to recover any monies paid.

### **Recommendations**

We recommend that the Arizona District Director take the following actions:

- 1A. Coordinate with the Office of General Counsel to determine if SBA can recover from the lender any or all of the \$834,081 paid to purchase the loan guarantee for loan number [ EX-4 ]
- 1B. Remind the lender of its obligations to comply with SBA regulations, policies, and procedures for originating loans, particularly in the area of obtaining the seller's historical financial data for the prior three years.

### **Management Comments**

With respect to Recommendation 1A of the Report, the Arizona District Office, in conjunction with the Office of General Counsel, will examine all options and potential remedies available to SBA to recover from the lender the \$834,081 paid to purchase the loan guarantee. It should be further noted that the lender recently

forwarded a check in the amount of \$48,650.69 to the SBA for reimbursement of excess interest on this loan.

With respect to Recommendation 1B, the Arizona District Office has already notified the lender's senior management of the deficiencies on this loan in a meeting in this office on June 24, 1999. On September 10 and 11, 1998, a comprehensive training for the lender was held in which SBA reminded them of their obligations to comply with SBA's regulations, policies, and procedures for originating, closing, disbursing, and servicing our loans. This was reiterated in a conference call with the lender's staff on September 8, 1999. A meeting is scheduled again on February 25, 2000 with the lender to further discuss their performance.

See Appendix A for management's response.

### **Evaluation of Management's Comments**

Management proposed and actual actions are responsive to the recommendations.

### **Lender Comments**

The lender disagreed with the audit finding and stated that they did not violate SBA origination procedures. The lender contended that the loan was for debt repayment and working capital and not for the purchase of a going concern. According to the lender, SOP 50 10 (4), paragraph 3(e) provides that three years of historical financial statements are generally but not always required. The lender further stated the historical financial statements would not have been available to the lender because it did not have a relationship with the bank making the original loan.

It was pointed out that SBA reviewed the financial statements and other documentation submitted by the lender and borrower before authorizing the loan guarantee and, therefore, SBA should bear the responsibility and consequences for relying upon the erroneous financial statements. If SBA required three years of historical financial statements, it should have requested them from the borrower or lender prior to authorizing the loan guarantee. The lender concluded its actions resulted in no loss to SBA and would not justify denial of liability.

See Appendix B for the lender's response.

### **Evaluation of lender's comments**

The section cited by the lender (SOP 50 10 4, Subpart A, Chapter 6, paragraph 4e), contradicts the lender's claim that financial statements are not always required. The citation states, "Balance sheets, reconciliation of net worth, and profit and loss statements are generally required for the past three years....". SOP 50 10 4, Subpart B, Chapter 1, paragraph 3c, adds that,

*"If a change of ownership involves the acquisition of a going concern, historical financial statements for no less than the last three complete fiscal years plus interim statements which are not older than 180 days from the receipt of application will be required...."*

The borrower had acquired a going concern, so the lender was responsible for obtaining historical financial statements for the last three fiscal years. Although the district office did not request the historical financial statements from the lender, it was still obligated to comply with this requirement. Had the lender complied with the SOP, the lender would have discovered the historical cash flow was insufficient to repay the SBA loan.

Contrary to the lender's claim, we obtained the business' historical financial statements for the past three fiscal years from the original lender, Capital Lending Corporation, by simply asking the borrower to sign a release statement and forwarding it to the original lender.

The lender's loan file showed the SBA loan proceeds would be used to repay debts related to the purchase of the two ongoing restaurants. The debt repayments included the seller of the business - as well as, a third party who provided funds for the purchase and renovation of the business properties and the original lender for the business purchase. The SBA loan, therefore, constituted a continuation of the change in ownership process and fell under the auspices of SOP 50 10 4 requirements for acquiring a going concern.





United States Government  
SMALL BUSINESS ADMINISTRATION  
Arizona District Office

2828 North Central Avenue, Suite 800, Phoenix, AZ 85004-1093  
Telephone: 602.745.7200 Fax: 602.745.7210

DATE: March 8, 2000

REPLY TO: Bruce L. Hodgman  
ATTN. OF: Acting District Director *B-31*  
Arizona District Office

SUBJECT: **AUDIT OF AN EARLY DEFAULTED LOAN TO  
GLT MANAGEMENT COMPANY**

TO: Robert Seabrook  
Assistant Inspector General for Auditing

This office is in receipt of the draft audit of an early defaulted loan to GLT Management Company and wish to provide a response.

The Inspector General should be aware that the Arizona District Director, the Assistant District Director for Finance who approved this loan, and the Loan Officer who recommended approval, are no longer with the Arizona District Office. The Loan Officer at Commercial Credit Corporation (CCC) who submitted the loan application to SBA is no longer with the lender. New senior management at the Arizona District Office has been in place since 1998. Since Robert J. Blaney's arrival as District Director in 1998, he has taken action to improve the quality of loan underwriting in this office by instituting a more careful oversight process and by providing comprehensive training to our lenders.

With respect to Recommendation 1A of the Report, the Arizona District Office, in conjunction with the Office of General Counsel, will examine all options and potential remedies available to SBA to recover from the lender the \$834,081 paid to purchase the loan guarantee.

It should be noted that the lender recently forwarded a check in the amount of \$48,650.69 to the SBA for reimbursement of excess interest.

With respect to Recommendation 1B, the Arizona District Office has already notified CCC's senior management of the deficiencies on this loan in a meeting in this office on June 24, 1999 (summary attached as Exhibit 1). On September 10 and 11, 1998, a comprehensive training for CCC was held in which SBA reminded them of their obligations to comply with SBA's regulations, policies, and procedures for originating, closing, disbursing, and servicing our loans. (Agenda attached as Exhibit 2.) We reiterated this in a conference call with CCC staff on September 8, 1999. We also met with [ ex. 6 ] on February 25<sup>th</sup> to further discuss these matters. (Summary attached as Exhibit 3)



Bruce L. Hodgman  
Acting District Director

- \* Please note that Robert J. Blaney, Arizona District Director, has recused himself from all matters involving Commercial Capital Corporation. Bruce L. Hodgman is Acting District Director with respect to such matters.

SUMMARY OF MEETING WITH COMMERCIAL CAPITAL CORPORATION  
ON JUNE 24, 1999 [by N. Rivera]

On June 24, 1999, Bruce Hodgman, ADD/F&I; Marilyn Eiklor, Chief  
PMD; and Nina Rivera, District Counsel, met with [ Ex. b ]

[ Ex. b ]  
of Commercial Capital Corporation ("CCC"). Items for discussion  
included the importance of selecting prudent business  
development officers, and of insuring prudent credit  
underwriting, loan closing and disbursement, liquidation, and  
litigation. We discussed the loans in our liquidation portfolio  
and [

FOIA Ex. 4, 5 + b

FOIA Ex. 4, 5, 6

**U. S. SMALL BUSINESS ADMINISTRATION***Phoenix District Office*

2828 North Central Avenue, Suite 800, Phoenix, Arizona 85004-1093  
Phone: (602) 640-2316 FAX: (602) 640-2360

Date: August 14, 1998

Reply To The Attention Of: Bruce L. Hodgman  
Assistant District Director/ED-F

Subject: **AGENDA**  
Commercial Capital Corporation Visit  
September 10-11, 1998

Through: Robert J. Blaney  
District Director-Phoenix District Office

[ Ex. 6 ] Commercial Capital Corporation

To: Phoenix District Office:  
Finance Division  
Legal Division  
Liquidation Division

**AGENDA**Thursday, September 10, 1998

	9:30 am	Commercial Capital Corporation staff arrives in Phoenix from New York
11:00 am	12:00 am	Legal Review and Environmental Issues <i>Legal Division:</i> District Office Conference Room
12:00 am	1:00 pm	Lunch
1:00 am	3:30 pm	Loan Packaging, Credit Memorandums and SBA Policy <i>Finance Division:</i> District Office Conference Room

Friday, September 11, 1998

8:00 am	12:00 noon	Liquidation and Servicing Training <i>Liquidation Division:</i> District Office Conference Room
12:00 am	1:00 pm	Lunch
1:00 pm	3:00 pm	Liquidation and Servicing Training (Continued) <i>Liquidation Division:</i> District Office Conference Room
3:00 pm	3:30 pm	Exit Meeting with District Director
	5:00 pm	Commercial Capital Corporation departs for New York

FOIA EX. 6

Each Division Supervisor will prepare a Division Training Agenda for distribution to all attendees and staff members.

**EXHIBIT** 66 2 95



United States Government  
SMALL BUSINESS ADMINISTRATION  
Arizona District Office

2828 North Central Avenue, Suite 800, Phoenix, AZ 85004-1093  
Telephone: 602.745.7200 Fax: 602.745.7210

Appendix A

DATE: February 25, 2000  
REPLY TO: Nina J. Rivera **NJR**  
ATTN. OF: District Counsel  
Arizona District Office  
SUBJECT: Summary of Meeting with  
Commercial Capital Corporation on 2/25/00  
TO: Robert Seabrook  
Assistant Inspector General for Auditing

A meeting was held February 25, 2000, with [ Ex. b ]  
[ Ex. b ] of Commercial  
Capital Corporation (CCC). SBA attendees were: Robert Blaney,  
District Director; Nina Rivera, District Counsel; and [ Ex. b ]  
[ Ex. b ] Business Assistance Division.

At this meeting Mr. Blaney announced to those present his  
recusal from all matters involving CCC and stated that Mr.  
Hodgman would be handling all CCC matters in the future as  
Acting District Director.

After Mr. Blaney's recusal was announced, Nina Rivera discussed  
with the CCC representatives the various areas of concern this  
District has with CCC's Arizona portfolio. Specific areas of  
discussion included credit underwriting, loan closing and  
disbursement, purchase requests, liquidation, litigation,  
collections. CCC was advised of [ ]

FOIA EX. 4, 5, 6

EXHIBIT " 3 "

FOIA EX. 4, 5, 6

At the meeting, [ Ex 6 ] discussed new developments and organizational changes at CCC and provided the District Office with an organizational chart and a packet of materials delineating those changes.

NJR/sak

cc: [ Ex. 6 ] Los Angeles IG Auditing Division  
[ Ex. 6 ] HQ IG Auditing Division  
[ Ex. 6 ] Regional Ethics Official, San Francisco

FBI EX 6

# Pepper Hamilton LLP

Attorneys at Law

Hamilton Square  
600 Fourteenth Street, N.W.  
Washington, DC 20005-2004  
202.220.1200  
Fax 202.220.1665

[ EX. 6 ]

February 1, 2000

[ EX. 6 ] Audit Manager  
Office of Inspector General  
U. S. Small Business Administration  
330 North Brand Boulevard, Suite 650  
Glendale, CA 91203

Dear [ EX. 6 ]

Please consider this to be the response of Commercial Capital Corporation ("CCC") to the draft Audit Report ("Audit Report") regarding a loan for \$1,000,000 guaranteed by the Small Business Administration ("SBA") and made to GLT Management Company ("GLT"), SBA Loan Approval No. [ EX. 4 ] ("the Loan").

### Facts

A seventy-five percent (75%) guaranty of the Loan was approved by SBA on [ 4 ] [ EX. 4 ] by virtue of SBA's Authorization and Loan Agreement ("Authorization") of that date, copy attached as Exhibit 1. The Authorization was amended several times with SBA approval and was executed by the GLT on November 13, 1996. GLT signed a note for \$1,000,000 evidencing the Loan on November 13, 1996. The Authorization provided that SBA's guaranty was conditioned upon the representations made by GLT in the Loan Application it made to CCC. The Loan Application provided that the use of proceeds of the Loan was for debt repayment associated with the prior purchase by GLT in 1995 of [ EX. 4 ] and for working capital (See Exhibit 2). GLT furnished interim financial statements to CCC in conjunction with the Loan Application.

The guaranty of the Loan was approved under normal (i.e., non-CLP or PLP) procedures. As such, properly authorized SBA personnel in the SBA Phoenix District Office, not CCC personnel, approved the Authorization after reviewing the Loan Application and supporting documentation submitted by GLT and CCC, and assuring themselves that the Loan Application complied with applicable SBA requirements. (See SBA SOP 50-10(4) Subpart A, ¶5).

FOIA EX. 4, b

Philadelphia, Pennsylvania	Detroit, Michigan	New York, New York	Pittsburgh, Pennsylvania
Wilmington, Delaware	Harrisburg, Pennsylvania	Berwyn, Pennsylvania	Cherry Hill, New Jersey

**Pepper Hamilton LLP**

[ Ex. 6 ]

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February 1, 2000

The Audit Report acknowledges that GLT submitted erroneous financial statements to CCC in order to overstate its cash flow, and thereby justify its ability to repay the Loan. The Audit Report acknowledges that the SBA Phoenix District Office authorized the guaranty of the Loan, but alleges that CCC is somehow culpable for the ultimate loss of \$834,081 by SBA, because it failed to obtain historical financial statements from GLT for the three years prior to the Loan Application and failed to comply with other unspecified SBA "loan origination" requirements. The Audit Report also alleges that SBA is entitled to release of liability on its guaranty of the Loan because CCC failed to comply materially with unspecified provisions of the SBA regulations or loan guarantee agreement and because its improper action or inaction placed SBA at risk.

**CCC Did Not Violate SBA Origination Procedures**

CCC did not violate SBA loan origination procedures in underwriting the Loan. As the Loan Application and Authorization clearly indicate, the use of the proceeds for the Loan, agreed upon by SBA, was debt repayment and working capital; not the purchase of a going concern. In such circumstances SBA SOP 50-10(4) ¶3(e) provides that three years of historical financial statements are generally but not always required. Therefore, failure by CCC to obtain three years of historical financial statements from GLT is neither a violation of the SOP nor a failure to comply with SBA underwriting standards.

CCC was furnished with interim financial statements by GLT which SBA officials in the Phoenix District Office reviewed before authorizing the guaranty of the Loan under normal SBA procedures. As indicated above, this was not inconsistent with SBA requirements. It should also be noted that historical financial statements of the [ Ex. 4 ] would not have been available to CCC from Capital Lending Corporation as the Audit Reports asserts, because Capital Lending Corporation had no relationship with CCC at the time the Application was filed and GLT had only been in operation since 1995.

In such a case, SBA rather than CCC bears the responsibility for the consequences of relying upon the erroneous financial statements. If SBA wished to require three years worth of historical financial statements prior to entering into the Authorization it could have asked for them from either CCC or GLT. However, it did not do so. Thus, by submitting the interim financial statements it was provided by GLT in conjunction with the Application, CCC committed no violation of SBA underwriting procedures, regulations, or loan guarantee agreement, nor did its actions place SBA at risk on the Loan.

FOIA EX. 4, 6



**Pepper Hamilton LLP**

[ Ex-6 ]

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**The Audit Report Contains Unsubstantiated Dicta**

The Audit Report also cites some extraneous contentions regarding a difference of opinion between the SBA counsel in the Phoenix District Office and other relevant SBA personnel over whether an SBA guaranty of the Loan was appropriate because of what the auditor characterizes as "inappropriate lender actions". However, as indicated above notwithstanding these vague references which may or may not accurately portray the counsel's views, (we have not been provided the text of these alleged comments) the guaranty was properly authorized by SBA personnel under standard SBA approval processes which require two of three affirmative votes on such actions (See SOP 50-10A). Thus, these misplaced references to differences of opinion in the Phoenix District Office are merely meaningless dicta, and may not serve as the basis for a denial of liability.

**CCC's Actions Resulted In No Loss to SBA and Do Not Justify Denial Of Liability**

Finally, the Audit Report alleges that because of the improper actions of CCC SBA lost \$834,081 (the amount of the guaranty plus accrued interest). This is a gross mischaracterization of the amount of loss, if any, which SBA may incur on the Loan, and a misassignment of blame for any such loss. First, at this point it is unclear what liquidation value may be realized on the collateral for the Loan. Normal liquidation of the Loan which is ongoing may result in a recovery of some or all of the \$834,081. Secondly, as indicated above, CCC bears no blame for the failure of GLT.

In addition, CCC committed no violation of SBA requirements in underwriting the Loan. It was misled by the submission of false financial statements by GLT's principals but it did not mislead SBA in any way. SBA authorized the guaranty of the Loan after its own review of the Application under normal SBA procedures, and must alone bear the ultimate risk of any loss.

Denial of liability is an extremely significant action, reserved only to the Administrator of SBA. 13 C.F.R. §120.524 provides the only bases upon which SBA may undertake a denial of liability. As indicated above, the bases cited in the Audit Report are not substantiated in this case. There is no indication that CCC failed to comply with SBA loan

FIA EX 6

**Pepper Hamilton LLP**  
Attorneys at Law

[ Ex.6 ]

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February 1, 2000

origination requirements in the underwriting of the Loan. To the contrary, SBA authorized the guaranty of the Loan after its own review of CCC's underwriting. Therefore, there is no legal ground, upon which SBA may deny liability on the guaranty of the Loan.

Please address all further comments on this matter to the undersigned.

Sincerely,

[ FIA EX.6 ]

cc:

[ Ex.6 ]

DC: #139633 v1 (2ZR9011.WPD)

FIA EX.6

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