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

AUDIT REPORT
ISSUE DATE: FEBRUARY 27, 2002
REPORT NUMBER: 2-03

To: Antonio Valdez, District Director
Fresno District Office

From: Robert Seabrooks, Assistant Inspector General
for Auditing

Subject: Audit of SBA Loan to Darshan's Paradise Inn

Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to your office. Your comments have been synopsized in the report and included in their entirety at Appendix A.

The recommendation in this report is subject to review and implementation of corrective action by your office in accordance with the existing Agency procedures for audit follow-up. Please provide your management decision for the recommendation to our office within 30 days of the date of this report using the attached SBA Form 1824, Recommendation and Action Sheet.

Any questions or discussion of the finding and recommendation contained in the report should be directed to Garry Duncan, Director, Credit Programs Group, at (202) 205-7732.

Attachments

AUDIT OF

SBA GUARANTEED LOAN TO

DARSHAN'S PARADISE INN

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AUDIT OF
SBA GUARANTEED LOAN TO
DARSHAN'S PARADISE INN

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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 SBA regulations, policies, and procedures. SBA is released from liability on a loan guarantee, in whole or in part, within SBA's exclusive discretion, if a lender failed to comply materially with SBA regulations, the Loan Agreement, or failed to make, close, service, or liquidate a loan in a prudent manner.

Heller First Capital Corporation (the lender) was a Small Business Lending Company authorized by SBA to make guaranteed loans under the Preferred and Certified Lenders Programs. Under the Preferred Lenders Program (PLP), lenders are permitted to process, close, service, and liquidate SBA guaranteed loans with reduced requirements for documentation to and prior approval by SBA. Under the Certified Lenders Program (CLP), SBA processes loan guarantee applications and servicing actions on a priority basis. The lender also made loans under SBA's Low Documentation Loan Program (LowDoc). Although this program streamlined the guarantee application process, participating lenders are expected to perform a loan analysis in a manner consistent with prudent lending practices. The analysis is included with the lender's request for a SBA guaranteed loan. The lender stopped making SBA guaranteed loans in February 2001 and was acquired by General Electric Capital Corporation on October 25, 2001.

Prior audits of early default loans found that the lender did not always materially comply with SBA rules and regulations. In a January 2000 response to one of the audits, the lender acknowledged that the loan, which closed in 1997, would not have been approved under its current underwriting and closing procedures. A few months later in response to a SBA PLP review, the lender admitted that combined growth in volume and processing locations across the country was not in the best interest of the lender or SBA's lending program. Consequently, certain regions exercised more discretion in both credit analysis and compliance with procedures than the lender would have liked.

Based on the lender's acknowledgement of the lack of controls over the SBA guaranteed loan process, the Office of Inspector General initiated an audit of 140 loans originated by the lender that were purchased by SBA between January 1996 and February 2000, to determine if the loans were processed correctly. The audit identified several loans that were originated, serviced, and/or liquidated in material non-compliance with SBA rules and regulations. One of these loans was to Darshan's Paradise Inn and is the subject of this report.

In December 1995, the lender approved a loan (loan number 8875783009) for $333,000 to Darshan's Paradise Inn (borrower) under the Preferred Lenders Program. The purpose of the loan was to purchase real estate. The last loan disbursement occurred January 11, 1996, and the borrower defaulted on the loan January 1, 1998. SBA purchased the loan guaranty for $245,981 on September 25, 1998. Subsequent payments on the loan as of October 2000, resulted in a net loss of $224,546 on SBA's portion of the principal.

AUDIT OBJECTIVE AND SCOPE

The objective of the audit was to determine if the lender originated, disbursed, and liquidated the loan purchased by SBA in accordance with SBA rules and regulations.

The subject loan was reviewed for compliance with 11 requirements found in SBA rules and regulations and the SBA-lender guarantee agreements. All identified lender deficiencies were evaluated to determine if a material loss to SBA resulted. A material loss was defined as exceeding $25,000.

The audit was conducted during October 2000 in accordance with Government Auditing Standards.

RESULTS OF THE AUDIT

Finding 1 - The Lender Did Not Fully Secure the SBA Guaranteed Loan

The lender did not secure the loan with all available property as required by SOP 50 10 (3), Chapter 2-16. The $333,000 loan was secured with only $259,000 in collateral. As a result, the loan was under secured by $74,202, which increased the loss to SBA. SOP 50 10 (3), Chapter 2-16 provides that SBA loans must be secured as fully as possible. When there is a shortfall of business assets, the lender must secure worthwhile available assets owned by the principals.

The principal listed two properties in his Personal Financial Statement: [FOIA Ex. 4 and 6], neither of which were taken as collateral. The chart below shows the potential value of these properties using SBA's calculation for a forced sale.

Asset	Stated FMV	Prior Mortgages	Liquidation Value[1/]
[FOIA	EX. 4 and	6]	

[1/]The potential collateral value in a forced sale is 70% to 80 % of the fair market value (FMV) less prior mortgages. The liquidation value is based on 75% of FMV.

As shown in the table, there was sufficient collateral available to fully secure the loan and reduce the risk of loss to SBA.

RECOMMENDATION

We recommend that the Sacramento District Office take the following action:

1. Seek recovery of [FOIA EX. 6] from General Electric Capital Corporation on the guaranty paid Heller, less any subsequent recoveries, for loan number 8875783009.

District Office Comments

The Fresno District Office [FOIA Ex. 5].

Evaluation of District Office Comments

The District Office comments and proposed action is responsive to the recommendation. The recommendation was modified accordingly.

Lender Comments

The lender did not provide comments to the draft report in time for inclusion in this report.

SBA
U.S. Small Business Administration

U. S. SMALL BUSINESS ADMINISTRATION
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Appendix A

DATE: January 2, 2002

FROM: Antonio Valdez
District Director

TO: Donald R. Ward
Auditor, OIG

SUBJECT: Audit of Darshan's Paradise Inn
#8875783009

It is our understanding that the objective of the audit of the above-named firm was to determine if Heller originated, disbursed and liquidated the loan purchased by SBA in accordance with SBA rules and regulations.

The IG's findings would indicate that Heller did not secure the loan with all available property/collateral as required by SOP 50 10 (3), Chapter 2-16. You also indicated the $333,000 loan was secured with only $259,000 in collateral, leaving the loan undersecured by $74,202.

We have no issue with your analysis of the available properties listed in the guarantor's financial statement. However, we might add that the SOP section cited also indicates that..."when collateral is insufficient to secure the loan request, other factors, such as strong indication of repayment ability and /or managerial ability, can offset this deficiency." The lender's analysis would indicate that the "discounted collateral coverage" was offset by the cashflow of the motel. However, the cashflow was built upon the representation that certain "renovations" were done to the subject property over the years, (1992, 1993, 1994) and expensed. It does not appear reasonable that "improvements" would be added back to the cash flow model on a yearly basis, which coincidentally provided the cash flow coverage the business needed. In fact, without these yearly expenses, the model does not support repayment at all. A review of the appraisal done in 1995 for Heller on the subject property does not support the notion of the value of improvements, going on to say...."There are no improvements, renovations, etc which would materially increase the property value as of the appraisal date."

We find suspect the lender's representation of on-going renovations not supported by the lender's own appraisal. This diminishes the cashflow model the lender used to mitigate taking additional collateral to strengthen the subject loan. [

FOIA EX. 5

]

Antonio Valdez
District Director
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Appendix B

AUDIT REPORT DISTRIBUTION

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Compliance Manager GE Capital Small Business Finance, Inc.	1