AUDIT OF

AN EARLY DEFAULTED LOAN TO

[FOIA Exemption 4]

Dallas, Texas

AUDIT REPORT NUMBER 4-26

June 22, 2004

AUDIT REPORT
ISSUE DATE: June 22, 2004
REPORT NUMBER: 4-26

To: James E. Rivera
           Associate Administrator for Financial Assistance

From: Robert G. Seabrooks [FOIA Exemption 6]
           Assistant Inspector General for Auditing

Subject: Audit of an Early Defaulted Loan to [FOIA Exemption 4]

   Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to your office. Your response to the draft audit report is included in Appendix A of this report.

   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 recommendations contained in the report should be directed to Garry Duncan, Director, Credit Programs Group, at (202) 205-[FOIA Exemption 2].

Attachments

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TABLE OF CONTENTS

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 guarantied loans. SBA 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. SBA is released from liability on the guaranty, in whole or in part, if the lender fails to comply materially with any of the provisions of the regulations, the loan authorization, or did not make, close, service, or liquidate the loan in a prudent manner.

Bank United (lender) was authorized by SBA to make guarantied loans under the Preferred Lender's Program (PLP). Preferred lenders are allowed to process, close, service, and liquidate SBA loans with reduced requirements for documentation and prior approval by SBA. In February 2001, the lender was acquired by Washington Mutual Bank.

In January 2000, the lender approved a PLP loan (number [FOIA Exemption 4]) for $1.2 million to [FOIA Exemption 4] (borrower). The purpose of the loan was to provide funds for the purchase of an existing convenience store/gas station in Dallas, Texas. The loan was disbursed on March 2, 2000. The borrower defaulted on the loan in November 2001. SBA reached an agreement with the lender for a 23 percent guaranty repair totaling $235,008.

AUDIT OBJECTIVE AND SCOPE

The objective of the audit was to determine if the lender originated, disbursed, and liquidated the loan in accordance with SBA rules and regulations. The loan was judgmentally selected for review as part of the Office of Inspector General's ongoing program to audit SBA loans charged off or transferred to liquidation within 24 months of origination (early default). SBA and lender loan files were reviewed and district office personnel were interviewed. The audit was accomplished during April through September 2003 in accordance with generally accepted Government Auditing Standards.

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RESULTS OF AUDIT

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FINDING   The Lender made an SBA Loan to an Ineligible Borrower

The lender did not use prudent lending procedures to process a Section 7(a) loan to the borrower. The lender's failure to verify the residency status of a non-United States citizen resulted in the approval of an SBA loan to an ineligible borrower. In addition, the lender did not ensure that the total equity injection was made nor verify the accuracy of provided financial information. As a result, SBA made an improper payment of $235,008 when the loan guaranty was repaired.

Residency status

The lender approved a 20 year, $1.4 million, SBA loan to a borrower who was a non-immigrant alien[1]. The borrower was ineligible for the loan because he could not legally remain in the United States long enough to repay the SBA loan.

A review of the borrower's January 25, 2000, Statement of Personal History revealed that he was not a U.S. citizen. Also, his VISA, which expired 9 days before the Personal History Statement was signed, showed him to be a non-immigrant alien. Further, the lender loan file showed his petition to work in the United States was approved only through September 2000. According to SOP 50 10(4) Subpart A, the lender must verify residency status to ensure the principal can legally remain in the United States to conduct business. Additionally, the owner's residency status must provide the right to remain in this country for at least half of the maturity of the approved loan (in this case 10 years). Since the lender did not properly verify the residency status of the borrower, an SBA loan was approved to an individual who could not lawfully remain in the country to conduct business and repay the loan.

Equity injection

The lender did not comply with the Loan Authorization Agreement to obtain evidence that the borrower had made the required equity injection. The agreement stated that prior to loan disbursement, the lender must have evidence that the borrower had injected $375,000 from personal funds into the business. A review of the loan file, however, indicated that the borrower only injected $201,000.   Inadequate equity injection can result in excessive debt, placing unreasonable demands on a company's ability to develop sufficient cash flow to service the debt.

Verification of financial information

The lender had not obtained Internal Revenue Service verification of the business' tax returns. The lender did not require the applicant to execute an IRS Form 4506 in order to obtain Federal

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[1] **According to the U.S. Department of Justice, non-immigrant aliens are generally admitted to the U.S. on a temporary basis, most often as a tourist.**

tax information to validate the financial information submitted by the business. According to SOP 50 10(4), Subpart A, the accuracy of the financial statements relied upon in making a credit decision that repayment ability exist, must be verified through the tax verification process. Not properly verifying the financial information submitted by the seller, could compromise the quality and accuracy of the analysis provided to the applicant, resulting in the inability to repay the loan.

Justification for the loan repair

The Dallas/Fort Worth District Office reached an agreement with the lender for a 23 percent guaranty repair totaling $235,008. The repair was justified based on the following factors:

- the borrower's appraisal was faulty resulting in a 100 percent financed acquisition,
- the lender failed to obtain a Standby Agreement for the equity injection, and
- the source of some equity injection was questionable.

Based on these factors plus the discrepancies noted in our audit report, the District Office should have either obtained a 100 percent repair or processed a full denial of the guaranty.

RECOMMENDATION

We recommend that the Associate Administrator for Financial Assistance take the following action:

1. A   Seek recovery of the SBA guaranty repair of $235,008 paid to the lender for loan number [FOIA Exemption 4].

Management Comments

The Office of Financial Assistance agreed with the recommendation to seek recovery of the SBA guaranty. The Office is requesting that the lender provide a full refund of the guaranty within 20 days. If the lender fails to comply, the matter will be referred to the Office of General Counsel.

Evaluation of Management Comments

The Office of Financial Assistance comments are responsive to the recommendation.

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

DATE: June 16, 2004

TO: Robert G. Seabrooks, Assistant Inspector General for Auditing

FROM: FOIA Ex. 6
James W. Hammersley, Acting AA/PM

SUBJECT: Audit of SBA Guaranteed Loan
           Loan: Ex. 4
                     PLP   Ex. 4
           Lender: Washington Mutual Bank (loan originated by Bank United)
                     Houston, Texas

We have reviewed the Office of Inspector General (OIG) March, 2004 draft audit report for this loan that recommends full recovery of the guaranty payment of $235, 008. The basis for the OIG recommendation is that lender made an SBA loan to an ineligible borrower, failed to obtain evidence that the borrower had injected the required amount of $375,000 from personal funds into the business, and not verify the financial information submitted by the seller by requiring the applicant to execute an IRS Form 4506 in order to obtain federal tax information to validate the financial information submitted for the business.

The Dallas/Fort Worth District Office reached an agreement with the lender for a repair of $235,008. Nevertheless, we are requesting that the lender respond to the audit findings and provide a full refund of the guaranty payment within 20 days. If the lender fails to comply, we will refer the matter to the Office of General Counsel for a review of the adequacy of the legal grounds to proceed with enforced collection against the lender.

AUDIT REPORT DISTRIBUTION

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Capital Access.. 1

General Counsel 3

Associate Administrator for
 Field Operations 1

Office of Chief Financial Officer
 Attn: Jeff Brown.. 1

General Accounting Office 1