

AUDIT OF
AN EARLY DEFAULTED LOAN TO
[FOIA Ex. 4]
Fort Worth, Texas
AUDIT REPORT NO. 4-29

The finding in this report is the conclusion of the OIG's Auditing Division based on testing of SBA operations. The finding and recommendation is subject to review, management decision, and corrective action in accordance with existing Agency procedures for follow-up 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.



**US Small Business Administration
Office of Inspector General
Washington, DC 20416**

AUDIT REPORT
ISSUE DATE: JULY 12, 2004
REPORT NUMBER: 4-29

To: James E. Rivera
Associate Administrator, Office of Financial Assistance

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

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

Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to your office. Your response is synopsised in the report and included in its entirety at Attachment 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 discussions of the finding and recommendation contained in the report should be directed to Garry Duncan, Director, Credit Programs Group, at 202-205-[FOIA Ex. 2].

Attachments

**AUDIT OF AN
EARLY DEFAULTED LOAN TO
[FOIA Ex. 4]**

Fort Worth, TX

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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 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 a loan guaranty, in whole or in part, within SBA's exclusive discretion, if a lender failed to comply materially with SBA regulations, the Loan Authorization, or did not make, close, service, or liquidate a loan in a prudent manner.

Bank United (lender) was acquired by Washington Mutual Bank in February 2001. The Preferred Lenders Program (PLP) allowed the lender to process, close, service, and liquidate SBA loans with reduced requirements for documentation without prior approval by SBA. In October 2000, Bank United processed a \$1 million SBA loan (number [FOIA Ex. 4]) to [FOIA Ex. 4] (borrower). The proceeds were for the purchase of an existing convenience store/gas station in Fort Worth, Texas. Zions First National Bank of Salt Lake City, Utah, held the senior lien position on this property with a \$540,000 loan. The balance of the project was to be funded by an owner's equity injection of \$265,000 and a standby loan from the seller. Loan proceeds were disbursed in November 2000 and January 2001. The loan was placed in liquidation status in August 2001.

AUDIT SCOPE AND OBJECTIVE

The audit objective was to determine if the early loan default was caused by lender or borrower noncompliance with SBA requirements. We reviewed SBA and lender loan files and interviewed district office and lender personnel. 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). The audit was performed in Dallas, Texas during July 2002, through December 2003, in accordance with generally accepted Government Auditing Standards.

RESULTS OF AUDIT

Finding **The Lender did not Comply with SBA Loan Guidance**

The lender did not follow SBA guidance and prudent lending practices when it approved and closed a loan to the borrower. The lender did not: i) validate the source of the borrower's equity injection; ii) use proper appraisal methods; iii) adequately examine the borrower's credit reports; or iv) verify the borrower's management qualifications. In addition, SBA's purchase review did not consider the borrower's repayment ability or credit worthiness. As a result, SBA repaired the loan guaranty by accepting \$373,760 (50 percent of the guaranty) from the lender.

The Lender did not validate the source of the borrower's equity injection

The lender did not validate the source of the borrower's equity injection to ensure that it was legitimate. The Authorization and Loan Agreement required the lender to obtain evidence prior to loan disbursement that at least \$265,000 had been injected into the business. According to the lender's memo, on November 6, 2000, the borrower indicated that the sources of the equity injection were \$100,000 from an inheritance from his grandfather in Pakistan, an \$85,000 gift from his father, and \$80,000 from the sale of an 18-wheel tractor-trailer jointly owned by the borrower and his father. The borrower stated that these funds had been deposited into his bank account.

As support for the equity injection, the lender accepted questionable documentation in the form of two cashier's checks for \$235,000 and \$50,000 and a letter from the borrower's bank verifying the checks were deposited into the borrower's account.

During the audit, the OIG subpoenaed the bank records for both cashier's checks in order to determine the actual source of the borrower's equity injection. Bank records showed:

- The source of funds used for the borrower's \$235,000 cashier's check, drawn on Landmark Bank, was a November 6, 2000, wire transfer from the seller of the business (New Texas Petroleum, LLC). The borrower subsequently returned the funds to the seller on November 7, 2000.
- The source of the borrower's \$50,000 cashier's check from Bank of America was a check from the loan broker. A typical arrangement would have the borrower compensating the broker of the loan. Therefore, it would be expected that the borrower would eventually repay the broker for the \$50,000 that was used as proof of an equity injection.

The lender's vice president prepared a memo dated November 7, 2000, in which the various sources of the equity injection were discussed. In the memo, the vice president stated that the borrower's account balance had been verified to ensure that sufficient funds were

available to make the injection. Additionally, the vice president noted that the account transaction history should be verified to validate the sources of the funds. Had this task been performed as stated (there is no documentation in the file which confirms or denies whether it was performed), the vice president would have discovered that the sources of the equity injection were not those stated by the borrower, but instead were inappropriately obtained from the seller and loan broker. This resulted in an inappropriate equity injection of \$285,000. The SBA district office, in its pre-purchase review in September 2002, stated that the equity injection was questionable and may never have existed. The misrepresentation of sources would have provided cause to disqualify the borrower had the lender verified the actual sources of the equity injection as required by the Loan Authorization Agreement.

Property appraisal

The lender did not use an acceptable method to appraise the property being acquired with the loan proceeds. Standard Operating Procedure (SOP) 50-10(4) (E) states that when a real estate transaction or the estimated value of the real estate collateral is over \$1 million, a “complete appraisal” must be performed. A “complete appraisal” includes three methods of valuation (comparable sales, cost, and income). The two appraisals obtained by the lender did not qualify as a “complete appraisal”. The appraisals, dated January and September 2000, identified market and going concern values. These appraisals did not meet the “complete appraisal” requirement of the SOP. Further, the loan authorization required that the property be appraised with a market value of at least \$1.66 million. The two appraisals obtained by the lender reported market values of only \$1.35 million and \$1 million, respectively. The lender prepared July 2001 liquidation plan included a “complete appraisal” showing that the property had a market value of only \$875,000.

Analysis of the borrower’s credit

Code of Federal Regulations section 120.150 states that loan applicant’s credit history must be considered when determining the applicant’s creditworthiness. The lender did not identify the borrower as a high-risk creditor or address the apparent irregular actions taken by the loan packager to improve the borrower’s credit score. The Loan Officer’s Report cited a satisfactory credit rating based on the credit report provided by the loan packager.

The packager’s initial credit investigation was first performed in July 2000 using the loan principal’s Social Security Number (SSN). That investigation resulted in an unacceptable credit score (high risk). The loan packager then requested a second credit investigation that was performed in August 2000. For this investigation, the packager provided two SSNs– the borrower’s and an individual that was not a loan principal. The use of the second SSN resulted in a credit score that improved the borrower’s classification from high risk to a medium risk. The lender’s file did not include an explanation of why the two SSNs were used on the August credit report. An adequate validation of the credit reports should have resulted in the lender denying the loan since the borrower was a high credit risk.

Borrower’s management experience

The lender did not adequately resolve several inconsistencies relating to the borrower's management experience as reported on his loan application. Specifically, the borrower stated that he had worked as the manager of a Subway Restaurant for two years. In a recent application for a life insurance policy, however, the borrower reported that he had been a truck driver for the previous five years. The lender stated in its loan officer's report that the management experience obtained through his position at Subway was a reason for expected success of the business. The borrower also reported on his application for life insurance that he had an annual income in 1999 of \$60,000. This figure does not agree with his 1999 Federal Income Tax Return which indicated that his entire income of \$5,980 was from unemployment compensation.

Pursuant to SOP 50 10(4) (B), when assessing management ability, the lender must independently assess and evaluate the applicant's management ability. The lender did not question the inconsistencies associated with the borrower's loan application. The borrower's inexperience could have been a factor which contributed to the failure of the business.

Potential SBA Loss

During the course of the audit, SBA reached an agreement with the lender for a 50 percent repair of \$373,760. SBA's justification for the repair was that the original lender's lack of prudent lending practices had contributed to the loss. Specifically, i) the going concern appraisal was faulty and overstated the real value of the business being sold, which resulted in an essentially 100 percent finance acquisition, ii) the experience of the owner appeared to have been limited and may have contributed to his failure, and iii) the source of the borrower's equity injection was questionable and may never have existed. In our opinion, however, the district office should have either obtained a 100 percent repair or processed a full denial of the guaranty because of the factors discussed above including the questionable equity injection, the repayment ability issue, and the credit worthiness of the borrower.

RECOMMENDATION

We recommend that the Associate Administrator, Office of Financial Assistance take the following action:

- 1A.** Seek recovery of an additional \$373,760 from the lender for loan number [FOIA Ex. 4].

Associate Administrator, Office of Financial Assistance (AA/OFA) Comments

The AA/OFA agreed in general with the recommendation in that the lender will be required to repay \$111,240. The Office of General Counsel will be requested to provide an opinion as to whether any additional recovery is possible. Regarding the elements of the finding, AA/OFA:

- Agreed the lender did not identify the borrower as a high-risk creditor.

- Agreed the lender did not adequately resolve several inconsistencies relating to the borrower's management experience as reported on his loan application.
- Agreed the lender did not use an acceptable method to appraise the property being acquired with the loan proceeds. However, management cites a violation of the loan authorization in regard to required market value whereas the OIG concluded the lender did not use a complete appraisal to substantiate the value of property.
- Agreed that a reasonable explanation was not given for the reduction in cost of goods sold, but states that an apparent overstatement of "other expenses" offset the adjustment.
- Agreed the lender did not validate the source of the borrower's equity injection, however, stated neither the loan authorization nor SBA policy required such verification.

Evaluation of AA/OFA Comments

The AA/OFA comments are generally responsive to the recommendation. We will evaluate any action to recover the balance of the amount recommended during the audit follow up process.

- Regarding the appraisal, we agree with AA/OFA's conclusion that a violation of the loan authorization occurred and that the lender should be required to repay \$111,240. However, Standard Operating Procedures do require a "complete appraisal" when real estate transactions exceed \$1 million. Accordingly, our report was not modified.
- We agree with AA/OFA's position that the overstatement of "other expenses" offset the adjustment made to cost of goods sold in the projected cash flow analysis. Based on further analysis of the cash flow projections, this section was removed from the report.

Regarding equity injection, we agree that neither the loan authorization nor SBA policy required the lender to verify the source of cash injection. However, upon realizing the possible absence of available equity, a prudent lender should have verified the sources of the funds. Accordingly, we have not modified our report.



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

Appendix A
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Redacted for FOIA

DATE: June 25, 2004

TO: Robert G. Seabrooks, Assistant Inspector General for Auditing
FOIA Ex. 6

FROM: James W. Hammersley, Acting AA/PM

SUBJECT: Draft Audit of SBA Guaranteed Loan
Loan: Ex. A - Fort Worth, TX
PLP Ex. 4
Lender: Washington Mutual Bank (loan originated by Bank United)

We have received the Office of Inspector General (OIG) February 4, 2004, memorandum and accompanying draft audit report for this loan that recommends recovery of an additional \$373,760 from the lender for the above referenced loan. We have reviewed the audit report and agree that there were sufficient deficiencies in the lender's handling of the origination of the loan to support a substantial adjustment of the guaranty purchase amount. As you indicate in your report, the district office reduced by 50 percent the amount paid under SBA's guaranty. We question whether there is a sufficient legal basis for SBA to now proceed against the lender because of the settlement reached by the district office, except possibly for a recovery of \$111,240 as indicated below. Consequently, we have requested that the Office of General Counsel provide a legal opinion addressing the sufficiency of the grounds to pursue enforced recovery from the lender. When we review this legal opinion, we will determine what additional recovery from the lender should be pursued.

The audit report indicates that the lender did not validate the source of the borrower's equity injection, and we agree that this was not done. The loan authorization required prior to disbursement that at least \$265,000 cash had been injected into the business. The authorization stated that the borrower may obtain this cash from personal resources or from a loan placed on standby. The lender did verify the equity injection through copies of cashier's checks and a letter from the borrower's bank verifying that the checks were deposited in the borrower's account, but the lender did not further verify the source of this cash. However, neither the loan authorization nor SBA policy required that the lender verify the source of the cash injection.

The audit report next questions the lender's credit analysis with regard to the borrower's repayment ability since there was no justification provided for the reduction in the cost of goods sold (COGS) to 56 percent from the historical average of 67 percent, compared with total sales. Although no explanation was provided for the reduction in COGS, we note that the category entitled "Other Expenses" nearly doubled in the borrower's projections. If the average for the previous three years for "Other Expenses" (15.2 percent) had been used in the cash flow projections instead of the increased amount of 24.7 percent, there would have been adequate cash flow to cover the SBA loan even if the projections had used 67 percent for COGS instead of 56 percent. Consequently, we do not consider the cash flow analysis considered as a whole to be sufficiently inadequate to justify a denial of liability.

The audit report further contends that the lender did not use a "complete appraisal" consisting of three methods of valuation (comparable sales, cost and income) to substantiate the value of the property being acquired with the loan proceeds. It is our view that the market value and income methods are the most important methods of determining the value of a convenience store. The fact that the cost method was not considered by the lender, while deficient, is not a reason to deny liability. However, the loan authorization required prior to disbursement that the lender must obtain an appraisal on the real property showing a market value of at least \$1,660,000. This was not done. The two appraisals obtained by the lender showed market values of \$1.35 million and \$1 million, for an average of \$1.175 million. This deficiency would have supported a guaranty adjustment of \$485,000 instead of the \$373,760 negotiated by the district office. Consequently, we believe that the lender should be required to repay \$111,240.

The lender's failure to resolve inconsistencies in the applicant's credit history and management experience may provide additional evidence of the lender's deficient handling of the origination process were this case to be litigated.

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