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

AUDIT REPORT
ISSUE DATE: July 30, 2004
REPORT NUMBER 4-33

To: James E. Rivera
Associate Administrator for Financial Assistance

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

Subject: Audit of a SBA Guarantied Loan to [FOIA Ex. 4] and [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 synopsized 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 discussion 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 A SBA GUARANTIED LOAN TO

[FOIA Ex. 4]**. AND**

[FOIA Ex. 4]

[FOIA Ex. 4]**, MASSACHUSETTS**

AUDIT REPORT NO. 4-33

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 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.

AUDIT OF A SBA GUARANTIED LOAN TO
[FOIA Ex. 4] **AND**
[FOIA Ex. 4]

[FOIA Ex. 4]**, MASSACHUSETTS**

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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. Loans are made by participating lenders under an agreement to originate, service, and liquidate loans in accordance with SBA regulations, polices, and procedures. SBA is released from liability to purchase a loan guaranty, in whole or in part, within SBA's exclusive discretion, if a lender fails to comply materially with SBA regulations, the Loan Agreement, or does not make, close, service, or liquidate the loan in a prudent manner.

First International Bank (lender) was authorized by SBA to make guarantied loans under the Preferred Lender's Program (PLP). PLP lenders are permitted to process, close, service, and liquidate loans with reduced requirements for documentation review and prior approval by SBA.

On March 27, 2000, the lender approved a $480,000 SBA loan (number [FOIA Ex. 4]) to [FOIA Ex. 4], an Eligible Passive Company (EPC)[1], and two operating companies: [FOIA Ex. 4] (borrowers). The purpose of the loan was to reimburse the borrowers for the costs associated with leasehold improvements. The borrowers defaulted in January 2001. SBA purchased the loan guaranty of $362,207 in April 2001.

AUDIT OBJECTIVE AND SCOPE

The audit objective was to determine if the lender and borrower materially complied with SBA's requirements to originate, close, and liquidate the loan. 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). We reviewed SBA's and the lender's loan files for compliance with requirements found in SBA's rules and regulations and the loan authorization. We also interviewed SBA and lender personnel. The audit was performed in accordance with generally accepted Government Auditing Standards.

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1 An EPC does not engage in regular and continuous business activity, but leases real or personal property to one or more operating companies for use in the operating companies' business. The EPC must use loan proceeds to acquire or lease, and/or renovate, real or personal property (including eligible refinancing) that it leases to the operating company.

RESULTS OF AUDIT

Finding 1: The Lender did not Comply with SBA Loan Guidelines

The lender did not have adequate documentation to support 96 percent of the leasehold improvements reimbursed with loan proceeds. The lender also allowed the EPC to charge rent above the limit permitted under SBA regulations. As a result of these violations, SBA is entitled to recover from the lender $362,207 paid to purchase the guaranty on the loan from the secondary market.

Proof of Leasehold Expenditures

The EPC purchased a facility in 1999, which required extensive renovation before it could be occupied. According to the loan officer's report, the renovation (leasehold improvements) was paid from the working capital of the two operating companies. After the renovation was completed, the lender approved a SBA guarantied loan to reimburse the borrowers for the leasehold improvement expenses. In accordance with the loan authorization, the lender was required to obtain documentation that loan proceeds were used for the purposes stated. Documentation would include a completed contract, paid invoices, cancelled checks, and/or inspection reports.

After the borrowers defaulted on the loan and the loan guaranty was purchased from the secondary market, the District Office began its post purchase review by requesting the lender to provide supporting documentation for the use of proceeds. In response, the lender stated in a letter that "***There is no evidence of use of proceeds outside of the documented settlement statements.***" After additional correspondence with the District Office, the lender provided copies of the following documents to support the cost of the leasehold improvements:

- A 1999 appraisal indicating "as is" and "as completed" values;
- a budget of completed, ongoing, and to be completed leasehold improvements used by the appraiser;
- 1998 financial statements indicating the dollar value of leasehold improvements; and
- 1999 financial statements indicating an increase in the dollar value of leasehold improvements.

The District Office notified the lender that the information provided was insufficient to support the majority of the leasehold expenditures claimed or that the renovations were completed. The District Office was able to validate only $19,890 (4 percent) of the $480,000 leasehold improvements.

Furthermore, information found in the lender's files indicates that the borrowers acted as their own contactor. Pursuant to SOP 50 10(4), SBA generally does not allow "do-it-yourself" construction or installation of machinery and equipment. Nor is the borrower permitted to act as the contractor unless the project is small compared to their financial resources or the applicant is a qualified contractor. The District Office Counsel concluded that the applicant did not qualify to act as its own contractor.

Excessive Lease Payments

[FOIA Ex. 4] was an EPC who owned the facility occupied by the operating companies. In accordance with SBA policies for EPC loans, the lease payments received from the operating companies were used by the EPC to repay the SBA loan. The lease payments, however, greatly exceeded the amount needed to repay the loan in violation of SBA procedures. SOP 50 10(4), Chapter 2, provides that an EPC cannot charge lease payments in excess of the SBA loan payments, except for additional amounts to cover such costs as maintenance, insurance, and property taxes. The SOP further provides that **"…***to permit the EPC to charge a rate of rent in excess of the loan payment would qualify the property as investment real estate which is prohibited by 13 CFR 120.110(c)."*

The operating companies annual lease payments totaled $231,192, excluding real estate taxes which were the responsibility of the operating companies. The EPC's annual guarantied loan and mortgage payments were only $151,372. Consequently, the lease payments exceeded the allowable limit under SBA rules by $79,820 ($231,192 - $151,372). Furthermore, the lender had a copy of the lease agreement in its files but took no apparent action to ensure that the terms of the agreement complied with SBA policies and procedures. As a result of the excessive payments, cash flow was reduced which may have contributed to the failure of the operating companies.

Therefore, in accordance with SBA Policy Notice 500-831, "7(a) Loan Guaranty Purchase Policy," SBA should seek full recovery of the guaranty based on the lender's failure to *"…comply with an SBA lending requirement in making or closing the loan, which placed the Agency at financial risk."*

Recommendation

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

1. Recover from the lender $362,207 paid to purchase the guaranty on loan number [FOIA Ex. 4].

Management Response

The Acting Associate Administrator for Portfolio Management (AA/PM) agreed that the lender did not adequately address leasehold expenditures and payments. He indicated that a final response to the audit recommendation would be provided after the lender is given the opportunity to furnish additional information.

OIG Evaluation of Response

The AA/PM did not take a position regarding the recommendation to seek recovery. As noted in the audit report, the borrower advised the district office during the guaranty purchase review that all documents had been provided. Consequently, we do not believe additional supporting documentation will be forthcoming. We will evaluate any action to recover the amount recommended during the audit follow up process.

Appendix A

Redacted for FOIA

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, DC 20416

DATE: July 13, 2004

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

FOIA Ex. 6

FROM: James W. Hammersley, Acting AA/PM

SUBJECT: Audit of SBA Guaranteed Loan

Loan:

FOIA Ex. 4

PLF

Lender: First International Bank
(loan now held by UPS Capital Business Credit)

We have received the Office of Inspector General (OIG) May 19, 2004, memorandum and accompanying draft audit report for this loan that recommends full recovery of the guaranty payment of $362,207, less any subsequent recoveries. The main reason for the OIG recommendation is that the lender did not materially comply with SBA policies and procedures when originating the loan.

Since the lender did not adequately address the proof of leasehold expenditures and excessive lease payments in the loan application or following the loan purchase by the SBA, we believe it is appropriate to allow the lender the opportunity to review and address the inconsistencies and provide any additional information or documentation pertaining to the matter. Therefore, we have requested that the lender respond to the audit findings within 20 days. When we receive the lender's response, we will provide a further reply with regard to the audit findings.

Appendix B

AUDIT REPORT DISTRIBUTION

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