

DATE: January 31, 2005

TO: Herbert L. Mitchell
Associate Administrator
for Disaster Assistance

FROM: **/s/ Original Signed**
Daniel J. O'Rourke
Assistant Inspector General
for Investigations

SUBJECT: Advisory Memorandum (Report #5-10)
[FOIA Ex. 4]

The Office of Inspector General (OIG) is reviewing defaulted disaster assistance loans. Our review of one such loan revealed problems that we believe merit a change to section 21e of the disaster loan application.

BACKGROUND

[FOIA Ex. 6] (the principals) applied for a \$50,000 Economic Injury Disaster Loan (EIDL) for [FOIA Ex. 4] (the borrower) in November 2001, claiming economic injury as a result of the terror attacks on September 11, 2001. The loan was approved on December 3, 2001; on February 16, 2002, the loan amount was increased to \$124,300. The loan is in default, and at the time of our review, the borrower was making interest-only payments.

DETERMINING THE FEDERAL TAX DELINQUENCY OF A BUSINESS

According to the SBA Disaster Assistance Program Standard Operating Procedure # 50 30 5 (paragraph 76, section J), potential borrowers with a federal debt with the IRS for which there is not a valid and current repayment plan are not eligible to receive an EIDL. The disaster loan application (see attached) requires borrowers to accurately represent the financial position of the business, but does not directly ask if the *business* itself has any delinquent Federal taxes. Section 21e of the application does ask if the *business' management* has delinquent Federal debt. As the following discussion of the underlying facts of this loan make clear, other methods that SBA disaster staff rely upon to identify business tax delinquencies do not provide adequate protection to the agency.

In this particular case, in December 2002 (approximately a year after the loan was disbursed), SBA learned that the borrower had a \$6,003 Federal tax delinquency dating from tax year 2000 and declined to authorize additional financing. The SBA-OIG investigation revealed that the borrower did not have a valid repayment plan prior to September 11, 2001, for the \$6,003 tax delinquency, thus making it ineligible to receive the EIDL.

Borrowers certify on their SBA loan application that “all financial statements submitted with the application fully and accurately present the financial position of the business.” However, the \$6,003 tax debt was not explicitly disclosed anywhere in the financial documents submitted by the principals of the business.

The SBA loan officer who worked on the loan advised that the principals should have disclosed the business’ IRS debt on their Schedule of Liabilities, a required document that asks the borrower to disclose all “Notes, Mortgages, and Accounts Payable.” The Schedule of Liabilities is intended to “balance the liabilities presented” on the borrower’s Balance Sheet. However, the file for this particular loan does not contain a Schedule of Liabilities. When informed of this, the loan officer advised that the principals should have also disclosed the IRS debt on either their Balance Sheet or their Statement of Income and Retained Earnings, both of which were submitted as part of the loan application. While the Balance Sheet reflects “Miscellaneous” liabilities in the amount of \$7,500, it does not explicitly list the IRS delinquency.

The Loan Officer’s Report (LOR) should have provided another avenue for disclosing the firm’s Federal tax liability. However, the LOR indicates that the company had no fixed debt. The loan officer advised that the LOR is written based on the financial documents submitted by the principals and/or statements made directly to the loan officer. The correspondence log does not reflect a conversation between the loan officer and the principals about fixed debt. The loan officer could not recall whether or not he relied solely on the financial documents submitted by the borrower in making the statement about borrower’s debt.

In summary, the disaster loan application requires borrowers to accurately represent the financial position of the business, but does not directly ask if the *business* has any delinquent Federal taxes. Yet, the application does ask if the *business’ management* has delinquent Federal debt in section 21e. The required supplemental document in which the debt should have been disclosed (the Schedule of Liabilities) is not in the file, which did not stop the loan from being processed and approved. The principals listed liabilities on their Balance Sheet in excess of \$6,003, but the liabilities were not identified and it appears that the loan processing staff did not follow up to obtain more information about these liabilities. Moreover, SBA did not receive verification of the applicant’s tax returns prior to disbursing the loan, although the transcripts were requested using an IRS Form 8821.

If the disaster loan application had directly asked if the *business* itself had any delinquent Federal taxes, then a truthful answer from the principals might have prevented the loan from having been made in the first place, and thus the default. Conversely, a false answer to the question would likely have resulted in the U.S. Attorney deciding to prosecute. The actions of the SBA loan processing staff also contributed to the U.S. Attorney’s decision to decline prosecution. This is

one of several recent cases in which the lack of clarity of the questions asked on the disaster loan application has presented problems in prosecuting such cases.

WARNING SIGNS IGNORED

During the origination and processing of this loan, SBA did not question the borrower's representations despite the appearance of two major warning signs: discrepancies about [FOIA Ex. 4] ownership and a principal's failure to disclose civil and county tax judgments. It is understandable that the pressures of originating and processing many loans quickly can result in errors. However, in this case, the inconsistencies were significant, as shown below.

Ownership/Guarantor Issues

The loan application indicates that the ownership was split between the two principals at the time of application, with each owning 50 percent. Both were co-guarantors on the loan. The LOR indicates the loan officer was told that [FOIA Ex. 6] sold [FOIA Ex. 6] his 50 percent ownership in 1999. However, the borrower's 2000 tax return, which the LOR indicates was provided to SBA with the loan application, reflects that [FOIA Ex. 6] owned 100 percent of the business. This discrepancy was not noted by SBA reviewers and the loan was disbursed. The issue of ownership, however, should have been significant to the processing staff because, in an interview with the OIG, the loan officer who processed the loan advised that [FOIA Ex. 6] was necessary as a guarantor because he had an excellent credit history, which balanced [FOIA Ex. 6] poor credit history.

Actions by disaster assistance staff after the loan was closed reflected additional confusion. On December 10, 2001, shortly after the initial \$50,000 disbursement, [FOIA Ex. 6] requested that SBA remove [FOIA Ex. 6] as a guarantor, stating that [FOIA Ex. 6] had reduced his 50 percent ownership interest to 19 percent. The request was repeated on December 15, 2001, and again on December 27, 2001. Each of these requests was denied, presumably due to the LOR which stated that "both owners would be required as guarantors on any proposed SBA loan."

On February 7, 2002, [FOIA Ex. 6] contacted a second SBA loan officer, and again requested to have [FOIA Ex. 6] removed as a guarantor, stating that he was previously told by an SBA attorney that removing [FOIA Ex. 6] after the loan was made would not be a problem. SBA denied the request, stating "the credit history of [FOIA Ex. 6] was a major factor in approving the loan . . . and deleting this guarantor would significantly alter the credit basis for this approval."

On February 16, 2002, the Note was modified and increased to \$124,300. Despite SBA's earlier written statements concerning [FOIA Ex. 6] importance as a guarantor and the disbursement of additional disaster loan funds, [FOIA Ex. 6] was removed as a guarantor on March 13, 2002. On the SBA Form 913 approving [FOIA ex. 6] removal as a guarantor, the loan officer (who was different from the two previous loan officers) wrote "Request is reasonable and

deletion of [FOIA Ex. 6] is warranted. Repayment ability is still reasonably assured and collateral is still adequate to secure the loan.”

In conclusion, SBA failed to note the discrepancy between the statement on the loan application (and [FOIA Ex. 6] verbal explanation) of the ownership structure and the ownership representation on the business’s 2000 tax return. This error was compounded when SBA reversed its previous decision concerning the release of [FOIA Ex. 6] as a guarantor, despite having documented in writing on two different occasions the importance of [FOIA Ex. 6] as a guarantor.

Non-Disclosure of Judgments

[FOIA Ex. 6] failed to disclose four civil judgments and one county tax judgment on the loan application. Section 21b requires the borrower to certify that each individual listed in item 20 “[h]as no outstanding judgments, tax liens, or pending lawsuits against them . . .”. The file reflects that SBA learned about the judgments prior to loan disbursement from a Dun & Bradstreet report but received satisfactory explanations from the borrower prior to loan approval. Given the number of judgments, the borrower’s failure to disclose the judgments raises the suspicion that the omission of this information was fraudulent. When there is a suspicion of fraud by an applicant, loan processing staff should undertake heightened scrutiny of the loan application. Had they done so in this case, the discrepancy concerning business ownership in the application may have prevented the loan from being approved.

CRIMINAL PROSECUTION

The issues described above were presented to the U.S. Attorney’s Office in Buffalo, NY, for prosecutive consideration. As a result of deficiencies in the disaster loan application form itself and SBA’s actions in processing the loan, the case was declined for criminal prosecution.

RECOMMENDATIONS

1. Section 21 of the Disaster Loan application asks a series of questions concerning the management of the applicant business. As a result of the application’s language, however, a borrower whose business has a delinquent tax debt would not have to answer “Yes” to section 21e. This question only asks if *individuals* listed in section 20 are delinquent on any federal taxes, loans, contracts, etc. We recommend that the Associate Administrator for Disaster Assistance (AA/DA) change the language of section 21 to include the *business* itself, as well as the individuals.
2. In accordance with SOP # 50 30 5, we recommend that the AA/DA instruct loan officers to not originate any disaster assistance loan for which there remains material discrepancies in the information provided by the business’ principal(s). Furthermore, we recommend that any actions taken to address discrepant issues should be thoroughly documented in the loan file.
3. We recommend the disaster loan processing staff receive training from the OIG on identifying fraud indicators, and be instructed (or reminded) that if there is a suspicion of fraud by an

applicant, the staff should give the entire application a heightened level of scrutiny and refer the matter to the OIG, when appropriate.

4. We recommend that the AA/DA consider the findings in this report as his office carries out its disaster assistance program's quality assurance process.

OFFICE OF DISASTER ASSISTANCE RESPONSE

OIG personnel met with the AA/DA and his staff on January 11, 2005, concerning the advisory memorandum. He agreed with the recommendations. The AA/DA's response to each recommendation was as follows:

1. The Disaster Assistance Program created a new loan application that was approved by Office of Management and Budget in March 2004. The new application contains the proposed language concerning section 21 (section 20 in the March 2004 application). The AA/DA advised that the new application had not been used to date because of a large surplus of the existing applications, but it is anticipated that the new application will be used beginning in February 2005.
2. The AA/DA advised that recommendation #2 is the current practice of the disaster assistance staff. He agreed that the information contained in the recommendation should be reiterated to disaster assistance staff.
3. The AA/DA agreed with the recommendation and requested that the OIG provide a fraud module for the disaster loan training program, which we agreed to do.
4. The AA/DA agreed with the recommendation.

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

If you have any questions concerning this Advisory Memorandum, please contact me at (202) 205-[FOIA Ex. 2].