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AUDIT OF SBA GUARANTEED LOAN TO

R. L. B. VENDING, INC.

DBA

BREAK TIME VENDING

AUDIT REPORT NO. 2-32

HOUSTON, TEXAS

SEPTEMBER 30, 2002

The finding in this report is the conclusion of the OIG's Auditing Division based on testing of the auditee's operations. The findings and recommendation are 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.

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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 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 and include it 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 all 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 R. L. B. Vending, Inc., dba Break Time Vending (borrower) and is the subject of this report.

In [ex. 4] the lender approved a SBA guaranteed loan (loan number [ex. 4]) for $793,000 to the borrower under the Preferred Lenders Program. The purpose of the loan was to refinance [ex. 4] of debt, purchase [ex. 4] of machinery and equipment, and provide working capital of [ex. 4] The last disbursement occurred on October 13, 1998, and the borrower defaulted on the loan in [ex. 4] after making eight payments totaling $91,560. SBA purchased the loan guarantee for $595,925 on [ex. 4]

FOIA Ex. 4

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 in August 2000, in accordance with Government Auditing Standards.

RESULTS OF THE AUDIT

Finding 1. Loan Proceeds were used to Refinance Ineligible Debt

The lender disbursed $493,747 in SBA guaranteed loan proceeds to refinance borrower debt that was ineligible for refinancing. SBA Standard Operating Procedure (SOP) 50 10 4, subpart A, chapter 2, para.11, provides that loan proceeds may be used to refinance debt when the terms of the existing debt are unreasonable and the refinancing will provide a substantial benefit to the small business in the form of increased cash flow. The SOP further provides that the lender must certify in writing that the debt to be refinanced is and always has been current.

The only documentation found in the lender's loan files for the refinanced debt was a manually prepared spread sheet titled "Schedule of Notes Payable," which comprised 35 notes payable. There was no evidence to support the information provided in the schedule, such as copies of the original notes or similar documentation. The schedule also did not include the original balances for 19 of the 35 notes payable and showed that the principal balances for two notes payables did not decrease for between 9 month and 2 years prior to approval of the SBA guaranteed loan, indicating that interest only or no payments were made during this period. Consequently, even if the schedule was supported by other documentation, it did not contain enough information to properly evaluate the eligibility of the all of the debt and, in two cases, indicated that the notes were delinquent.

Because the lender did not properly ensure the eligibility the debt to be refinanced, SBA was not obligated to honor the guaranty portion of loan proceeds used to refinance $493,747 of borrower debt.

Finding 2. Lender did not Verify Use of Loan Proceeds

The lender did not exercise prudent measures to ensure that loan proceeds were used as authorized. An attachment to the settlement sheet noted that $107,000 was disbursed via a joint payee check to pay off the balance on the purchase of an unknown quantity of vending machines that were secured as collateral. The closing documents found in the loan file stipulated that, prior to forwarding a joint payee check to a vendor, the borrower should have their signature endorsed by their bank in order to avoid delays the vendor may have depositing a two party check. The purchase contract for the vending machines stipulated that:

> "*...the balance of $107,000 shall be paid at closing of the Heller Financial Loan Agreement. It is understood that the check will be made payable to RLB Vending Inc.*

[borrower] and [Ex. 6] [seller]. [Ex. 6][borrower principal] shall endorse the check and the keys to the machines will not transpire until the funds are accepted in [Ex. 6] bank."

The lender did not employ any of the above controls over the use of loan proceeds and instead, made the check out directly to the borrower who deposited the full amount into the small business checking account. The lender's files contained no evidence, such as a canceled check or a paid receipt, to show that the borrower eventually used the proceeds to pay off the balance on the purchase contract or took ownership of the vending machines. The only other evidence related to the vending machines was a limited appraisal that did not include visual inspections and assumed existence and ownership; and a purchase agreement which contained only enough information to adequately support 10 of the 155 vending machines taken as collateral. After the borrower defaulted, the liquidator was not able to locate 150 vending machines.

Due to the lender's lack of prudent controls over the use of loan proceeds, the loss to SBA was increased by $80,250, the guaranteed portion on the loan proceeds inappropriately disbursed directly to the borrower.

RECOMMENDATION

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

1. Seek recovery of $450,559 from General Electric Capital Corporation on the guaranty paid to Heller First Capital Corporation, less any subsequent recoveries, for loan number [Ex. 4]

(After issuance of the initial draft report, the Houston District Director took action against the lender for the misuse of loan proceeds to refinance ineligible debt and recovered $370,309 from the lender, the guaranty portion of the refinanced debt. ***Accordingly, as noted in Finding 2, only $80,250 remains to be recovered from the lender.)***

Management Response

The Houston District Office agreed to seek recovery from the lender in the amount of $80,250. A written response to the revised draft report was not provided in time for inclusion in this report.

Lender Comments

The lender did not respond to the revised draft report.

FOIA Ex. 4 + 6

Appendix A

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