US SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416

AUDIT REPORT
Issue Date: May 17, 2006
Report Number: 6-22

To: James E. Rivera
Associate Administrator for Financial Assistance

From: Robert G. Hultberg
Acting Assistant Inspector General for Auditing

Subject: Audit of an SBA Guarantied Loan to R. R. Fox, Inc.

Attached is a copy of the subject audit report. The report contains one finding and recommendation addressed to you. The lender's response has been synopsized and included in the report. SBA's response was provided by email and is synopsized in the report.

The recommendation in this report is subject to review and implementation of corrective action by your office in accordance with 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 Action Sheet.

Should you or your staff have any questions, please contact Stephen Seifert, Director, Credit Programs Group, at 703-487-[FOIA Ex. 2].

Attachment

cc: IG

AUDIT OF AN SBA GUARANTIED LOAN TO

R. R. FOX, INC.

Youngstown, Ohio

May 17, 2006

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R. R. FOX, INC.

Youngstown, Ohio

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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 SBA regulations, policies, and procedures. 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 agreement, or did not make, close, service, or liquidate a loan in a prudent manner.

During an on-going review of the guaranty purchase process at the National Guaranty Purchase Center (Center) in Herndon, Virginia, we identified a problematic loan made by Bank One to R. R. Fox, Inc. (borrower), which is the subject of this audit report. On July 1, 2004, Bank One merged with JPMorgan Chase Bank (Chase) and Chase became responsible for servicing and liquidating SBA guarantied loans approved by Bank One (lender).

The loan was part of a sample selected from a universe of 7(a) loan purchase requests processed at the Center by Headquarters personnel from the Office of Financial Assistance (OFA). The loan was processed as a regular 7(a) guarantied loan; therefore, SBA was responsible for determining if the borrower met eligibility and credit requirements. The lender was required to service and liquidate the loan in accordance with SBA regulations, policies, and procedures.

The $510,800 loan ([FOIA Ex. 2]) was approved on November 22, 2002 with a 75 percent SBA guaranty. The borrower was in the business of pursuing collection on charged off credit card debt. The purpose of the loan was to finance the purchase of assets from an existing business and to provide working capital. The loan was disbursed on December 27, 2002. The borrower defaulted on April 4, 2003, less than four months after loan disbursement. SBA purchased the guaranty for $373,258 on June 9, 2004.

AUDIT OBJECTIVE AND SCOPE

The objective of the audit was to determine if the lender originated, serviced, and liquidated the purchased loan in accordance with SBA rules and regulations. During the audit, we examined loan files maintained by SBA and the lender, and interviewed both SBA and lender officials. The audit was conducted in Dallas, Texas from May through August 2005, in accordance with Government Auditing Standards.

RESULTS OF AUDIT

Finding 1 – Valuations Submitted by the Lender were not Independently Prepared

The lender did not disclose a material fact to SBA during loan origination regarding the lack of independence of the company that performed the valuation of the assets purchased with loan proceeds. The lender also made a false statement regarding the same company in connection with the asset injection valuation. As a result, SBA was denied the opportunity to consider the potential adverse effect of the conflict of interest during the loan process. Furthermore, because these deficiencies were not detected during the guaranty purchase process, SBA made an erroneous payment of $373,258 when it honored the guaranty.

Purchased Assets

During loan origination, the lender submitted for SBA's approval, a valuation of the business assets to be purchased with loan proceeds. The valuation, which was performed by Compass Recovery Solutions, Inc. (CRS), was accepted by SBA.

Pursuant to SBA Standard Operating Procedure (SOP) 50 10(4), subpart B, Chapter 1, Paragraph 3(C)(2), *"The value of acquired assets needs to be substantiated. Therefore, a valuation conducted by an independent third party must be obtained prior to loan approval or disbursement."*

CRS was not an independent third party, however, because the Chief Executive Officer/President of CRS was also the proposed Chief Financial Officer of the borrowing business. Based on a memorandum found in the loan file, the lender was aware of CRS' lack of independence when the loan was approved but did not disclose this fact to SBA. Given the $2 million valuation assigned to the assets, CRS' lack of independence was highly material to the loan. The lender's failure to disclose this lack of independence is even more significant because the evidence strongly indicates that CRS substantially over valued the assets. At loan origination, the assets were valued at $2 million ($1 million liquidation value[1]), but were worth only $105,300 seven months after the loan was disbursed. In a letter to SBA written shortly before the loan guaranty was purchased, an Assistant Vice President for the lender stated that she believed the assets purchased by the borrower were over-valued by CRS.

In accordance with 13 CFR 120.524(a)(4), SBA is released from liability on a loan guaranty if the lender failed to disclose a material fact to SBA regarding a guarantied loan in a timely manner. Additionally, per 13 CFR 120.524(a)(2), SBA is released from liability on a loan guaranty if the lender failed to make or close the loan in a prudent manner. We believe that a prudent lender would have recognized the conflict of interest that existed between the borrower and CRS and would not have relied on that

[1] Based on SOP 50-51, Chapter 17, Paragraph 9(a), the value of machinery and equipment is reduced by 50 percent to determine the liquidation value.

valuation of the assets, particularly given the high valuation of the assets and their importance to determining whether the loan was adequately secured.

Asset Injection

The lender made a false statement to SBA regarding the independence of CRS in its capacity as the valuator of the asset injection. Shortly after loan approval, the lender submitted a portfolio of charged-off credit cards to SBA for approval as the required asset injection. The lender stated in a memorandum submitted with the portfolio that CRS was a third party consultant that independently verified the value of the portfolio. SBA accepted the lender's statement and approved the asset injection. Contrary to the lender's claim, however, CRS was not an independent third party consultant due to the conflict explained above. Furthermore, the valuation of the charged-off credit card portfolio may have been overstated. The valuation was based on a three year collection cycle, but the lender informed SBA in its purchase request that the credit card portfolio "was exhausted during start up operations." Thus, there was nothing left in the portfolio to liquidate after the borrower defaulted on the loan. Although this deficiency by itself may not warrant a denial of liability, it raises serious questions about the lender's acceptance of the value of the equity injection for this loan.

Pursuant to 13 CFR 120.524(a)(2) and 120.524 (a)(4), we believe that full recovery of the $373,258 guaranty paid to the lender is warranted based on the lender's failure to disclose a material fact to SBA in a timely manner.

RECOMMENDATION

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

1. Seek recovery of $373,258 from Chase on the guaranty paid, less any subsequent recoveries, for loan number [FOIA Ex. 2].

Lender Response

Chase disagreed with the audit finding and recommendation and stated it believed the valuation company was independent of the borrower. Although the October 15, 2002 memorandum indicated a specified individual employed by the valuation company prepared the projections and would be joining the borrower as its CFO, Chase believed this to be an incorrect statement. The loan officer advised that the specified individual actually performed a consulting function for the borrower and was, to Chase's knowledge, never expected to become and never became an employee or officer of the borrower. An organizational chart for the borrower dated after loan disbursement did not list the individual that performed the valuation as an officer or employee. Moreover, this individual lived in California and employment with the borrower would have required relocation to Ohio, which Chase believes was never contemplated. Furthermore, Chase claimed that bankruptcy documentation filed by the borrower supported the lender's

belief that contrary to the suggestion included in the October 15, 2002 notes, the individual who provided the projections was never offered nor accepted employment with the borrower.

Chase also believed the October 15, 2002 memorandum was part of the file sent to the SBA District Office when SBA approved the guaranty for this loan and, notwithstanding the potential conflict suggested in the memorandum, SBA did not require a new appraisal. Chase stated that this indicates SBA was comfortable with the valuation. The lender's complete response is included as Appendix A.

Evaluation of Lender Response

The loan officer's October 15, 2002 memorandum thoroughly documented conversations he had with the borrower. The memorandum clearly stated that the individual who prepared the valuations would be joining the borrower as CFO. There is no reason to believe the loan officer misrepresented this relationship in his memorandum. The memorandum stated the individual was going to prepare the projected financial statements and provide details of the assumptions used, as well as provide invoices on the assets he "personally purchased" and work on getting information on equipment valuations. These statements demonstrate he was acting in the capacity of a CFO and performing more than a consultant function. In fact, the memorandum indicated he was valuing some assets he "personally purchased." Thus, whether or not he was expected to become an employee or officer of the borrower, he clearly was not an independent third party. Furthermore, documentation in the lender's file indicated that he may not have become an employee of the borrower due to an adversarial relationship that transpired between the two parties. One of the reasons cited for the business failure was that the borrower was unable to meet his obligations because the valuator intercepted and retained some collection accounts that were consigned to the borrower. This is also further evidence of the lack of independence between the two parties.

There was no support for Chase's belief that SBA was provided a copy of the October 15, 2002 memorandum during loan origination. The SBA loan file was reviewed as part of the audit and the October 15, 2002 memorandum was not in the file.

As a result of the above, we continue to believe that full recovery of the $373,258 guaranty paid to the lender is warranted based on the lender's failure to disclose a material fact to SBA in a timely manner.

SBA Management Response

SBA concurred with the recommendation to recover the entire guaranty purchase amount from the lender.

Evaluation of SBA Management Response

SBA's agreement to recover the entire guaranty payment of $373,258 from the lender is responsive to the recommendation.

Appendix A

March 28, 2006

US Small Business Administration
Office of Inspector General
Attention: Mr. Jose Aragon, Senior Auditor
4300 Amon Carter Blvd. Suite 116
Fort Worth, Texas 76155-2653

SBA Loan No [FOIA Ex. 2] to R. R. Fox, Inc.
Dear Mr. Aragon

This letter is provided in response to your letter of March 8, 2006 to JPMorgan Chase Bank, N.A. regarding subject loan and the SBA's claim, as set forth in the related draft audit report, that the bank "did not disclose a material fact to SBA during loan origination regarding lack of independence of the company that performed the valuation of the assets purchased with the loan proceeds" and the finding that "valuations submitted by the Lender were not independently prepared".

We feel the valuation company was independent of the borrower. Although the calling notes of October 15, 2002, referenced in your letter, indicate that a specified individual, employed by the valuation company, prepared the projections and would be joining the borrower as its CFO, we believe this to have been an incorrect statement. We have reviewed this matter with the loan officer who advises that the specified individual actually performed a consulting function for the borrower and was, to our knowledge, never expected to become and never became an employee or officer of the borrower. This belief is supported by a February 2003 organization chart for the borrower that does not list this individual as an officer or employee. Moreover, the individual involved resided in California. Employment with the borrower would have required his relocation to Ohio, something we believe to never to have been contemplated by this person. Additional documentation, including a resolution and documentation associated with borrower's subsequent bankruptcy, support our belief that contrary to the suggestion included in the October 15, 2002 notes, the individual who provided the projections was never offered nor accepted employment with the borrower.

We believe that the October 15, 2002 calling notes were part of the file sent to the SBA District Office when SBA approved the guarantee of this loan. Notwithstanding the potential conflict suggested in those notes, the SBA did not require a new appraisal, which indicates to us that the SBA was comfortable with this valuation notwithstanding the suggestion, which we now believe to have been incorrect, of a possible employment arrangement between the individual referenced above and borrower.

Based on the foregoing, Chase respectfully disagrees with the findings set forth in the draft audit report and requests the SBA to reconsider its decision. We remain available to work with the SBA to investigate these matters to the extent possible.

Please do not hesitate to contact me at 214/904-3526.

Sincerely,

Larry S. Conley
SBA Manager

Appendix B

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