

AUDIT OF AN SBA GUARANTEED LOAN TO

[Exemption 6]

Malta, Montana

Audit Report Number: 7-15

February 12, 2007



U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416

AUDIT REPORT
Issue Date: February 12, 2007
Report Number: 7-15

To: Janet A. Tasker
Acting Director for Financial Assistance

/S/ original signed

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Audit of an SBA Guaranteed Loan to [**Exemption 6**]

The purpose of this memorandum is to notify you of an \$82,411 improper payment that should be recovered. As part of a larger audit of the guarantee purchase process at the National Guaranty Purchase Center, we randomly selected purchased loans to assess the accuracy of the purchase process. When erroneous purchases of at least \$25,000 are identified, we issue a separate report to recover the erroneous payment to SBA. In this instance, we identified a problematic loan [**Exemption 2**] made by Independence Bank to [**Exemption 6**](borrower). We reviewed the loan to determine if the lender originated, serviced and liquidated the purchased loan in accordance with Small Business Administration (SBA) rules and regulations. The audit was conducted in February 2006 in Herndon, Virginia, in accordance with *Government Auditing Standards* prescribed by the Comptroller General of the United States.

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 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. If a lender fails to comply materially with SBA regulations, the loan agreement, or does not make, close, service, or liquidate a loan in a prudent manner, SBA has exclusive discretion to release itself from liability, in whole, or in part, on the loan guarantee.

On July 6, 2000, SBA approved a \$150,000 loan for a borrower's purchase of the assets of an existing business known as [**Exemption 6**]. The loan was processed under LowDoc procedures and therefore, SBA was responsible for determining the eligibility and credit risk of the borrower. The lender was required to service and

liquidate the loan in accordance with SBA regulations, policies and procedures. The loan was disbursed on October 6, 2000. The borrower demonstrated repayment problems beginning in May 2001, or about 7 months after disbursement, and the loan defaulted on January 14, 2002, approximately 15 months after disbursement, making this both an early problem and early default loan. According to SBA's *7(a) Loan Guaranty Purchase Policy*¹ in effect when this loan was purchased, early problem loans occur when either prior to or within the first 18 months after final disbursement a borrower consistently makes late payments or partial payments, funds monthly payments through the sale of collateral, or the lender has deferred two or more consecutive scheduled payments. An early default loan is one that defaults within 18 months of the last disbursement.

The borrower filed Chapter 7 bankruptcy on May 3, 2002. A purchase review was completed by the National Guaranty Purchase Center on March 21, 2005, and no material deficiencies were found. SBA purchased the guarantee on April 6, 2005, for \$82,411.

The Lender did not Verify Borrower Equity Injection

The lender did not verify that the borrower injected the required amount of equity into the business prior to loan disbursement. As a result, SBA made an erroneous payment of \$82,411 when it purchased the loan guarantee.

The loan authorization required the lender to obtain evidence that the borrower injected at least \$25,000 into the business prior to the first loan disbursement. Before the loan was approved, SBA had concerns about the source of the borrower's equity injection. This was demonstrated by the Sacramento LowDoc Processing Center's request for clarification of the source of the cash injection since the principal's personal financial statement showed only \$4,400 in liquid assets. At this time, the lender responded to SBA stating that the source of the equity injection was "deposits of \$10,000" and "Loan on 401 Plan of \$15,000."

Documentation in the lender's loan file, however, showed that the principal's bank persuaded him to obtain a \$15,000 unsecured loan instead of borrowing against his 401(k) plan. Moreover, there was no evidence in the loan file that the principal borrowed against his 401(k) plan to provide the required equity injection. Additionally, the loan authorization contained a separate section entitled "Other Funding" which required evidence that the borrower received the proceeds of a loan from Universal Bank in the amount of \$15,000 for a term of not less than 4 years prior to loan closing. Consequently, the \$15,000 loan could not be considered equity injection since it was required in addition to the \$25,000 cash injection.

When we requested support for the required equity injection during our audit, the lender claimed the borrower's equity injection consisted of a \$2,500 cashier's check drawn on another bank and used to pay for the appraisal, a \$21,000 deposit to the

¹ Policy Notice 5000-831.

principal's personal checking account derived from a cashier's check drawn on another bank, and a \$4,000 wire transfer to the borrower's personal checking account.

The \$4,000 wire transfer could not be considered equity as it was made more than four months after loan disbursement, and the cashier's checks should have been a red flag to the lender that the funds may have been borrowed because the principal did not have the funds available for these injections. As a result, it would have been prudent for the lender to verify the source of the funds.

Based on the above, it is clear the SBA processing center considered the verification of the source of equity injection to be a prudent lending practice. Furthermore, SOP 50 10 4 provides that borrowed funds can be deemed equity only if: (1) the lender agrees to a formal standby agreement of payment until the SBA loan is paid in full, or (2) the borrower can demonstrate repayment ability from a source other than the cash flow of the business or from reasonable withdrawals or salary. There were no standby agreements in the file, the borrower was not taking a withdrawal from the business, and there was no evidence the borrower had the ability to repay these amounts from other sources.

Also, while the borrower had a business account with the lender, \$21,000 of the claimed injection was deposited into the borrower's joint personal checking account. As a result, there was no evidence the funds were actually injected into the business and available for business use.

The SBA note provided for monthly payments of \$1,498 due on the 24th of each month beginning in November 2000. The lender's transcript of account indicated that the borrower made six required regular payments for November 2000 through April 2001. The borrower demonstrated repayment problems beginning in May 2001, 7 months after loan disbursement, missing its May and June payments. The lender, however, continued to work with the borrower, who made three payments of \$3,146, \$1,928 and \$2,825 on July 31, 2001, September 26, 2001, and November 28, 2001, respectively.² In December 2001, the lender approved the borrower's request to make weekly payments of \$325 for 14 weeks. The borrower, however, was unable to comply with the agreement and the last payment was made on January 22, 2002. This payment brought the loan current as of January 7, 2002, therefore, the default date was January 14, 2002 (the next payment due date), or approximately 15 months after loan disbursement.

The borrower's early repayment problems demonstrate the business had cash flow problems and that the required equity injection was important to the success of the business. Furthermore, the Service Corps of Retired Executives (SCORE) performed a review of the borrower's operations in March 2001, approximately 5 months after loan disbursement. SCORE also concluded that the business had a cash flow shortage of \$21,000 and that the business was purchased with 100 percent financing, including the equity, which is further evidence that the source of the equity was borrowed funds.

² Payments were rounded up to the nearest dollar.

As the subject loan was both an early default and an early problem loan and there was no evidence that the claimed equity injection was derived from borrower sources, full recovery of the \$82,411 paid to purchase the guarantee is warranted.

Recommendation

We recommend that the Acting Director for Financial Assistance:

1. Seek recovery of \$82,411, less any subsequent recoveries, from Independence Bank on the guarantee paid.

Lender Comments

The lender disagreed with our draft report finding and provided additional documentation to support the verification of equity injection. The additional information consisted of cashier's checks and bank statements showing that a \$2,500 cashier's check was received by the lender prior to loan disbursement, a \$21,000 deposit was made to the principal's personal checking account prior to loan disbursement, and a \$4,000 wire transfer was made to the borrower's personal checking account more than four months after loan disbursement. The lender's comments, less enclosures, are included as Appendix I.

Office of Inspector General Response

Although the lender claimed there was valid support for the required equity injection, the documentation provided did not show the source of the injection. As a result, the lender's claim that there was more than enough evidence that the borrower's cash was used for the injection was unsupported. As there were indications the injection was from borrowed funds, it would have been prudent for the lender to verify the source of the injection. There was no support for the source of the \$2,500 cashier's check the lender claimed was used to pay for the appraisal. Additionally, while the borrower had a business checking account with the lender, the \$21,000 deposit, which was part of a \$21,500 cashier's check received by the lender and drawn on another bank, was deposited into the borrower's joint personal checking account. This raises the question as to whether or not the funds were actually injected into the business and available for business use. Lastly, the \$4,000 wire transfer does not constitute equity, as it was received more than four months after loan disbursement.

Agency Comments

SBA agreed to request recovery of the total purchase amount of \$82,411. SBA's comments are included as Appendix II.

Office of Inspector General Response

Based on the comments received from the lender and SBA, we revised our report to support our position that it would have been prudent for the lender to verify the source of the equity injection based on the indications that the injected funds were borrowed. SBA's planned action to recover the purchase amount is responsive to our recommendation.

We appreciate the courtesies and cooperation of the Office of Financial Assistance representatives during this audit. If you have any questions concerning this report, please call me at (202) 205-[**Exemption 2**] or Robert Hultberg, Director, Credit Programs Group at (202) 205-[**Exemption 2**].



INDEPENDENCE BANK

BRANCHES IN HAVRE • GLASGOW • MALTA • POPLAR • SCOBEEY
Havre (406) 285-1241 • 1-800-823-2274 • (406) 262-9699 Real Estate Department

P.O. Box 2090
Havre, MT 59501

October 19, 2006

Terry Settle
SBA Office of Inspector General
1145 Herndon Parkway
Suite 900
Herndon, Virginia 20170

RE: Review of an SBA Guaranteed Loan to [Exemption 6]

Dear Terry,

This letter is a follow up to the letter we received from your office dated 9-28-06. Please accept this letter as the bank's disagreement with the finding and our reasons for that disagreement. The letter states that the bank lacked evidence of the borrower's cash injection of \$25,000 prior to loan disbursement. The following is the bank's evidence of the borrower's cash injection.

- 8-7-00 Bank received a check from US Bank in the amount of \$2,500 to pay for the appraisal. (Attachment A)
- 10/3/00 Deposit to checking account in the amount of \$21,000 [Exemption 2]
(attachment B) proceeds from US Bank (Attachment C)
- 10/6-00 Note was disbursed in the amount of \$150,000 with check made payable to the closing attorney.
- 2-8-01 Additional cash injection was noted in the form a wire from US Bank (attachments D and E)

I believe that with the above information along with the attachments provide more than enough evidence that the borrower's cash was used. It also proves that made [Exemption 2] another effort five months into the new business with additional cash injection. Please review the information. If further detail or copies are required, the bank is requesting that the SBA allow the bank another 30 days to do our research.

Also in your letter, it was stated that SBA form #1824 was attached for us to complete. No form was in our mailing for me to complete. I left a message for a Stephen Seifert, Director of Credit Program Groups at 703-487- concerning the form.

[Exemption 2]

Please review the above information and attachments. If you have further questions or concerns, please give me a call at 406-265-1241.

Sincerely,

[Exemption 6]

Deborah Hedstrom
Senior Vice President

Enclosures



U. S. Small Business Administration
Washington, D. C. 20416

Date: January 29, 2007

To: Debra Ritt, Assistant Inspector General for Auditing

From: James W. Hammersley, Acting Deputy Director, OFA

Subject: Draft Audit Report of an Early Defaulted Loan to [Exemption 6]

Ref: Memorandum of January 17, 2007 on the same subject

On September 28, 2006, the Office of Inspector General (OIG) provided this office with a draft audit report on this loan. The report requested recovery of the guaranteed loan balance of \$82,411 which was paid to the lender on April 4, 2005. The OIG draft report cited a request made of the lender for a written response. On October 19, 2006, the lender provided additional information via a letter to Terry Settle of OIG's Herndon Office.

In OFA's memorandum dated January 17, 2007 to OIG, OFA took the position that \$21,000 of the disputed equity injection was supported by adequate documentation and should be accepted as meeting the loan authorization requirement. This resulted in a recommended repair of \$4,000 based on inadequate documentation for this amount of the required equity injection, which both OIG and OFA agreed was not properly substantiated. Subsequently, on January 25, Larry Harris of OIG's Herndon office provided additional information to OFA on the transaction. This information was obtained from the lender's file to which OIG has access but of which OFA was not aware at the time of its January 17 memorandum.

The additional information provided by OIG indicated that although the borrower had a business checking account with the lender, the \$21,000 "equity" was deposited in the borrower's joint personal checking account at the bank. This raises questions as to whether the funds were actually invested in the business and remained available for business use. Also, additional information has been provided regarding the possible use of borrowed funds to provide the required equity injection. At one point, the lender indicated that the sources of the equity injection would be deposits of \$10,000 and a loan of \$15,000 from the borrower's 401(k) plan. Documentation that the OIG found in the lender's loan file (of which OFA was not aware) indicated that the borrower's bank persuaded the borrower to obtain a \$15,000 unsecured loan rather than borrow against his 401(k) plan assets. The loan authorization also required evidence that the borrower had received proceeds of a loan from Universal Bank in the amount of \$15,000 for a term of not less than 4 years for working capital purposes. The conclusion is that the \$15,000 loan obtained by the borrower cannot be considered part of the required equity injection

since the borrower was required to obtain the loan in addition to injecting \$25,000 in cash equity. Based on the foregoing and the materiality of the \$25,000 required equity injection, OFA now preliminarily concurs that full recovery of the \$82,411 guarantee paid to the lender is warranted (less any subsequent recoveries). However, before reaching a final conclusion we would appreciate OIG's providing the documentation in support of the additional information made known to us by e-mail from Larry Harris to ensure that we reach the same conclusions as OIG.

With regard to future audits sent to OFA for review and comment, it is recommended that OIG include all of the reasons for its conclusions, including those emanating from documents to which OFA does not have access (in the instant case, the lender's file). We do not necessarily need to see the supporting documents in every case, but we need to know the background information which forms a part of the OIG recommendations. This will save time in responding to OIG findings since all parties will be working from the same set of facts. Thank you for your cooperation.

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