

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



**MEMORANDUM  
AUDIT REPORT**

**Issue Date: June 30, 1997**

**Number: 7-7-F-002-016**

**To:** Laura A. Brown, District Director  
Atlanta District Office

**From:** *Peter L. McClintock*  
Peter L. McClintock, Assistant Inspector General  
for Auditing

**Subject:** Final Memorandum Audit Report - Defaulted  
Loan made by Eastside Bank and Trust

We reviewed an SBA guaranteed loan made by Eastside Bank and Trust (lender) to [ \* ] owners of [ \* ] (borrower) of [ \* ], Georgia. Loan number [ \* ] was selected for review as an early defaulting loan (it defaulted within 12 months of origination). This report presents the audit results and recommends actions to be taken by the Atlanta District Office.

### BACKGROUND

Section 7(a) of The Small Business Act of 1958, as amended, gives SBA the authority to provide financial assistance to small businesses. To obtain a guarantee, the lender must meet SBA's requirements and execute a Loan Guaranty Agreement. The execution of this document binds the lender to abide by SBA regulations and procedures for loan origination, servicing, and liquidation.

Title 13, Code of Federal Regulations (CFR), Section 120, and Standard Operating Procedure (SOP) 50 10 3 require a review of the borrower's eligibility, repayment ability, management qualifications, use of proceeds, and adequacy of collateral. Other guidance provided by SBA requires verification of the information provided by the applicant(s).

The lender, a wholly owned subsidiary of Eastside Holding Corporation, was authorized by SBA to make loans to small businesses, effective April 19, 1990. [ \* ] SBA provided the lender with a 75 percent guarantee for a [ \* ] loan. The borrower used the proceeds to purchase the real estate, equipment, and inventory of an existing golf driving range. The borrower defaulted on the loan in January 1996, and SBA purchased the guarantee in May 1996.

## AUDIT OBJECTIVES AND SCOPE

The audit objectives were to determine if

- the loan guarantee was obtained through the use of false or misleading applications,
- the lender originated and disbursed the loan in accordance with the Authorization and Loan Agreement, and
- the borrower used loan proceeds and business assets for authorized purposes.

The loan was selected for audit from a universe of loans approved during the period October 1993 to September 1995, with disbursed amounts greater than \$100,000, that defaulted within 12 months of origination. Other selection factors included

- time between loan approval and transfer to liquidation,
- loan balance at default, and
- inconsistent information provided on Form 912, Statement of Personal History.

We examined documents contained in the district office, lender, and borrower loan files. Interviews were held with district office and lender loan officers and the borrower's principals. The audit field work was conducted from November 1996 through January 1997. The audit was conducted in accordance with Government Auditing Standards.

## RESULTS OF REVIEW

The loan was properly disbursed and proceeds used for authorized purposes. We noted two deficiencies, however, relating to the loan.

- The principals of the borrower failed to disclose that they had felony convictions for check fraud and drug possession. Such disclosure could have resulted in the loan officer declining the loan. The discrepancy has been referred for investigative consideration as a possible violation of Section 16(a) of the Small Business Act and requires no action by the District Office at this time.
- The loan was not originated in accordance with the loan authorization agreement. Specifically, the lender neither ensured that the borrower's taxes were current nor notified SBA of a discrepancy between the loan application and the IRS tax verification. Because these are material omissions by the lender, they are discussed further.

### **FINDING    Payment of Federal Income Taxes was not Verified**

To support the loan application, the borrower provided a 1992 Federal tax return that showed a tax obligation of \$2,460. The Internal Revenue Service (IRS) income tax verification, however, showed that a 1992 tax return was not on file. The lender's loan officer stated the borrower was questioned concerning the discrepancy with the 1992 tax return. The loan officer did not document, nor could he remember, the borrower's explanation for the discrepancy. He

neither questioned the borrower further nor obtained support for the explanation. The lender did not inform SBA of the discrepancy because the loan officer considered the matter resolved. The loan guarantee, therefore, was inappropriately approved because SBA was unaware of the borrower's tax delinquency.

As the result of the business failure, the borrower filed for bankruptcy in May 1996. The filing confirmed that the 1992 Federal taxes, as well as other Federal and state taxes, were delinquent. Both the IRS and the State of Georgia had unsecured claims totaling about \$26,500. After the loan defaulted, SBA honored the \$339,572 guarantee, but had only recovered \$354 as of February 7, 1997.

The lender was negligent because it did not obtain evidence that the borrower was current on all taxes as required by Section 4(f)(2) of the loan agreement. Further, the lender did not notify SBA of the tax discrepancy as required by Policy Notice 9000-941, which requires notification as soon as a material discrepancy between data submitted by a borrower and data received from the IRS is disclosed. The notice also states that a guarantee will not be given until the discrepancy is resolved. Section 120.202.5 of the 13 CFR (January 1, 1995) states that "SBA shall be released from obligation to purchase its share of the guaranteed loan unless the lender has substantially complied with all of the provisions of these regulations, the Guaranty Agreement, and the Loan Authorization, and has not failed to disclose material facts, and has made no material misrepresentations. . . ." (The provisions in §120.202.5 are now included in §120.524 of the revised regulations, dated March 1, 1996.)

The loan authorization and Guaranty Agreement were not substantially complied with because the lender failed to ensure that the borrower was current on all taxes and notify SBA of this material tax information discrepancy. SBA, therefore, should not have paid the guarantee. Because the guarantee has been paid, SBA should now seek recovery.

#### Recommendations

We recommend that the Atlanta District Director take the following actions:

- 1A. Recover \$339,572 from the lender for Loan Number [ \* ]
- 1B. Remind the lender of its obligation to
  - investigate material discrepancies concerning verification of Federal income taxes,
  - inform SBA of material discrepancies involving such taxes, and
  - obtain evidence that loan guarantee applicants' taxes are current.

#### Auditee's Response

Concerning the [ \* ] false statement, the Bank's SBA Loan Officer stated the bank had the [ \* ] execute the required documents indicating they did not have a criminal record, and the

Bank had no reason to believe the responses were not true or to conduct further investigation.

The Bank's SBA Loan Officer stated that the requirement to notify SBA of IRS verification discrepancies was not applicable because this was a new business and the Bank was not required to obtain tax verification. He stated that the verification was done because of the newness of the procedure and because the Bank did not know exactly on whom to get the information. He further stated that, when the principals of the borrower were questioned about the discrepancy, they stated that their 1992 return had been filed in August of 1993, and they had no idea why the IRS had no record. Because the 1992 tax return was consistent with the 1991 and 1993 tax returns, which were verified and had no discrepancies, the Bank had no reason to doubt the borrower. Also, the Bank felt the discrepancy was insignificant and believed that district office personnel would have felt the same.

Concerning the Bank's noncompliance with the requirement to ensure that the borrower's taxes were current, the Bank's SBA Loan Officer stated the Bank followed prudent lending practices by obtaining a signed affidavit by the borrower that there were no tax liens or outstanding obligations, by conducting lien searches, and by reviewing the credit history of the borrower. Based on the borrower's statement and the lack of "red flags," the Bank felt that the requirement was satisfied.

#### Evaluation of Auditee's Response

The false statements of the borrower's principals on Form 912 were discussed in the Results of Review Section of the audit report as information for the SBA District Office and were not meant to describe a deficiency in the lender's processing of the loan.

Because the borrower was a proprietorship, its tax status can not be separated from that of its owners. The loan authorization required the lender to ensure that the tax documents submitted with the application conformed to the results of the IRS verification, and the district office memo referred to by the lender required discrepancies to be reported to SBA. The lender's statements indicate that it was aware of the discrepancy between the tax return and the IRS verification and that it chose to accept the verbal statements of a borrower with whom it had no prior relationship rather than investigate further. This course of action resulted in a loan to individuals who were tax delinquents and may impact on the recovery efforts.

The lender's claim to have used prudent lending procedures to determine if the applicant had outstanding judgments and liens only addressed part of the loan authorization requirement. The lender was also required to obtain evidence that the borrower was current on its taxes. Actions taken by the lender were not adequate to satisfy this requirement. Affidavits, lien searches, and credit reports are not sufficient evidence to indicate an applicant is current on its taxes. The lender had a "red flag," the IRS verification, to indicate that the applicant may not be current on its taxes. This red flag, along with the applicant's indication that it had a 1992 tax obligation, should have been sufficient indicators to the lender that more evidence was needed to comply with the loan authorization.

### District Office Comments

The District Director stated the lender was not required to verify the personal tax returns of the owners and that the steps taken by the lender to verify the applicant's tax status indicated taxes were current. The Director further stated that, in a civil action against the lender, SBA would have to show that a monetary loss was suffered, and at present, SBA can not show that a loss has been suffered. The Director recommends that SBA allow the lender to liquidate the collateral, as no prior problems were encountered with this lender, the lender is proceeding toward selling the collateral, and SBA can not determine the amount of the loss to the Agency.

### Evaluation of District Office Comments

The District Director's comments do not address the issues of whether the lender failed to disclose material facts and whether the lender complied with the requirement to obtain evidence that the borrower was current on all taxes. The fact that the lender was not required to obtain the IRS verification of the owner's tax returns is not relevant. Once received, the IRS data showed material facts that should have been disclosed to SBA.

The lender's actions to determine that the borrower was current on its taxes were not prudent in light of the facts received from the IRS. The lender obtained evidence that no liens had been imposed by taxing authorities, but did not obtain evidence that the borrower was current on its taxes.

Title 13 CFR Part 120.202.5 does not require that SBA suffer a monetary loss to be released from its guarantee. SBA has to show that the lender did not substantially comply with SBA's requirements, did not disclose material facts, or made material misrepresentations. The facts show that this lender did not substantially comply with SBA's requirement and did not disclose material facts. Furthermore, SBA is suffering a monetary "cost" because it has disbursed \$339,572 and has no assurance that it will be repaid. Also, the disbursement and subsequent liquidation income, if any, results in a "cost" relating to the time value of the outlay. This transaction, therefore, could increase the amount of the subsidy rate which is paid through taxpayer-supported appropriations. We respectfully request that the District Director reconsider her position.

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The finding included in this report is the conclusion of the Office of Inspector General's Auditing Division based on testing of the auditee's operation. **The finding and recommendations are subject to review, management decision, and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution.**

Please provide us your proposed management decision, and estimated time frames for implementation, within 30 days on the attached SBA Forms 1824, Recommendation Action Sheet.

This report may contain proprietary information subject to the provisions of 18 USC § 1905. Do not release this report to the public or another agency without permission of the Office of Inspector General.

Should you or your staff have any questions, please contact Garry Duncan, Director, Field Operations, at (202) 205-7732.

Attachments