



Office of Inspector General Small Business Administration

June 1996 Update

Business Loans

OIG Study Finds that SBA's Section 7(a) Loan Program Loss Rate Methodology is Valid, but the Rate is Not Comparable to Banking Industry Statistics. The OIG issued an inspection report requested by the Administrator on **SBA's Section 7(a) loan program loss rate**. The report focuses on the methodology used to compute the loss rate and on the ways in which the rate is used by SBA. While there are minor differences in how the SBA and the banking industry compute the commercial, or one-year, loss rate, the OIG found that the methodology used by SBA is fundamentally valid.

The OIG also found, however, that SBA's commercial loss rate is not comparable with banking industry loss rates due primarily to significant differences in their loan portfolios: SBA's portfolio includes only small businesses, whereas the industry rate reflects losses on loans to businesses of all sizes; SBA's loans are concentrated primarily in retail trade and services, while private lender loans cut across all industries; and SBA's portfolio includes real estate loans, which are excluded from the industry loss rates. Differing charge-off policies also affect the timing of charge-offs

and, therefore, the loss rates. Finally, the commercial loss rate is misleading as an indicator of current Section 7(a) loan program performance because of the rapidly expanding portfolio and the three-to-four year lag between loan disbursements and charge-offs. It should also be noted that SBA program officials no longer use the commercial loss rate for internal management purposes; they focus instead on cohort performance and other indicators such as purchase, currency, and subsidy rates, which appear to be more useful measures.

For these reasons, we recommend that SBA discontinue the public use of the commercial loss rate comparison to the banking industry when discussing the success of the Section 7(a) loan program.

The OIG also found that loss and default rate data are not always properly identified, and may inadvertently misrepresent Section 7(a) loan program performance. The OIG recommends that the Office of the Chief Financial Officer and the Office of Financial Assistance ensure that information on loss and default rates is more clearly defined and labeled. Because of changes resulting from credit reform, the OIG also recommends that they determine

whether revisions can be made in the format of the Agency's Annual Loss Study.

New York Computer Company Owner Pleads Guilty to Bank Fraud and Making False Statements. The former owner of a computer sales and service business in Binghamton, New York, pled guilty on June 10, 1996, to five counts of **bank fraud** and one count of **making false statements to SBA**. A multi-agency investigation revealed that the owner had grossly overstated the value of assets in a listing he submitted, in order to forestall the participating lender and SBA from calling his delinquent \$450,000 SBA-guaranteed loan. He also admitted using personal and business credit cards to obtain approximately \$34,000 in fraudulent cash advances (establishing a false account receivable with his credit card and then withdrawing cash against the credit) and kiting (taking improper advantage of the cash float) approximately \$10,000 in checks drawn on his credit union account. The OIG and the Federal Bureau of Investigation (FBI) joined the investigation initiated by the Secret Service.

Minnesota Business Owner Indicted for Bank Fraud. The owner of a technology company dealing in graphics software in Bloomington, Minnesota, was indicted on June 5, 1996, on one count of **bank fraud** and one count of **making a false statement to SBA**. The OIG's joint investigation with the FBI determined that the man prepared

and submitted a bogus independent auditor's report to a participating bank in an unsuccessful attempt to obtain a \$175,000 SBA-guaranteed loan for his technology company. The OIG initiated this investigation based on a referral from the SBA's Minneapolis District Office.

Four Clients of a California Loan Broker Charged with Making False Statements. Three Los Angeles business owners, all clients of the same loan broker, were charged in criminal informations filed during June 1996 as a result of the OIG's joint investigation with the Secret Service:

- ① The owner of an automotive transmission company was charged with one count of **making a false statement on a loan application to a Federally-insured financial institution** in connection with his \$420,000 SBA-guaranteed business loan. The investigation revealed that the loan applicant submitted altered tax returns for the years 1988-90, each of which significantly overstated his income. In addition, in support of his loan he submitted invoices in the names of nonexistent businesses, and the fictitious business names were subsequently used by the loan packager. The investigation also determined that the businessman received a \$208,000

residential loan from another lender by using altered income tax returns.

② The owner of a sporting goods store was charged with one count of **making a false statement on a loan application to a Federally-insured financial institution** in connection with her \$1,000,000 SBA-guaranteed business loan. The investigation revealed that she submitted altered tax returns for the years 1988-90, each of which significantly overstated her income. In addition, the investigation determined that she illegally used her loans to purchase a home and a new automobile.

③ The owner of a combined grocery market and liquor store was charged with one count of **making a false statement** to SBA in connection with his \$231,000 disaster business loan. The investigation first discovered that an altered tax return for 1989 had been submitted to obtain the \$161,119 SBA-guaranteed loan that enabled the man to purchase the market. The investigation also found that he submitted altered 1989 and 1990 returns to obtain the disaster loan for repair of damage stemming from the 1992 civil unrest. Each of the three returns significantly overstated his income. In

addition, the businessman sold the grocery market to the City of Los Angeles in 1992 under a program that paid liquor store owners to sell their businesses and start different businesses in other locations. He sold SBA's collateral for the disaster loan and received nearly \$500,000 from the sale of the business.

④ The owner of a clothing manufacturer in La Canada, California, was charged in a criminal information filed on June 24, 1996, with one count of **making false statements in a loan application to a Federally-insured bank** in connection with his \$1,000,000 SBA-guaranteed business loan. The OIG's joint investigation with the Secret Service revealed that the owner submitted altered copies of his income tax returns for 1987-89, each of which significantly overstated the net profit from his business in an effort to qualify for the loan.

The OIG initiated the investigation after the participating lender and the SBA's Los Angeles District Office referred the matter.

Three Pennsylvania Businessmen Charged with Making False Statements to SBA. Three southeastern Pennsylvania men were charged in an information filed on May 28, 1996, with one count of **making false statements** to SBA.

The president and vice president, respectively, of a watch and jewelry retailer in Plymouth Meeting, Pennsylvania, and the store's certified public accountant, allegedly collaborated in the preparation of tax returns containing fictitious information and submitted them to a participating lender bank to qualify for a \$50,000 Low-Doc loan. On learning that the tax returns submitted as part of the application differed significantly from those on file with the Internal Revenue Service (IRS), SBA canceled the loan before any proceeds were disbursed. The accountant pled guilty to the charge on June 6, 1996, and has surrendered his CPA license. The discrepancies, which were detected by SBA's tax return verification program, were referred to the OIG by the Philadelphia District Office.

Three Georgia Businessmen Sentenced on a Variety of Charges.

Three LaGrange, Georgia, businessmen--the proprietor of a restaurant, a corporate president, and an attorney in private practice--were convicted on a variety of false statement and conspiracy counts on June 26, 1996. The restaurant owner was sentenced to 20 months incarceration, 4 years supervised release, 200 hours community service, \$35,000 restitution, and a \$350 special assessment. The corporate president was sentenced to 18 months incarceration, 4 years supervised release, \$85,000 restitution, a \$4,000 fine, and a \$150 special assessment. The attorney was also sentenced to 2 months

home detention, 3 years probation, \$4,620 restitution, and a \$2,000 fine.

Illinois Businesswoman Pleads Guilty to Theft by Deception.

The sole proprietor of a weight loss center in Chicago, Illinois, pled guilty in Cook County (Illinois) Circuit Court on June 25, 1996, to one misdemeanor count of **theft by deception**. She was sentenced to 2 years supervised conditional discharge and 30 days community service. The woman admitted filing with the Cook County Recorder of Deeds two fraudulent lien releases on properties previously pledged as collateral for a \$64,900 SBA-guaranteed loan. After obtaining the unauthorized releases, she pledged the properties to a local mortgage company to obtain more than \$50,000 in additional financing. The OIG's investigation found that the woman prepared and filed two release deed forms represented to have been prepared by an SBA attorney. At the time she filed the false releases, she was unaware the attorney had died several years earlier! The OIG initiated this investigation based on a referral from the SBA's Chicago District Office.

Texas Couple Pleads Guilty to Making False Statement to FDIC-Insured Bank.

An Alvin, Texas, couple pled guilty on June 4, 1996, to one count of **making a false statement to an FDIC-insured bank**. In return, the Government agreed to dismiss the other ten felony charges on which they had each been indicted. In an effort to

obtain approval of a \$338,000 SBA-guaranteed loan to finance their purchase of a convenience store in Houston, Texas, the couple altered and submitted copies of the previous owner's tax returns. They also submitted false tax returns for another store in LaMarque, Texas, to obtain approval of a \$200,000 SBA-guaranteed loan for its purchase. SBA foiled their scheme by declining the loan applications after the profits reflected on the false returns could not be verified. The charges were the result of an OIG investigation based on a referral from the Office of District Counsel of the Houston District Office.

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Disaster Assistance

Minnesota Businessman Found Guilty of and Sentenced for Conspiracy and Mail Fraud. The owner of an agricultural service company in Clarkfield, Minnesota, was sentenced on February 21, 1996, to 23 months imprisonment, 2 years supervised release, and \$5,000 restitution to the State of Minnesota. He had been indicted on 16 criminal counts, including 2 counts of **making false statements** in applying for a \$500,000 SBA disaster business loan in 1992 to repair tornado damage to his business. The man and three other defendants had also been indicted on multiple felony counts of conspiracy, bribery, mail fraud, and false statements to defraud the Department of Housing and Urban Development (HUD) in

another loan scheme.

More Results From Ongoing Investigation of California Loan Packagers. In the latest results from the continuing investigation of two southern California brothers who acted as disaster loan packagers, one more of their clients has been charged with crimes against SBA, another has entered a guilty plea, and a third has been sentenced. All of these actions involve applications for economic injury disaster loans filed in the wake of the 1992 civil unrest in Los Angeles, California.

❶ A client of the southern California disaster loan packagers pled guilty on June 3, 1996, to a misdemeanor count of **theft of Government funds**. In connection with his application for a \$360,000 economic injury loan following the 1992 Los Angeles civil unrest, the applicant claimed to be the sole owner of a clothing manufacturer in Los Angeles, when he actually owned only 65 percent. He concealed the other owner's interest from SBA to hide his own poor credit history. As part of his plea agreement, the man has agreed to repay the SBA loan on an accelerated basis, including a \$50,000 payment made at the time of his plea.

❷ A Northridge, California, man was sentenced on June 10, 1996, to 3 months in a

half-way house, 3 months home detention, 5 years probation, 300 hours of community service, and \$35,000 restitution. He previously pled guilty to one count of **making a false statement to a Federally-insured bank**. To facilitate the approval of a \$241,500 home loan to his wife, the applicant submitted a false employment verification form, claiming that his wife was employed at a salary in excess of \$100,000 per year; in fact, she was unemployed.

Following the 1992 Los Angeles civil unrest, the couple became subjects of the investigation when the Disaster Assistance Area 4 Office questioned their application for a \$300,000 economic injury disaster loan for the wife's business, a fashion boutique. SBA turned down the application, and the investigation later established that the business did not exist.

③ The owner of a clothing manufacturer in Los Angeles, California, was charged in a criminal information filed on June 14, 1996, with **filing a false claim with SBA**. With his application for a \$500,000 economic injury disaster loan following the 1992 civil unrest, the man submitted altered copies of income tax returns which significantly overstated his business's income. He

also submitted a schedule of liabilities that included numerous creditors with which he had never done business. These were the latest results of a joint OIG/Secret Service investigation of falsified loan applications prepared by the two southern California brothers acting as disaster loan packagers. The case was opened as a result of a tip from a concerned citizen and a referral from the Disaster Assistance Area 4 Office.

Florida Company Executive Sentenced for Making False Statement.

The president of a sports entertainment business in Belleair Beach, Florida, was sentenced on June 14, 1996, to 1 year probation, 100 hours community service, and a \$150 fine.

He had previously pled guilty to one count of **making false statements to SBA**. Having submitted Borrower's Progress Certifications to SBA which contained a number of false statements to induce disbursement of \$190,400 in business physical disaster loan proceeds, he also submitted fraudulent copies of invoices, proposals, checks, and other documents purportedly corroborating his certification of damaged video equipment used in his business. In 1995, after being interviewed by an OIG special agent, he voluntarily repaid the \$95,609 balance of the fraudulently-obtained loan, as well as the

\$19,393 balance of his economic injury disaster loan and the \$40,837 balance of his disaster home loan. This investigation was based on a referral from the Disaster Assistance Area 2 Office.

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Minority Enterprise Development

California Section 8(a) Company Accounting Manager, Trustee, and CEO's Administrative Assistant Sentenced. The last three of the ten original defendants who entered guilty pleas as a result of the OIG's participation in a Federal task force investigation of a Section 8(a) company with offices in Los Angeles and Houston, were sentenced recently. The firm's former accounting manager, and the trustee of a trust which was created by the chief executive officer (CEO) and his wife, had previously pled guilty to one count of **violation of National Aeronautics and Space Administration (NASA) security regulations**. Both were sentenced on May 20, 1996, to 6 months supervised probation and 120 hours community service. The CEO's administrative assistant, who had also pled guilty to one count of **conspiring** with the firm's CEO and others to file false claims for payment by NASA under various Section 8(a) contracts, was sentenced on June 3, 1996, to 3 years probation and 180 hours community service. The CEO had used the trust and three other

associated corporations to bill inflated rents and other expenses to NASA subcontracts, including a Section 8(a) contract initiated in 1981 for \$4.4 million and extended through December 1989 with additional charges of \$6.4 million. Also included in the conspiracy were a series of materially false statements, regarding the existence of the firm's San Diego office, that were made to secure and maintain Section 7(j) cooperative agreements totaling more than \$60,000. The SBA/OIG was asked by the NASA/OIG to join the task force, which also included the IRS, the Postal Inspection Service, the Federal Bureau of Investigation (FBI), and the Departments of Defense and Labor.

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Agency Management and Financial Activities

Former SBA Employee Sentenced for Conversion of Government Property. A former clerk with the Disaster Assistance Area 4 Office, Sacramento, California, was sentenced on June 24, 1996, to 30 days home detention, 5 years probation, and \$3,748 restitution. He previously pled guilty to one count of **conversion of Government property** to his own use. A joint OIG/Federal Protective Service investigation of the man was initiated based on information provided by the Area 4 Office. It determined that, without authorization, he obtained a rented

automobile which was paid for by SBA and used it exclusively for personal business. Area 4 officials became aware of the crime when the employee was involved in an accident with the vehicle.

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Other OIG News

OIG Semiannual Report Sent to Congress. The SBA Administrator sent the OIG's Semiannual Report to the Congress on July 2, 1996. The report summarizes activities for the 6-month period ended March 31, 1996. The OIG reported six months of optimal productivity (indictments, convictions, dollar recoveries, and management agreement to use funds more effectively.) Copies for distribution to the public are available on request.

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The Activity Update is produced by the SBA/OIG, James F. Hoobler, Inspector General.

Comments or questions concerning this update or requests for copies of OIG audits, inspections, or other documents should be directed to Johnny Cahn, SBA/OIG, 409 Third Street, SW, Washington, DC, 20416-4110.

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