



Office of Inspector General Small Business Administration

July 1998 Update

Business Loans

Audits of SBA's Section 7(a) Business Loan Program Find Instances of Lender Non-Compliance With Required Procedures. A recent audit of Section 7(a) loans in Buffalo, New York; Newark, New Jersey; and Madison, Wisconsin, found that lenders did not comply with at least one required procedure in 16 of 30 loans at Buffalo, 11 of 30 loans at Newark, and 15 of 30 loans at the Madison, Wisconsin district office according to three reports issued by the Inspector General as part of a national audit of lender processing of 7(a) loans. Buffalo, Newark, and Madison are three of eight areas randomly selected for review in the audit, with a random sample of 30 loans drawn from all loans made in each district from March 1996

through June 1997. The objective of the audit was to review lenders' compliance with 22 required procedures. Failure to follow these procedures increases the chance that ineligible or risky loans will be approved. After the eight individual district reports are completed, the OIG will summarize findings in a national report.

The errors in the Buffalo district involved **incorrect size standards, ineligible purposes, adverse changes not reported to SBA, lack of capital injection, lack of verification of financial data with IRS data, and inadequate credit review.** The errors in the Newark district involved **cash injections, IRS verification, misuse of loan proceeds, lack of current financial information, and lack of a standby agreement.** The errors in the

Madison district involved **lack of equity injections, lack of IRS verification of financial data before disbursement, inappropriate use of proceeds, lack of joint payee checks for disbursements, and lack of credit reports.** The auditors also identified three borrowers who made false statements concerning their criminal histories. Recommendations for corrective action were agreed to by the directors of the three districts

Audit Finds Loan-Making Policy Change Increases Risk. An audit of Section 7(a) loan processing found that SBA changed a portion of its loan-making policy, thereby allowing lenders to waive the IRS verification requirements as a means of verifying the accuracy of financial information of an existing business being acquired. The OIG believes that this **policy change increases the risk of losses to SBA.** In October 1994, SBA issued Policy Notice 9000-941, that required lenders to obtain IRS verification of financial information of business applicants, prior to loan disbursement. When a loan was for the purchase of another existing business, the verification was obtained before that business was purchased. In December 1997, SBA revised SOP 50-10(4) to waive the IRS verification requirement for the business to be purchased.

The report recommended that the Office of Financial Assistance revise the language of SOP 50-10(4) to require IRS verification of seller financial information for all loan applications except when the seller provides audited financial statements. The Acting AA/FA concurred with the recommendation and has already begun the modifications.

and the PLP processing center, except that the Buffalo District Director disagreed with two recommendations--one concerning credit reports before disbursement and one concerning actions to protect the Government's interest before default or a purchase request. The latter issue is being negotiated currently between the Office of Financial Assistance and the OIG.

Audit of an Early-Defaulting Loan Reveals Improper Processing by Lender. An audit of an SBA-guaranteed loan, made by a participating non-bank lender, that defaulted within 12 months of origination showed that the loan's **early default was caused by improper lender processing procedures and possibly false statements** made by the borrowers. Specifically, the lender did not adequately verify the status of borrower's outstanding debts or comply with all of the terms of the loan agreement. The borrowers may have made false statements during the application process, and that issue was referred to the Office of Inspector General's Investigations Division. The audit determined that SBA sustained a loss of about \$189,400. The report recommended that the District Office recover the loss from the lender and remind the lender of its obligations to comply with the terms of the loan agreement and SBA regulations. The District Director agreed with the recommendations.

California Loan Brokerage Investigation Continues to Yield Results. Five new actions have resulted from the ongoing investigation of an Inglewood, California, loan brokerage firm:

❶ The former owner of a gas station in Compton, California, was sentenced on July 6, 1998, to 15 months incarceration, 3 years supervised release, and \$225,000 restitution (80% to SBA). He previously pled guilty to one count of **making false statements to a Federally-**

❷ The former owner of a gas station in Fontana, California, was indicted on six counts of **making false statements to a Federally-insured lender** for allegedly submitting a false Source of Cash Injection letter, a false personal financial statement, a false SBA settlement sheet, and altered individual income tax returns for 1987-89, with his application for a \$1,000,000 SBA-guaranteed loan. The man subsequently defaulted on the loan, leaving an unpaid balance of \$968,664.

❸ The former owner of a gas station in San Bernardino, California, pled guilty on June 1, 1998, to three counts of **making false statements to a Federally-insured lender** by submitting altered individual income tax returns for 1988-90 with her application for a \$300,000 SBA-guaranteed loan. The loan was disbursed in June 1991; by April 1992, the woman had filed for bankruptcy protection. In August 1994, SBA charged off a \$292,189 loss on her loan.

❹ A Harbor City, California, tax preparer pled guilty on June 18, 1998, to three counts of aiding and abetting the **making of false statements to a Federally-**

insured lender by submitting altered individual income tax returns for 1987-89 with his application for a \$225,000 SBA-guaranteed loan. The man subsequently defaulted on the loan, leaving an unpaid principal balance of \$225,000.

insured lender. The man admitted assisting principals of the loan brokerage by preparing fraudulent tax returns (some fictitious, others altered), fraudulent personal financial statements, fictitious profit and loss statements, and other false documentation for their clients. He admitted having known that the false documents would be included in application packages being submitted for SBA-guaranteed loans. The charges address the preparation of false documents in three loan application packages, which resulted in the approval of SBA-guaranteed loans totaling \$2.5 million.

❺ The former co-owner of a West Covina, California, gas station pled guilty on July 13, 1998, to one count of **making false statements to a Federally-insured lender.** He was previously charged with submitting altered individual income tax returns for the years 1987-89 with his application for a \$1,000,000 SBA-guaranteed loan. The man and his co-borrowers (who were previously indicted in connection with this investigation) subsequently defaulted on the loan. After all liquidation efforts had been

completed, SBA charged off a balance of approximately \$500,000.

These actions resulted from an extensive investigation, conducted jointly with the FBI and the IRS, based on allegations from an anonymous complainant. The investigation focused on loans submitted by this loan brokerage to a participating lender Kansas Couple Pleads Guilty to Making False Statements. The former president and the former secretary (his wife) of a wood-pellet manufacturing company in Erie, Kansas, pled guilty on June 3, 1998, to two counts and one count, respectively, of **making material false statements to SBA** regarding the company's application for a \$147,650 SBA-guaranteed loan. As part of the plea agreements, the Government agreed to dismissal of all the other charges on which the couple had been indicted. The loan was intended to finance the opening of a fuel-pellet manufacturing plant, but the business failed and defaulted on repayment of the loan. In the plea agreements, the company president admitted that he failed to disclose both a prior defaulted SBA disaster loan and fuel taxes owed to the state of Arizona, and the company secretary admitted that she failed to disclose her husband's prior bankruptcy. The OIG's joint investigation with the U.S. Secret Service was initiated based on a referral from SBA's Kansas City District Office.

Pennsylvania Emergency Vehicle Manufacturer Pleads Guilty to Misappropriation of SBA Collateral. The owner of a Luzerne County, Pennsylvania, manufacturer of ambulances, fire trucks, and paramedic units pled guilty on July 22, 1998, to

bank. The loan brokerage's portfolio at the bank totaled approximately 170 loans, originally valued at more than \$60 million. Partially as a result of the default rate of these allegedly fraudulent loans, the bank was closed by the Office of the Comptroller of the Currency in April 1994. The investigation has focused on a sample of these loans and is continuing.

one misdemeanor count of **misappropriation of SBA collateral**. The OIG's investigation, based on a referral from SBA's Philadelphia District Office, had found that he knowingly disposed of property which was pledged as collateral to secure a \$171,842 SBA-guaranteed loan. In the plea agreement, the man acknowledged that he fraudulently pledged as collateral a \$55,842 ambulance which he also sold to a volunteer fire company without SBA's knowledge or permission. The loan is in liquidation, and the owner is in Chapter 11 bankruptcy.

Mississippi Trucking Accessories Business Owner Indicted for Misappropriation of Collateral and Bank Fraud. The owner of a trucking accessories business in Gulfport, Mississippi, was indicted on June 24, 1998, on one count of **misappropriation of SBA collateral** and four counts of **bank fraud**. The man obtained a \$100,000 LowDoc loan for the firm. The OIG's joint investigation with the FBI found that he removed, disposed of, and/or converted to his own use various items of business inventory that were pledged as collateral for the SBA-guaranteed loan. The owner filed for bankruptcy with SBA facing a loss of \$79,705. The investigation also determined that he double-billed customer credit cards,

“kited” checks to several banks, forged signatures to cash checks, and deposited closed account checks, producing a total bank fraud loss of \$49,077.

① The owner and president of a grocery retailer in Kennesaw, Georgia, was sentenced on July 10, 1998, to 4 months incarceration, 4 months home detention, 1 year supervised release, and \$133,000 restitution to SBA. He previously pled guilty to one count of **making a materially false statement** in an SBA-related matter. On the Form 912, Statement of Personal History, submitted as part of the loan application package, the owner certified that he had never been arrested. He had previously been arrested twice, however, and the responsible SBA official asserted that the loan would have been declined if he had disclosed his arrest record.

② The owner and chief executive officer of the firm which had brokered the sale of the second grocery retailer was convicted on July 16, 1998, of one count of **conspiracy**, three counts of **making false statements** to SBA, and three counts of **making false statements to a Federally-insured bank**. The man was found to have conspired with the purchaser and others to conceal the true purchase price from the participating lender bank and SBA. The original loan application indicated a purchase

One Georgia Businessman Sentenced, Another Convicted, for Making False Statements. The OIG’s investigation of a \$155,000 SBA-guaranteed loan made for one grocery retailer to buy another has led to two recent results:

price of \$300,000, with the seller financing \$100,000; however, SBA declined the application based on that price, stating that repayment of the projected debt was unrealistic. The broker subsequently told the bank’s senior vice president that the buyer and seller had agreed to reduce the purchase price to \$200,000; the broker also faxed an Offer to Purchase to the bank indicating a purchase price of \$200,000. The loan application was re-submitted and approved by SBA. This investigation revealed that the purchase price was never reduced to \$200,000, but remained at \$300,000, restructured into \$200,000 for the sale of tangible assets and \$100,000 for the sale of goodwill. SBA and the bank were never informed about the goodwill aspect of the sale. This investigation was based on a referral from SBA’s Atlanta District Office.

Missouri Music Retailer Pleads Guilty to Making False Statements. The former president of a Springfield, Missouri, retailer of musical instruments pled guilty on July 21, 1998, to a criminal information charging him with **making false statements** to SBA. The man admitted misrepresenting on his SBA Application for Business Loan that certain outstanding company loans were current, when they were actually past

due. The company received a \$155,000 SBA-guaranteed bank loan in March 1995 but defaulted after only two payments. The OIG's joint investigation with the FBI was initiated based on a referral from SBA's Springfield, Missouri, Branch Office.

California Lighting Company Owner Sentenced for Making False Statements. The former owner of a Los Angeles, California, lighting company was sentenced on July 6, 1998, to 27 months imprisonment, 3 years supervised release, and \$4,033 in fines. He previously pled guilty to one count of **making false statements to SBA** and one count of **making a false statement on a bankruptcy petition.**

The man was approved for a \$25,900 disaster business loan following the 1994 Northridge earthquake; however, no proceeds beyond the first \$10,000 were disbursed because SBA became aware of a foreclosure on a property which he owned (and where he resided) but had not disclosed on his application.

He also applied for a disaster home loan following the 1995 floods in southern California, but this loan was declined due to lack of repayment ability. The investigation, which the OIG initiated based on information provided by SBA's Disaster Assistance Area 4 Office, found that his business closed even before SBA disbursed the \$10,000. It also showed that he used a false Social Security number (SSN) and provided altered income tax returns in support of both applications. The owner filed for bankruptcy to forestall eviction from the property that was in foreclosure and used a second false SSN in the bankruptcy petition.

California Market Owner Sentenced for Making False Statements. The former owner of a Los Angeles, California,

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Disaster Assistance

mini-market was sentenced on June 10, 1998, to 4 months home confinement, 5 years probation, and \$22,500 restitution. He previously pled guilty to one count of **making false statements** to SBA. After the mini-mart was burned down during the 1992 civil unrest, the man had obtained disaster loans totaling \$116,000. With SBA approval, he relocated to Oregon City, Oregon, and opened an Asian-food restaurant. The OIG's investigation found that, to receive further disbursements of disaster loan funds, he falsely certified that he had spent the previously-disbursed loan funds in accordance with the Loan Authorization and Agreement. He submitted to SBA a Borrower's Progress Certification with an invoice showing purchases exceeding \$94,000 from a restaurant equipment supplier. The investigation found that he only purchased approximately \$2,000 of items from the supplier and instead used at least \$56,000 of the loan funds as a down payment on a home. The man subsequently filed bankruptcy, and SBA incurred a loss of approximately \$91,000. The case was referred to the OIG by SBA's Portland District Office.

Virginia Arcade Game Distributor Pleads Guilty to Making False Statements. The owner of an arcade game distributor in Roanoke, Virginia, pled guilty on July 8, 1998, to one count of **making false statements** to SBA. He was sentenced, on the same day, to the 72 days he had been incarcerated since his arrest, 5 years probation, \$104,700

restitution, and a \$50 special assessment. In 1986, after receiving \$104,700 in disaster loan funds for his business, the man submitted receipts showing the purchase of video games which he had never actually bought. In fugitive status since his indictment in 1992, he was located in Florida living under an alias. He was arrested by the ***Small Business Investment Companies***

Florida Financial Consultant Charged and Arrested With Fraud. A West Palm Beach, Florida, man who was a consultant to the officers of a now-failed small business investment company (SBIC) in New York City was arrested on July 6, 1998, based on a subsequently-unsealed indictment charging him with one count of **financial-institution fraud**. Between February 1991 and May 1992 the man, without SBA's approval, allegedly acquired control over the day-to-day operations of the SBIC, a financial institution licensed by SBA, and executed a scheme to defraud it. The indictment charges that his scheme involved misappropriating and embezzling funds and other assets intended for or belonging to the SBIC and guaranteed by SBA. In furtherance of the alleged scheme, he opened accounts at three banks in a corporate name deceptively similar to the name of the SBIC. The man allegedly controlled the deceptively-named entity and its various accounts and deposited checks made payable to the SBIC into the bogus accounts and converted the proceeds. Over \$1 million was allegedly misappropriated in this fashion. In May 1992 the SBIC failed and was placed in receivership. SBA, honoring its guaranty, was obligated to

Marshals Service in April 1998 and returned to Virginia. The OIG initiated its investigation based on a referral from a loan liquidation officer in SBA's Richmond District Office.

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pay \$4.7 million to the bank that issued the Federally-guaranteed debentures. The OIG's joint investigation with the FBI was based on a referral from SBA's Office of General Counsel.

Michigan SSBIC Officer Sentenced for Misapplying Funds and Failing to Report a Currency Transaction. An officer and director of a specialized small business investment company (SSBIC) in Farmington Hills, Michigan, was sentenced on April 9, 1998, and was ordered, jointly with another SSBIC officer, to pay \$325,000 to the Government. The two men had each pled guilty to misdemeanor counts of **misapplying funds of a financial institution and failing to file a required Currency Transaction Report**. (The other SSBIC officer was sentenced earlier.) With regard to the count of "misapplying funds," the two businessmen caused the SSBIC to loan money to a business in Michigan which they knew was going to forward the funds to a business in California previously denied a loan from the SSBIC. With regard to the count of "failing to file," the pair, as officers of the SSBIC and a related company, caused the related company to accept, in the regular course of business, \$20,000 in cash but failed to file a Currency Transaction Report with the Department of the Treasury. The investigation was conducted jointly by the U.S. Secret Service, the IRS, and the SBA/OIG. It

developed from information uncovered in an investigation of another SSBIC. Under the civil forfeiture order, the \$325,000 will go to the IRS and the Secret Service. SBA will receive none of these proceeds even though more California Restaurant Owner Convicted on Charges of Bank Fraud. The former owner of a restaurant in La Mesa, California, was convicted on May 29, 1998, of two counts of **bank fraud** and acquitted of a third **bank fraud** count. The counts of which he was convicted charged him with fraudulently obtaining loans from two southern California financial institutions. He was acquitted on the count involving a \$465,000 loan from a now-defunct specialized small business investment company (SSBIC). The man applied for the loan in the name of the restaurant, purportedly to improve the restaurant facility. He was alleged to have falsified documents submitted to the SSBIC to conceal that the true (and ineligible) use of the loan proceeds was to make a down payment on an option contract to purchase stock in a chain of convenience stores. The joint OIG/FBI/Secret Service investigation developed from information uncovered in a previous investigation of the SSBIC.

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Agency Management

SBA Job Applicant Pleads Guilty to Fraud. A man who had applied for employment with SBA's Office of Financial Operations, Denver, Colorado, pled guilty on July 27, 1998, to one misdemeanor count of **making a fraudulent demand** for wages by making false statements in the application he submitted to SBA. The

than \$100,000 of the misapplied funds came from the SSBIC. The SBA/OIG continues to seek legislation allowing it to participate in the Government's Asset Forfeiture program.

OIG's investigation determined that, in applying for a Financial Specialist position, the man had failed to disclose five occasions on which he had been arrested and/or imprisoned. In addition, he falsely stated that he had received two Bachelor of Science degrees and a Master's degree and that he was a CPA. He also represented that he had not been fired from a job, when in fact he had been fired by another Government agency for submitting a falsified job application. The OIG initiated the investigation based on a referral from SBA's Office of Human Resources. In the fall of 1997, after the OIG's initial inquiries confirmed that certain statements in his application were false, SBA withdrew the job offer previously made.

Editor's Notes:

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The following identifies the use of adjectives in these **Updates** to describe tax returns fraudulently submitted in support of loan applications:

Fictitious tax returns: The applicant submits "copies" of tax returns never filed with the IRS.

Altered tax returns: The applicant submits altered copies of tax returns actually submitted to the IRS.

Bogus tax returns: The applicant submits tax returns containing false information to both the IRS and SBA.

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Most audit and inspection reports can be

found on the Internet at:

WWW.SBAONLINE.SBA.GOV/IG/REPORTS.HTML

Other IG related material can be found at:

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The Activity Update is produced by the SBA/OIG, Karen S. Lee, Acting Inspector General.

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