



Office of Inspector General U.S. Small Business Administration

March 2008 Update

Business Loan Programs

Ongoing Investigation Results in Indictments. In January 2007, agents from the SBA OIG and the U.S. Secret Service arrested 18 individuals sought in connection with a scheme in which a lender's former executive vice president and others not employed by the lender conspired to fraudulently qualify loan applicants for SBA-guaranteed loans. The scheme involved as many as 76 fraudulent loans totaling about \$76 million. The following case is part of this ongoing investigation, which is being conducted jointly with the U.S. Secret Service.

- On March 4, 2008, a Michigan woman pled guilty to one count of conspiracy. From April 2002 to November 2006, she conspired with others to defraud SBA by (1) claiming to be the 100% owner of a business on several loan application documents, (2) overstating her financial status, (3) alleging that the source of a \$250,000 equity injection was a gift from an uncle, (4) making misrepresentations on the management resume, and (5) obtaining the loan in her name only for a brother-in-law, who was in fact the owner and intended operator of the business. The \$825,000 SBA-guaranteed loan was made by a Detroit lender in August 2002.

OIG Issues Report on an Audit of UPS Capital Business Credit's (UPSC) Compliance with Selected 7(a) Lending Requirements. On March 21, 2008, the OIG issued an audit on *UPS Capital Business Credit's (UPSC) Compliance with Selected 7(a) Lending Requirements*. The objective of the audit was to determine whether UPSC materially complied with SBA's requirements for documenting (1) borrower equity injection, (2) use of loan proceeds, and (3) qualifications for debt refinancing. The OIG reviewed a statistical sample of 36 of 103 loans originated by UPSC and purchased by SBA between October 2003

and March 2007. The OIG did not identify problems in the areas of equity injection and qualifications for debt refinancing. However, it was determined that 16 (about 44 percent) of the 36 loans in the sample did not have adequate supporting documentation to show how borrowers used the loan proceeds. These loans had an outstanding balance of about \$4.3 million. When projected to the 103 loans purchased by SBA during the time period reviewed, it was estimated that 44 percent of \$11.2 million in guaranties purchased by SBA as of March 31, 2007, were made without the appropriate documentation showing how the borrower used the loan proceeds.

The OIG recommended that the Director, Office of Financial Assistance, obtain the appropriate documentation for the use of loan proceeds for the 16 loans, establish a corrective action plan addressing the lender's procedures for documenting the use of loan proceeds, and repair one loan for improper use of loan proceeds. The Agency concurred with the OIG's recommendations, and stated that actions were being taken to satisfactorily address the three report recommendations.

OIG Issues Report on an Audit of Loan Classifications and Overpayments on Secondary Market Loans. On March 26, 2008, the OIG issued an audit on *Loan Classifications and Overpayments on Secondary Market Loans*. The objectives of the audit were to determine if SBA (1) classified secondary market loans appropriately, (2) purchased loans from the secondary market in a timely manner, and (3) pursued lenders for overpayments it made to secondary market investors. Our audit disclosed that an estimated \$161 million in secondary market loans were reported as current even though loan payments were 60 days or more past due. Furthermore, it was determined that SBA did not purchase guaranties from the secondary market in a timely manner and, as a result, incurred \$7.4 million of additional interest expense. While SBA

generally pursued lenders for overpayments it made to secondary market investors, the OIG identified instances where SBA had overbilled lenders by \$1.9 million on loans where transcripts either were not provided or were incomplete. Finally, the OIG identified approximately \$1.1 million of income that SBA reported from ongoing guaranty fees it never collected from lenders.

The report contains 10 recommendations addressed to the Director, Office of Financial Assistance and one recommendation addressed to the Chief Financial Officer. The Agency agreed with two of the recommendations, partially agreed with three of the recommendations, disagreed with four of the recommendations, and neither agreed nor disagreed with one recommendation. The Agency also indicated it had already taken the proposed action for one recommendation

Slaughtering Business President Indicted. On March 12, 2008, the president of a slaughtering business located in San Angelo, Texas, was indicted on four counts of wire fraud and aiding and abetting, and two counts of making a false statement to a bank and aiding and abetting. Between 2002 and 2004, the business president received \$1,236,500 in SBA-guaranteed loans and an additional \$1,812,000 in non-SBA loans. He is accused of using false and fraudulent representations and documents to convince at least four different lenders that he had sufficient collateral and income to repay the financing he received. The OIG is conducting this investigation jointly with the Federal Bureau of Investigation.

New York Business Owner Pleads Guilty. On March 19, 2008, the owner of a New York trading company pled guilty to one count of conversion and concealment of property mortgaged and pledged to the SBA. In February 2005, he received a \$250,000 SBA-guaranteed loan from a New York bank. The loan was secured by his primary residence in New Jersey. In July 2006, he sold his primary residence for a profit of approximately \$487,000 and concealed the sale from the bank and SBA. He also signed an Affidavit of Title which concealed from the buyers that SBA had an interest in the property. He subsequently defaulted on his SBA loan. The case was initiated based upon a referral from the OIG's Early Fraud Detection Working Group.

California Man Pleads Guilty. On March 20, 2008, a California man was indicted on two counts of mail fraud and aiding and abetting and causing an act to be done, one count of possession of 15 or more unauthorized access devices, and five counts of aggravated identity theft. The investigation revealed that he was a leader behind a sophisticated identity theft ring operated for the purpose of obtaining fraudulent SBAExpress lines of credit, conventional and/or residential loans, and credit cards. He created three identities using other individuals' Social Security account numbers, fictitious businesses, and credit cards obtained for each false identity. He also falsely claimed to be a U.S. citizen. He applied for business lines of credits at various lenders using these false identities and was awaiting responses from lenders when the OIG and other participating agencies arrested him on different California state felony charges relating to a fraudulent \$35,000 SBAExpress and \$1,445,000 residential mortgage loans. He pled guilty to those charges and was sentenced on March 7, 2008, to time served in prison (344 days), three years probation, restitutions of \$34,650 to SBA and a bank and \$1,445,000 to another lender, and a \$200 fine. The OIG is conducting this investigation jointly with the Los Angeles Police Department; California Department of Insurance; Department of Homeland Security, Immigration and Customs Inspection Bureau; Postal Inspection Service; and the Social Security Administration OIG.

Illinois Business Man Indicted. On March 20, 2008, an Illinois businessman was indicted by a federal grand jury in the Northern District of Illinois on one count of bank fraud and one count of wire fraud in connection with schemes to defraud SBA, an Illinois lending company, and an Illinois bank. The schemes involved two SBA-guaranteed loans—a \$660,000 loan to a sealant business and a \$200,000 loan to an equipment rental company—to be used for his nearly simultaneous purchases of the businesses. At the time of his loan applications, he had been arrested and faced theft and fraud charges related to a third business he owned. He concealed this information from the lenders and certified that he had never been arrested or charged with any offense. Moreover, he falsified the required equity injections for both loans by altering a previously-cancelled business check to show the required \$27,000 investment into the equipment company. On the same day that he reported he would be the sole owner of sealant company, he converted some of the collateral stock he would

receive to two friends in exchange for \$80,000 cash. He concealed the sale and used the funds to partly finance the required equity injection. He also admitted that, after he defaulted on the loans, he sold collateral machinery and tools from both businesses.

California Dry Cleaners Owner Indicted. On March 21, 2008, the owner of a dry cleaning business was indicted by a federal grand jury on two counts of making false statements to a financial institution and one count of causing an act to be done. The owner and his partner had been approved for a \$650,000 SBA-guaranteed loan from a California bank to purchase the business in December 2003. After a public records check for additional assets, the bank learned that he had not disclosed his criminal history on his loan application. An OIG investigation confirmed that he had a prior criminal record that was not disclosed on his SBA Statement of Personal History (Form 912) or on the bank's documents. Specifically, he had been found guilty of making false statements to a financial institution in July 1999. The investigation also revealed that the \$350,000 cash injection to purchase the business had been borrowed by the owner of the dry cleaning business, even though a letter submitted by another individual to the bank indicated that the \$350,000 was not borrowed. The OIG investigation resulted from a referral by the bank.

Disaster Loan Program

OIG Issues Report on an Audit of Annual Credit Reviews for Gulf Coast Hurricane Disaster Loan Disbursements. On March 28, 2008, the OIG issued an audit report on *Annual Credit Reviews for Gulf Coast Hurricane Disaster Loan Disbursements*. The audit disclosed that SBA's monitoring efforts were not adequate to ensure that the financial status of borrowers had not deteriorated to levels that would adversely impact their loan repayment ability. Generally, the audit found that the Office of Disaster Assistance (ODA) did not: (1) perform annual credit reviews, as required by Agency procedures, before making loan disbursements; (2) obtain updated financial information on borrowers; and (3) cancel loans, as required, when the borrower had no repayment ability. ODA disbursed \$4.9 million on about 70 percent of 159 sampled loans without verifying that loan recipients were creditworthy. Although SBA originally established annual credit reviews as a management control, internal ODA policy

memos extended the period for credit reviews, effectively eliminating reviews on 10,100 loans totaling over \$1 billion in disbursements. Additionally, although disbursement deadlines for these loans are included in the Disaster Credit Management System (DCMS), funds were continually disbursed after the deadlines (this occurred for 74 of the 159 loans reviewed during our audit).

The OIG recommended that the SBA reinstitute the requirement that updated financial records and credit reports be collected during annual credit reviews and ensure that the reviews are performed when disbursements are made a year after loan authorization. The OIG also recommended that written justification be provided for disaster assistance policy made outside of the Agency's SOP clearance process, and that internal controls be implemented to ensure that the DCMS prevents the payment of loan proceeds after disbursement deadlines expire. ODA generally concurred with the audit findings, but non-concurred with three of the four recommendations, commenting on several issues raised in the report. The Agency agreed that not all credit reviews were completed as required, but believed it had the authority to relax credit review requirements, even though such action circumvented its own regulations and standard operating procedures. The OIG believes that since ODA's decision not to comply with credit review requirements placed a significant amount of loan funds at risk, it should have secured approval for such action from executive levels of the Agency.

OIG Issues Report on an Audit of the Withdrawal of Disaster Loan Applications to Individuals and Businesses Impacted by the Gulf Coast Hurricanes. On March 28, 2008, the OIG issued an audit report on the *Withdrawal of Disaster Loan Applications to Individuals and Businesses Impacted by the Gulf Coast Hurricanes*. The audit disclosed that SBA generally acted appropriately when withdrawing incomplete loan applications. However, for 30 of the 96 loans sampled, SBA withdrew the loans without providing applicants with advance notice. When the results were projected to the universe, it was estimated that SBA inappropriately withdrew between 2,075 and 3,879 loan applications. Of the 30 loans withdrawn without advance notice, 12 were withdrawn within 4 days of SBA's attempted contact, 12 applicants did not receive a withdrawal letter advising them of the necessary steps to have their applications reaccepted, and one application was erroneously withdrawn.

However, the OIG was unable to determine a significant impact upon applicants. Of the 30 applicants, the OIG was able to reach 7, only 1 of whom still desired the loan.

The OIG recommended that SBA implement better internal controls, preferably through DCMS, to ensure that 14-day letters and withdrawal letters are sent to applicants, as required. The OIG also recommended that SBA revise production goals to exclude loan application withdrawals.

ODA generally agreed with the recommendations, but asserted that the production standards used when processing the Gulf Coast hurricane loans, and discussed in a February 24, 2006 memo from the Director of Loan Processing, were not new. However, the OIG's report did not claim that these production goals were new. It merely reported that loan officers who were interviewed believed that the established goals were unreasonable and frequently took priority over providing customer service. It was noted that the goals may have seemed unreasonable because many of the loans were being processed by newly hired employees who may have lacked the experience needed to achieve the goals.

Statutory/Regulatory/Policy Reviews

In an effort to proactively identify and correct potential Agency inefficiency and management problems at the onset of policy and regulatory development, the OIG reviewed, cleared, and/or provided comments, as appropriate, on 5 Agency initiatives, including proposed legislation, SBA Standard Operating Procedures, and Agency notices containing directives to its employees.

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The OIG has established an e-mail address (oig@sba.gov) that we encourage the public to use to communicate with our office. We welcome your comments concerning this update or other OIG publications. To obtain copies of these documents please contact:

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