



# Office of Inspector General Small Business Administration

March 1998 Update

## *Business Loans*

Audit Identifies Lack of Coordination and Control Weaknesses for Certain Agency Disbursements. An audit of 66,000 automatically processed and 5,500 manually processed "rebate and refund" type disbursements made in FY 1996 identified **no errors in the automate d disbursements and 260 manual processing errors, resulting in about \$96,000 in inappropriate payments .**

The manual errors included recording delays -- 237 payments (18 percent of the manual payments made in the first quarter) were not recorded in the Agency's Loan Accounting System until more than 30 days after confirmation by the Treasury. Of these, 166 of were not recorded within 1 year. In addition, incorrect transaction codes were used to record 30 transactions, and 28 duplicate or inappropriate disbursements were identified. The audit found that the errors were caused by a lack of coordination between different activities within the Office of Financial Operations (OFO) and weaknesses in controls for detecting and correcting errors. According to OCFO, the transfer of accounting operations from Washington, DC, to Denver, CO, and an unprecedented level of disbursement activity following the Northridge earthquake also contributed to

the processing errors.

Consequently, SBA's accounting records reflected incorrect information and SBA was due approximately \$96,000 from overpaid payees. The OIG recommended that the OFO develop, document, and implement procedures to improve controls for these types of payments, periodically review associated accounts for abnormal balances and recover funds related to those abnormal balances, and recover the \$96,000 identified during the audit as due SBA. The OFO concurred with the findings and recommendations, and has already begun their implementation.

### Inspection Report Recommends Strategies to Combat Loan Agent Fraud.

The OIG issued an inspection report that identifies cost-effective ways to **prevent loan agent fraud in the Section 7(a ) program**. While loan agents can provide valuable assistance to small businesses seeking access to capital, some have perpetrated fraudulent schemes that have resulted in defaulted loans that had to be purchased by SBA. The OIG recommends that the Agency (1) establish a loan agent registration process to provide accountability, (2) expand current legislation to include loan agents among those subject to National Crime Information Center criminal history

checks; and (3) develop a system for monitoring loan agent performance to provide early warning of any potential problems. The criminal history checks should be performed for each prospective loan agent as part of the registration process to identify and/or deter unsuitable candidates. The OIG also recommends that SBA maintain two lists on the Internet: currently registered agents, and agents whose privilege to conduct business with the Agency has been suspended or revoked. This would allow borrowers and lenders to verify the status of agents they are considering using.

#### Investigation of California Loan Brokerage Firm Yields Host of Charges.

As a result of an investigation of an Inglewood, California, loan brokerage firm, criminal charges were filed against the following individuals in February and March of 1998:

❶ A former principal of the brokerage firm was charged with three counts of aiding and abetting the **making of false statements to a Federally-insured lender** by causing the submission to a participating lender bank of Individual Income Tax Returns which he knew had been altered to overstate the applicants' adjusted gross income. The loans applied for totaled \$1,850,000.

❷ The former owner of a Burbank, California, gas station was charged with one count of **making false statements to a Federally-insured lender** by submitting altered Individual Income Tax Returns for the years 1988-90 while applying for a \$160,000 SBA-guaranteed loan.

The man subsequently defaulted on the loan, leaving an unpaid principal balance of \$151,472.

❸ The owner of a Manhattan Beach, California, gas station was charged with one count of **making false statements to a Federally-insured lender** by submitting altered Individual Income Tax Returns for the years 1988-90 while applying for a \$350,000 SBA-guaranteed loan. The man also defaulted on his loan, leaving an unpaid principal balance of \$292,617.

❹ The former owner of a gas station in Compton, California, was charged with one count of **making a false statement 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 balance of \$225,000.

❺ The owner of a car wash in Lomita, California, was charged with one count of **making a false statement to a Federally-insured lender** by submitting altered Individual Income Tax Returns for 1987-89 with his application for a \$1,000,000 SBA-guaranteed loan. He also submitted altered Individual Income Tax Returns for 1990 and 1991 in response to the requirement, in his Loan Authorization and Agreement, to provide information about his financial condition throughout the time the loan was in force. The

man is currently making loan payments quarterly through the U.S. Trustee's Office pursuant to a bankruptcy reorganization plan.

⑥ The former owner of a gas station in San Bernardino, California, was indicted on four counts of **making false statements to a Federally-insured lender**. Three counts charged her with submitting altered Individual Income Tax Returns for the years 1988-90 and count four charged her with submitting a false financial statement with her application for a \$300,000 SBA-guaranteed loan. The loan was disbursed in June 1991; by April 1992, she had filed for bankruptcy protection. In August 1994, SBA charged off a \$292,189 loss on her loan.

The individuals identified in items 2 and 3 above pled guilty to the charges against them on March 2, 1998. All 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 to Mechanics National Bank by the brokerage firm. The firm's portfolio at Mechanics National 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, Mechanics National 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.

Missouri Bank Settles Civil Suit Brought by SBA and Department of Justice. A

Missouri bank paid the Government \$200,000 on March 2, 1998, to settle a civil fraud suit brought under the Department of Justice's Affirmative Civil Enforcement program. The suit was filed in 1997 against the bank, its president, and its chairman and chief executive (a father and son) based on the results of an OIG investigation. The suit alleged that the defendants submitted a fraudulent application to obtain SBA's guaranty of a \$150,000 loan to a New Bloomfield, Missouri, water bottling company. Allegedly, the company's loan application misrepresented the status of the company's prior loans at the bank, which were shown as current when they were actually delinquent. SBA guaranteed the loan, which soon went into default, and subsequently paid the bank \$137,215 for its guaranteed portion. (This is the share of the \$200,000 to be paid to SBA.) The suit sought treble damages, civil penalties, interest, and costs pursuant to the **False Claims Act**. The Government's settlement agreement with the bank and the two bank officers noted that this \$200,000 payment was a compromise and not to be considered an admission of liability by the defendants. In 1996 the bottling company's corporate secretary pled guilty to mail fraud in connection with this loan and was sentenced to 1 year and 1 day in prison. The OIG initiated this investigation based on a referral from SBA's St. Louis District Office.

California Realtor Sentenced for Bribery of SBA Employee. A real estate salesperson in Glendale, California, was sentenced on March 2, 1998, to 4 months home detention, 3 years probation, and a \$5,100 fine. She had previously pled guilty to one count of **bribery** of an SBA employee. The investigation was initiated based on a referral from SBA's Los

Angeles District Office (LADO) on the same day that the woman offered compensation to a loan assistant in its Liquidation Division to become the listing agent for an SBA-foreclosed business property. Immediately after receiving the offer, the loan assistant notified his supervisor, who in turn notified the local OIG office. During subsequent telephone calls, and despite warnings that she and the loan assistant could get into trouble, the Realtor offered the loan assistant \$3,500 for the real estate listing. At a later face-to-face meeting, she gave the loan assistant \$1,000 as good faith money, and she and the SBA employee signed the real estate listing agreement. The following day, the Realtor was given a letter from the LADO's Legal Division stating that the loan assistant did not have the delegated authority to execute the listing agreement. When given the letter, she denied ever personally meeting with the SBA loan assistant, making him any promises, or giving him any money. The evidence contradicted those denials.

Idaho Farm Implement Manufacturing Company Officer Sentenced for Bankruptcy Fraud. The former secretary/treasurer of a Caldwell, Idaho, farm implement manufacturer was sentenced on February 9, 1998, to 5 years probation, 200 hours community service, and \$52,750 restitution to the corporation's bankruptcy trustee. He had pled guilty to one count of **bankruptcy fraud** for hiding a corporate asset (a 6-year old Ferrari) from the bankruptcy court. The man cooperated with the OIG's joint investigation (with the FBI and the IRS) of his father--the company's former president. The father was previously indicted on 21 counts of bankruptcy fraud, bank fraud, money laundering, and criminal forfeiture in

connection with a \$750,000 SBA-guaranteed loan and other financial dealings of the company.

District of Columbia Waste Recycler Indicted for Making False Statements and Perjury. The president of a now-defunct waste-paper recycling company in Washington, D.C., was indicted on March 13, 1998, on four counts of **making false statements in a loan application to a Federally-insured bank**, four counts of **making false statements to SBA**, and two counts of **perjury**. The company had received a \$296,014 SBA-guaranteed loan to purchase equipment to convert waste paper into fuel pellets. Approval of the loan was based on the company president's projection of the company's income. The indictment charged that the woman made false statements in her loan application when she (1) provided an altered document to support her income projections, (2) lied about her education, (3) failed to inform the bank and SBA that her contract to obtain the required waste paper had been canceled prior to the loan closing, and (4) failed to list on her Personal Financial Statement that she was a personal guarantor on a loan from another lender. The investigation found that, in response to the bank's request for information supporting her income projections, she had directed her secretary to alter a letter to reflect that the company would receive approximately 100 tons of waste paper a day instead of the 16 tons she knew to be the true amount. This letter was then submitted to the bank and SBA to support her inflated projections. The woman was charged with perjury for lying to the U.S. Bankruptcy Court about the alteration of this letter. The company defaulted on the loan without making a single payment. This investigation, conducted jointly with the FBI, was

initiated based on a referral from the participating lender bank.

Texas Cellular Phone Distributor Sentenced for Making False Statement.

The president of a Plano, Texas, cellular phone distributor was sentenced on March 11, 1998, to 15 months incarceration and \$254,970 restitution to SBA. He had pled guilty to one count of **making false statements** to SBA. The man obtained a \$230,000 SBA-guaranteed loan by submitting an SBA Form 912, Statement of Personal History, that bore a bogus Social Security number (SSN) and failed to disclose his criminal history. The bogus SSN was used on his SBA Form 413, Personal Financial Statement, as well. He also failed to disclose a number of debts in the loan application and provided SBA with altered tax returns and falsified invoices in support of the loan disbursements. The OIG opened this investigation based on a referral from SBA's Dallas District Office and continued it jointly with the IRS.

Oklahoma Computer Store Owner Indicted for Making False Statements.

The co-owner of a now-defunct Ardmore, Oklahoma, computer store was indicted on March 17, 1998, on one count of **making false statements on a loan application to a Federally-insured financial institution**. The store had received a \$50,000 SBA-guaranteed loan from a participating lender bank. To increase his chances of obtaining the business loan, the indictment charges, the man indicated on SBA Form 912, Statement of Personal History, that he had never been arrested or convicted other than for minor motor-vehicle violations. In fact, he had been arrested for and convicted of extortion in 1976 and, in an incident involving a minor, arrested for sexual assault and convicted

in 1989 of indecency and fondling. The OIG's investigation found that both charges were material to approval of the loan application. The loan was disbursed in August 1993. The owner closed the store and filed for bankruptcy in April 1994, and the loan was charged off in July 1996, with a loss to the bank and SBA of \$54,319. The OIG initiated the investigation based on results of its Operation Clean Sweep inquiries in Oklahoma.

Wisconsin Business Consultant Pleads Guilty to Making False Statement.

A business consultant in Menomonee Falls, Wisconsin, pled guilty on January 8, 1998, to one count of **making a material false statement** to SBA to obtain a \$25,000 SBA-guaranteed loan. The woman admitted that she knowingly failed to disclose a recent criminal history and provided a false Social Security number on SBA Form 912, Statement of Personal History, in a LowDoc loan application for her consulting firm. The OIG's investigation found that she had been arrested on a charge of forging company checks the day before she applied for the loan, and she was convicted on that charge after obtaining the loan. The OIG initiated the investigation in response to a request from the U.S. Attorney's Office for the Eastern District of Wisconsin.

Mississippi Tractor Dealer Indicted for Making False Statement.

The owner of a now-defunct tractor dealership in Shubuta, Mississippi, was indicted on March 24, 1998, on one count of knowingly **making a material false statement** to obtain a \$150,000 SBA-guaranteed loan. The indictment charged him with representing on a Schedule of Collateral (SBA Form 4, Schedule A) that he already owned, and would grant the participating lender bank a first security

interest in, \$99,373 of inventory when, in fact, he had no such inventory. Supporting information was developed in the OIG's investigation, which was based on a referral from SBA's Jackson District Office.

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### *Disaster Assistance*

#### Pennsylvania Computer Vendor Sentenced for Making False Statement.

A Lycoming County, Pennsylvania, wholesale computer salesman and telemarketer was sentenced on February 23, 1998, to 3 years probation and a \$3,000 fine. He had pled guilty to one count of **making a false statement** to SBA by omitting from his application for disaster assistance a mail fraud charge to which he had agreed to plead guilty. The false statement was made in connection with his application for disaster loans, totaling \$78,300, relating to floods in the Susquehanna River valley in January 1996. SBA declined the loans after discovering the undisclosed criminal charge. The investigation, which the OIG worked jointly with the FBI, was based on information provided by SBA's Disaster Assistance Area 3 Office.

#### North Carolina Man Pleads Guilty to Stealing Disaster Victim's Check.

A resident of Surf City, North Carolina, pled guilty on March 2, 1998, to a one count information that charged him with **stealing Federal property**. The man admitted converting to his own use an improperly-delivered \$6,300 U.S. Treasury check intended for a Surf City disaster victim. The OIG initiated this investigation based on information received from the Disaster Assistance Area 2 Office.

#### California Disaster Home Loan Applicant Pleads Guilty to False Statements and Misuse of Social Security Number.

A resident of Culver City, California, pled guilty on March 12, 1998, to one count of **making material false statements** to SBA and one count of **misuse of a Social Security number** (SSN). The man was approved for a \$33,000 disaster home loan following the 1993 Los Angeles winter storms, but SBA canceled the loan before any funds were disbursed once its tax verification program identified discrepancies between 1990-91 individual income tax returns submitted to SBA and the IRS. The OIG's investigation confirmed that the tax return "copies" submitted to SBA had been altered to overstate the applicant's income. The investigation also found that this same applicant, using a very similar name, was the recipient of a \$25,000 disaster home loan following the 1994 Northridge earthquake. The application package for that loan also included altered 1991-92 individual income tax returns and a fictitious SSN. The OIG opened the investigation based on a referral from SBA's Disaster Assistance Area 4 Office.

#### California Nurse Registry Owner Pleads Guilty to Filing False Claim and Making False Statement.

The owner of a nurse registry in Los Angeles, California, pled guilty on March 16, 1998, to one count of **filing a false claim** with SBA and one count of **making a false statement to a Federally-insured lender**. The investigation, based on a referral from SBA's Disaster Assistance Area 4 Office, revealed that the owner submitted fraudulent applications for disaster-related business loans to a participating lender bank and SBA. He obtained a \$50,000 interim loan from the bank; then

he obtained an \$89,600 economic injury loan and a \$72,800 physical damage loan from SBA. (Of the SBA loan proceeds, \$50,000 was to be used to repay the bank loan; however, he admitted diverting that amount.) In each of the loan applications, he claimed his business was located in a building damaged by fire during the 1992 civil unrest in Los Angeles. The investigation disclosed, however, that his business sustained no damage because he actually operated the nursing service out of his residence, which was not affected by the civil unrest. False documents submitted with the loan applications included a lease, a telephone installation invoice, and an estimate of the cost of replacing his business' files. The SBA disaster loans went into default after only two payments on each loan were made, and SBA charged off both loan balances in 1993. The owner did not make any payments on the interim loan, which the bank charged off in 1994.

Mississippi Automobile Parts Franchisees Plead Guilty to Conspiracy to Defraud the Government. A couple who owned an automobile parts franchise in New Hebron, Mississippi, pled guilty on March 4, 1998, to one count of **conspiracy** to defraud the Government. In return, the Government agreed to dismissal of the other six counts of their indictment. Their company obtained a \$120,000 SBA-guaranteed loan in 1991 and a \$42,500 physical damage loan and a \$29,800 economic injury disaster loan in 1992. An OIG investigation found that the couple carried out a scheme, using fraudulent receipts and invoices, to conceal their misuse of proceeds of the SBA loans. The indictment also challenged their claim that a tornado damaged structural improvements, equipment, and inventory of their

business. The investigation was based on a referral from SBA's Jackson District Office.

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## *Small Business Investment Companies*

Board Chairman of California SSBIC Pleads Guilty to Conspiracy and Willful Misapplication of Funds. The chairman of the board of a now-defunct Westminster, California, specialized small business investment company (SSBIC) pled guilty on March 6, 1998, to one count of **conspiracy** and three counts of **willful misapplication of funds** belonging to the SSBIC. This plea is the culmination of an extensive OIG investigation initiated in 1992, based on information provided by SBA's Investment Division shortly after \$1 million in SBA funds were advanced to the SSBIC. The investigation found that the chairman made false statements with respect to his initial cash injection, the true ownership of the small business concerns to which the \$1 million was loaned, and the disposition of the loan proceeds. He recently repaid \$927,000 of the \$1 million he fraudulently obtained from SBA in April 1992. In addition, based on information developed in the investigation, the SSBIC's receiver negotiated out-of-court settlements with a bank and its operations officer for \$150,000 and \$50,000, respectively, for their assistance to the SSBIC's chairman in manipulating the SBA funds.

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## *Agency Management and*

## *Financial Activities*

SBA's Financial Statements Receive Second Unqualified Opinion From Outside Auditors. The SBA's FY 1997 Financial Statements received a unqualified opinion from its independent auditors, Cotton & Company (Cotton). The unqualified opinion means that the auditors found SBA's principal financial statements to be presented fairly in all material respects in accordance with OMB guidelines and SBA accounting policies. The results of the audit were transmitted to the Chief Financial Officer by the OIG, which contracted with Cotton to perform the independent audit. This was the second year that the Agency received an unqualified opinion.

Cotton did, however, find three problems that were considered "reportable conditions" in the internal control structure: (1) incorrect calculations were used in the credit reform subsidy modeling and reestimating process for the Section 7(a), 504, and disaster programs, resulting in substantial errors (these calculations were corrected upon discovery by the auditors); (2) lack of planning for financial reporting which resulted in untimely and erroneous draft financial statements; and (3) inadequate SBA computer security and applications development standards. Cotton considered reportable conditions (1) and (2) to be material control weaknesses.

In the section on compliance with laws and regulation, the auditors found SBA complied in all material respects with provisions of applicable laws and regulations tested.

### Acting Inspector General Testifies Before

House Subcommittee on Benefit Eligibility Verification. On March 2, 1998, the Acting Inspector General testified before the Subcommittee on Government Management, Information and Technology of the House Committee on Government Reform and Oversight. The Subcommittee hearing examined legislative proposals to improve debt collection and to ensure the accuracy of eligibility information provided by applicants for Federal benefit and credit programs. The Acting Inspector General provided an Office of Inspector General (OIG) perspective on the need for Federal benefit and credit eligibility verification and access to information to improve debt collection. She stated that investigating and prosecuting fraud after it occurs is very resource intensive and does not always result in full recovery of the benefits fraudulently obtained. OIGs have a keen interest, therefore, in deterring and preventing fraud -- stopping it at the front end instead of trying to find it at the back end.

If the Congress were to pass Government-wide legislation to support "front-end" eligibility verification, that would establish as a matter of public policy the principle of eligibility verification and demonstrate the Government's commitment to preventing fraud. It would also ensure consistency in the treatment of applicants for all programs, foster cooperation between agencies, and assist the IRS in identifying non-filers. In conclusion, the Acting Inspector General stated that given the voluntary nature of Federal benefit and credit programs, it is not unreasonable for applicants to expect that their eligibility will be verified and, as a matter of fiduciary duty, that the Federal Government will take all feasible steps to safeguard the taxpayers' money.



*Editor's Notes:*



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.



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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