



Office of Inspector General U.S. Small Business Administration

May 2007 Update

Business Loan Programs

Ongoing Investigation Results in Indictments/Guilty Pleas. 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 conspired to fraudulently qualify loan applicants for SBA-guaranteed loans. The scheme involved as many as 76 fraudulent loans totaling almost \$77 million. The following three cases are part of this ongoing investigation, which is being conducted jointly with the U.S. Secret Service.

- On May 1, 2007, a former assistant vice president of a Dearborn, Michigan, bank pled guilty to one count of conspiracy to defraud the SBA and one count of misapplication of bank funds. According to the indictment, she participated in the scheme to defraud SBA by supplying false verifications of deposit for loan applicants and by giving a loan broker unpaid-for cashier's checks to be used in connection with loan closings. In her plea, she specifically admitted giving the loan broker four unfunded official checks totaling more than \$2.8 million.
- On May 10, 2007, the owner of a Taylor, Michigan, oil company was charged with making false statements related to a \$1,212,000 SBA-guaranteed loan. The false statements concerned his employment history, the ownership of the oil company, the amount of cash he had on hand, and the fact that his brother had given him a gift of \$363,000 to satisfy the equity injection requirement for the loan.
- On May 22, 2007, the president and the secretary of a Detroit, Michigan, gas station and convenience store were each sentenced to one year probation and a \$2,500 fine. Both had previously

pled guilty to one count of making false statements to SBA and a lender for falsely representing that they had made an equity injection of \$130,000 in order to obtain a \$1,175,000 SBA-guaranteed loan. Although the borrowers falsified their required equity injection, they continued to make payments on their loan and the collateral appraised for more than the outstanding loan balance; therefore, the court viewed this as a "no loss" case.

OIG Issues Report on Guaranty Purchase Process. On May 8, 2007, the OIG issued a report, *Audit of the Guaranty Purchase Process for Section 7(a) Loans at the National Guaranty Purchase Center*. The audit disclosed that 25 of 58 loans reviewed – or 43 percent – were purchased by SBA without adequately analyzing available documentation or obtaining sufficient information to assess whether the loans had been originated, serviced, and liquidated in accordance with SBA requirements and prudent lending practices. We determined that SBA erroneously paid lenders \$904,901 when it purchased the guaranties for 17 of the 25 deficient loans. The remaining 8 deficient loans had purchases totaling \$290,807 that were not supported by documentation in SBA files; however, we were able to obtain additional documentation from the lenders to support the purchase decisions. We estimate that SBA made approximately \$36 million in erroneous payments for the 1,803 purchase reviews completed between October 1, 2004, and May 31, 2005, for an improper payment rate of 17 percent. The major deficiencies identified involved lenders not verifying borrower equity injections, not adequately documenting the use of proceeds, not properly securing collateral, and not verifying repayment ability.

Guaranty purchase reviews are the primary control to ensure that lenders follow SBA requirements and prudent lending practices in originating, servicing, and liquidating loans. The guaranty purchase review

process was impaired because of staffing problems, such as loss of experienced loan officers, and an overly aggressive emphasis on purchase review quantity rather than quality. This contributed significantly to the 17 percent erroneous payment rate that we identified. Due to the large difference this erroneous payment rate and SBA's FY 2006 reported rate of 1.56 percent, we believed that the reported rate may have been incorrect.

We recommended that SBA: (1) seek recovery of \$36,407 on the guaranties paid for six loans identified in the report; (2) develop a plan to improve purchase reviews; (3) require loan officers to identify the documentation relied upon to make a purchase decision; (4) require lenders to certify compliance with regulations, rules and prudent lending practices when requesting a guaranty purchase; (5) use Office of Management and Budget (OMB) sampling requirements to estimate erroneous payments; and (6) include the level of risk associated with the purchase process in its A-123 report on management controls.

OIG issues Report on Loan and Lender Monitoring System. On May 2, 2007, the OIG issued a report, *Audit of SBA's Use of the Loan and Lender Monitoring System (L/LMS)*. The objectives of the audit were to determine (1) whether L/LMS generates lender ratings that correspond to actual lender performance, and (2) the extent to which SBA uses lender ratings to manage the risk in the Section 7(a) Loan program. We found that L/LMS was a sound method for scoring lenders and provides the Agency with the capability to conduct the type of monitoring and analyses typical among lenders. However, SBA's method of assigning risk ratings arbitrarily limited the number of lenders that could be considered high-risk to no more than 10 percent of each lender peer group and excluded some lenders with poor historical performance from being considered for priority oversight. Further, although SBA acquired L/LMS in FY 2003, it made limited use of the lender risk ratings to guide its oversight activities, and did not share the lender risk ratings with offices responsible for purchasing guaranteed loans. These conditions occurred because SBA did not adopt policies to: (1) describe how L/LMS was to be used by other offices that would benefit from the lender data; (2) set explicit risk tolerance limits; and (3) identify the steps to be taken when the limits were violated.

We recommended that SBA: (1) establish specific standards for assigning risk ratings; (2) develop on-site review plans or agreed-upon-procedure reviews for high-risk lenders in the \$4.0 million to \$9.9 million peer group; (3) distribute lender risk data to SBA offices that make guaranty purchase decisions; (4) develop acceptable lender performance, risk tolerance levels and enforcement actions; and (5) determine how to incorporate L/LMS data in mission activities agency-wide. The Agency did not provide responses to the recommendations prior to the report being issued.

SBA Official Indicted. On May 16, 2007, the manager of an SBA Branch Office was indicted and charged with one count of making false statements to an SBA lender and one count of making false statements to SBA. Subsequent to his arrest on May 17, 2007, he was placed on administrative leave by the Agency. According to the indictment, he knowingly submitted a false personal financial statement to a lender in connection with an \$80,070 loan application. In the financial statement, he purported to own stock valued at \$235,000, when he knew the stock had little or no value. The indictment also alleged that he made false statements to SBA on his Confidential Financial Disclosure Report by failing to disclose both the SBA-guaranteed loan and the fact that he was the managing member of the business for which the loan was obtained. These omissions were significant because conflict of interest and ethics rules would have prohibited his receiving the SBA-guaranteed loan due to his position with the Agency. This case was referred by a participating lender. The OIG is conducting this joint investigation with the Federal Bureau of Investigation (FBI).

Company Officer Indicted. On May 22, 2007, the president of a now defunct construction contractor in Spokane, Washington, was indicted on one count of mail fraud and one count of false statements on a loan application. The construction company, which performed public works contracts for state agencies and city municipalities, obtained SBA-guaranteed surety bonds in order to perform these contracts. The investigation found that the president defrauded SBA and a surety company by falsely stating that his company was out of funds when, in fact, he had diverted and continued to divert contract proceeds of approximately \$87,000 to personal use. This forced the surety company to pay contract owners on defaulted jobs. SBA's surety bond program

guarantees 70 percent of the surety company's losses, and the Agency suffered losses of over \$500,000 due to the company's defaults on several contracts. The investigation also found that the company president made false statements to a federally-insured financial institution regarding the source of the down payment on his home. This case was referred to the OIG by the National Insurance Crime Bureau (NICB). The OIG is conducting this joint investigation with the FBI and NICB.

Former Business Owner Sentenced. On May 2, 2007, the former owner of an internet-based company located in Virginia Beach, Virginia, was sentenced to 84 months in prison and 3 years supervised release, and was ordered to pay \$2,755,281 in restitution, jointly and severally with a co-defendant who was sentenced previously. He was also ordered to pay, independently from the co-defendant, \$217,779.85 to the Internal Revenue Service (IRS) and was prohibited from engaging in banking, investment, tax preparation, or other financial businesses. He had previously pled guilty to one count of mail fraud, one count of engaging in a monetary transaction in criminally derived property, and one count of tax evasion. For a fee of at least \$3,500, the company promised, among other things, to provide a comprehensive business plan and an SBA-guaranteed loan to its customers. Investigative efforts disclosed that the business plans were worthless and that only one or two businesses ever received an SBA-guaranteed loan. It is estimated that over 900 people fell victim to the scam. This case was based on a referral from the Richmond District Office. The OIG conducted this joint investigation with the U.S. Postal Inspection Service and the IRS.

Disaster Loan Program

OIG Issues Report on Disaster Assistance Duplicate Benefit Adjustments. On May 15, 2007, the OIG issued a report, *Duplicate Benefit Adjustments to Disaster Assistance Loans Associated with Housing and Urban Development (HUD) Grants*. The objective of the OIG's review was to determine if SBA loans were properly identified and modified to prevent or detect duplication of benefits in accordance with the Stafford Act, which prohibits payments to individuals that duplicate benefits available to that person from another source. In conjunction with the HUD OIG, we reviewed a statistical sample of loans associated with HUD Community Development Block Grants. The

sample included 56 grants from the Louisiana Road Home Program and 116 grants from the Mississippi Homeowner Assistance Grant Program. The review of the 172 grants showed that SBA generally complied with provisions of the Stafford Act relating to preventing or detecting duplicate benefits within the Disaster Loan program. Because only two loans were incorrectly modified, which did not represent a major breakdown in internal controls, no recommendations were made.

OIG Issues Report on Securing Collateral for Disaster Loan Disbursements. On May 9, 2007, the OIG issued an audit report, *Securing Collateral for Disaster Loan Disbursements*. In the fall of 2006, SBA initiated a campaign to expedite loan disbursements for a backlog of more than 90,000 Gulf Coast hurricane disaster loans at its Loan Processing Center in Fort Worth, Texas. We initiated the audit based on a complaint from an Agency employee that loans processed during the campaign were disbursed contrary to borrowers' wishes and without obtaining all of the documents required to disburse the loan proceeds, and that mortgage documents were destroyed thus limiting SBA's ability to record liens on property serving as collateral on secured loans.

As a result of the expedited processing campaign, SBA disbursed over \$858 million on 25,732 loans by November 4, 2006, significantly reducing the backlog of undisbursed loans from 90,000 to less than 45,000. While the Agency's efforts to reduce the backlog succeeded in expediting loan disbursements, in its haste SBA did not properly secure its interest in collateral on many of the disbursed loans. We reviewed loan files associated with a statistical sample of 80 unprocessed checks – out of a backlog of 4,970 unprocessed checks as of January 18, 2007 – that were received from Gulf Coast hurricane borrowers for collateral recording and filing fees. Our review disclosed that SBA disbursed approximately \$7.3 million on 61 – or about 76 percent – of the 80 loans without properly securing all of the loan collateral. Of the 61 loans, 35 were disbursed prior to the expedited processing campaign. Projecting the sample results to the universe of loans disbursed, we estimated that SBA released \$368 million in loan proceeds on about 3,113 secured loans without perfecting liens on property used as collateral or completing all required filings.

While our review was limited to unprocessed checks on hand as of January 18, 2007, improperly securing collateral appeared to be a systemic issue that extended beyond the loans examined in our audit, as many of the underlying reasons for the problems related to how the center processed loan disbursements. For example, in some instances, case managers/closers disbursed loans before the collateral documents were properly reviewed for legal sufficiency by the title desk. Consequently, the documents had to be corrected and returned to the borrowers for execution, which in some cases took up to 6 months, delaying SBA from perfecting the collateral. In other instances, collateral documents and associated checks for filing fees had been separated in the mailroom and could not be re-matched once the documentation had been reviewed and was ready to be filed. Finally, the center could not process many of the checks either because they were too old or had incorrect information. In these instances, the checks had to be returned to the borrower and replacement checks issued before the collateral could be secured. Approximately 52 percent of the backlog of checks were over 90 days old and had to be replaced by the borrowers. We also found instances where borrowers' checks were either written for the wrong amount or to the wrong payee. When checks were incorrect, loan closers did not always follow-up timely with borrowers to obtain replacement checks, which created further delays in securing the collateral.

Government Contracting & Business Development

OIG Issues Report on Gulf Coast Hurricane Procurements. On May 10, 2007, the OIG issued an audit report, *Review of SBA Monitoring and Support of 8(a) Procurements Related to the Gulf Coast Hurricanes of 2005*. The objective of the audit was to determine whether SBA's partnered agencies obtained approval from SBA to accept the 8(a) contracts and reported the procurements to SBA, per the partnership agreements. We reviewed 60 8(a) contracts over \$1 million from the two largest Federal agencies procuring contracts for Gulf Coast reconstruction – the Department of Homeland Security (DHS) and the Department of Defense (DoD). We searched SBA's 8(a) database to determine if the 60 DHS and DoD 8(a) contracts were included in that database, and noted any inconsistencies. Based on available information from the contract files, we could not

determine whether DHS and DoD properly offered the contracts and SBA properly accepted them, per the partnership agreements. However, we noted that 31 of the 60 contracts awarded were either not reported to SBA or were reported but had not been entered into the information system that was used to service and monitor 8(a) firms and collect data on a nationwide level (SACS/MEDCOR).

We recommended that the Agency: (1) notify procuring agencies with partnership agreements of the requirement to provide a copy of any contract to the SBA servicing district office within 15 working days of the date of award; (2) provide training opportunities for Business Development Specialists to learn how to enter information into the successor database(s) to SACS/MEDCOR; and (3) develop a plan for ensuring the accuracy of all data in SACS/MEDCOR before migrating to a successor database(s).

Multiple Indictments Related to Bribery Scheme. On May 17, 2007, six individuals were charged in a 47-count criminal indictment in connection with a multimillion dollar bribery scheme that involved fixed contracts with the U.S. Army Medical Department at Fort Sam Houston in Texas. The six subjects, who were arrested on May 18, 2007, included a coordinator/project officer with the U.S. Medical Command at Fort Sam Houston; a civilian contracting officer, U.S. Army Medical Information Technology Center (USAMITC) at Fort Sam Houston; an operations manager at USAMITC; the son of the contracting officer; the owner of an SBA-certified 8(a) firm in San Antonio, Texas; and an employee of the 8(a) firm. The indictment includes charges of conspiracy to defraud the United States, paying a bribe to a public official, receipt of bribe as a public official, inclusion of kickbacks in a public contract, wire fraud, disclosure of confidential bid information on public contracts, money laundering, filing false income tax returns, and willful failure to file an income tax return.

The indictment alleges that the defendants committed these acts to ensure that the 8(a) company received government contracts. One such contract was for computer cable upgrades at U.S. Army hospitals. The indictment alleges that five defendants derived approximately \$1 million in graft from this contract, and that the sixth defendant was paid \$200,000 for accounting services. The indictment alleges that, in furtherance of the conspiracy, the USAMITC operations manager used his influence to help

formulate and steer over \$1.6 million in equipment and support contracts to the 8(a) company in exchange for a share of the contract proceeds. In addition to criminal charges, the indictment also seeks a monetary judgment of \$1.2 million. This case was initiated as part of an FBI task force investigating certified 8(a) firms that act as pass through companies. The OIG is conducting this joint investigation with the FBI, IRS, U.S. Army Criminal Investigation Division, General Services Administration OIG, Department of Interior OIG, and the Defense Criminal Investigative Service.

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 15 Agency initiatives, including proposed legislation, SBA Standard Operating Procedures, and Agency notices containing directives to its employees.

This monthly update is produced by the SBA OIG, Eric M. Thorson, Inspector General.

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:

Beverly Menier, SBA OIG
409 Third Street SW., 7th Floor
Washington, DC 20416
E-mail: OIG@SBA.GOV
Telephone number (202) 205-6586
FAX number (202) 205-7382

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