



## Office of Inspector General Small Business Administration

September 2002 Update

### *Business Loan Programs*

Texas Gas Station and Dry Cleaning Business Owner Repays SBA and the Lender. The former owner of two gas stations and a dry cleaning business in Houston, Texas, repaid, on August 21, 2002, SBA and the non-bank participating lender the entire amount due on one of his loans for a gas station resulting in a cost recovery of \$181,351. The defendant was indicted on charges of **conspiracy and making false statements** to SBA and the non-bank participating lender. OIG continues to conduct this investigation jointly with the Department of Treasury's Inspector General for Tax Administration.

Virginia Soap-Making Company President Arrested for Wire Fraud and Material False Statements. The president of a defunct soap-making business located in Woodbridge, Virginia, was arrested on August 29, 2002, by OIG special agents at the Richmond International Airport and transported to the U.S. District Courthouse in Richmond for his initial appearance. The defendant had been previously indicted on two counts of **wire fraud**; three counts of **making material false statements**; and three counts of **making false statements to SBA**. He made false statements to obtain a \$290,000 SBA-guaranteed loan. A warrant for his arrest was issued following his indictment; however, OIG special agents were unable to make the arrest because he had left the country. When the defendant learned of the indictment and the warrant for his arrest, he hired an attorney who agreed to coordinate his return and arrest. The defendant was released without bond per a coordinated agreement between the Assistant U.S. Attorney, OIG, and the defendant's attorney.

Kansas Bank President Signs Compromise and Settlement Agreements. The president of a Kansas bank, individually and as president, signed **Compromise and Settlement Agreements** agreeing that the bank would pay the U.S. Government \$250,000, release SBA from approximately \$570,505 in liability on nine outstanding SBA-guaranteed loans, and neither the president nor the bank would participate in any SBA loan program for 5 years. The president and the bank were charged in a civil fraud complaint that **alleged false statements** as well as **breach of contract** regarding an SBA-guaranteed loan the bank made to a foam core panel manufacturing plant. The plant defaulted on this loan and SBA paid the bank \$474,587 under the guaranty agreement. A joint investigation with the U.S. Secret Service resulted in indictments of two plant officials for making **false statements** about their ownership and officer positions. One of the officials pled guilty and the other died prior to trial. The related civil fraud suit was then filed charging that the bank president and the bank: 1) submitted a falsely redacted appraisal to SBA; 2) claimed the borrowers had excellent credit history when they had failed to obtain or review any credit report; and 3) falsely certified there had been no substantial adverse change in the financial condition of the borrower, when in fact, upon learning that the borrower would not be receiving a \$500,000 grant (the application for which was never disclosed to SBA), they demanded additional security for the SBA loan. Finally, the lawsuit alleged that the president and bank certified the lender had not received any Certificates of Deposit (CDs) in connection with this SBA loan, when in fact they had obtained undisclosed CDs totaling \$55,000. This civil fraud suit was litigated by the U.S. Attorney's Office in

Wichita, Kansas. This case was initiated based on a referral from the SBA Kansas City District Office.

Illinois Contracting Company President Sentenced to Prison. On September 4, 2002, in the Northern District of Illinois, the former president of a contracting company in Aurora, Illinois, was sentenced to a prison term of 12 months and 1 day with a 2-year term of supervised release. The defendant was ordered to make complete restitution in the amount of \$345,820. She previously pled guilty to one count of **making a material false statement**. The plea agreement was the result of an earlier criminal-information that was filed and related to a \$400,000 SBA-guaranteed loan that was obtained by the defendant's company through an SBA participating lender. The purpose of the loan was to obtain working capital for her company. During the loan application process, she signed an affidavit stating that she was individually, and as a corporation, current on all Federal and State taxes. According to information gathered by the SBA Illinois District Office, at the time she signed this affidavit, she and the company had tax debt totaling more than \$1 million. This investigation was worked jointly with Federal Bureau of Investigation (FBI) and was initiated based on a referral from the SBA Illinois District Office.

Texas Loan Scheme Participant Indicted for Conspiracy, Mail Fraud, and Wire Fraud. A Houston, Texas, man was indicted on August 7, 2002, on one count of **conspiracy**, three counts of **mail fraud**, and one count of **wire fraud**. His indictment superceded previous indictments of three alleged coconspirators in connection with a purported fraudulent loan scheme to finance the purchase of a motel. According to the indictment, the defendants submitted a loan application package with fraudulent personal financial statements and a false purchase contract that inflated the price of the motel from \$2 million to \$2.7 million. To satisfy the closing requirements, the defendants submitted altered fraudulent copies of cashier's checks as proof of their required equity injection. The defendant was arrested on August 8, 2002.

Ohio Bed and Breakfast Owner Pleads Guilty to Conversion of Collateral. The co-owner of a bed and breakfast in Sidney, Ohio, pled guilty to one count of **conversion of collateral** pledged to SBA. The owners, a husband and wife, were each indicted on one felony count of conversion of collateral pledged to

the SBA. The indictment related to a \$200,000 SBA-guaranteed loan secured by the couple. The purpose of the loan was to purchase a house in Sidney, Ohio, that was to be converted to a bed and breakfast business. The SBA loan agreement collateral provisions specifically stated the borrower would provide as collateral the land and the buildings, including their inventory. The investigation revealed that after the couple defaulted on the SBA loan and filed for bankruptcy, they signed a contract to have the interior woodwork (such as the trim, doors, and casings), an elaborate wood fireplace mantel, and a spiral staircase removed from the home and sold for \$10,000. This investigation was initiated based on a referral from the SBA Columbus District Office.

Illinois Company President Charged in an Information with Making False Statements. The former president of a mergers and acquisition company in Cary, Illinois, was charged in an information on September 17, 2002, for one count of **making false statements to the SBA**, in connection with a \$954,000 SBA-guaranteed loan. The purpose of the loan was to purchase a restaurant-maintenance and -repair business. As part of the loan application, he submitted an SBA Personal Financial Statement that failed to disclose a significant number of liabilities including approximately \$87,000 in debt to a bank, and a \$30,000 personal loan from his brother-in-law. The case was a joint investigation with FBI and was initiated based on a referral from the public.

Audit on Internal Controls Over Colson Services Corporation's Contract as Central Servicing Agent (CSA) for SBA's Certified Development Company (CDC) Loan Program Issued. On September 16, 2002, OIG issued an independent auditor's report on internal controls over Colson Services Corporation's contract as CSA for SBA's CDC Loan program. The auditors performed testing and reconciliation procedures over transaction data for calendar year 2000 and found that controls were generally in place and effective. The audit identified areas where improvements can be made such as: (1) **reconciliation procedures** between Colson and SBA's Loan Accounting System (LAS) were not effective (SBA did not record \$22.7 million in CDC loans funded in May 2000); and (2) **increased oversight** by SBA of Colson's compliance with various contract terms is needed. There were several instances in which Colson did not adhere to contract terms and SBA was

unaware of the noncompliance. These instances of noncompliance may have cost SBA and the CDC's thousands of dollars in lost interest earnings. The report contains recommendations to the CFO and the Associate Deputy Administrator for Capital Access (ADA/CA). These recommendations were for improvements in reconciliations and increased oversight of the CSA. The CFO agreed with the recommendations directed to him. The Associate Administrator for Financial Assistance (AA/FA) responded on behalf of the ADA/CA. The AA/FA generally agreed that Colson was not complying with all contract terms and stated that the noncompliance was primarily because the contractual terms conflicted with banking regulations. The AA/FA disagreed that SBA should monitor contract compliance directly or modify the contract to require Colson to obtain an independent evaluation of contract compliance. This issue will be resolved during the audit resolution process.

Inspection Report on Defaulted Franchise Loans Issued. On September 16, 2002, OIG issued a report on SBA's experience with defaulted franchise loans. The inspection examined the **franchise loan portfolio's potential exposure, purchase rates, and specific lenders' performance**. Despite SBA's public view that franchisees are generally more successful than nonfranchisees, SBA's experience with defaulted loans and some outside studies do not support this. OIG recommended that the Agency's printed and electronic information no longer state this view. In addition, SBA's loan databases inaccurately identified some loans to nonfranchisees as franchise loans, thus hampering the monitoring of potential franchisor control over franchisees. Despite this, the databases may still be useful because the control issue could apply to *any* situation in which a large entity allows the use of its brand name. OIG also recommended that SBA define what constitutes either a franchise loan or loans to small businesses that use a larger firm's brand name, communicate the definition(s), and recategorize its loan data. Finally, although most of the large defaulted loans examined in depth exhibited early warning signs, any deficiencies in credit analysis cannot be attributed solely to lender bias in favor of franchise loans or their equivalents. OFA agreed with OIG's recommendations.

Audit Report on SBA-Guaranteed Loan Issued. On September 24, 2002, OIG issued an audit report on an

SBA-guaranteed loan. OIG found that the **lender did not follow prudent lending practices** in assessing the borrower's repayment ability or securing collateral for the \$100,000 LowDoc loan. Sales were projected to increase 924 percent based on the borrower's negotiated agreements with two companies for product distribution. Projected cash flow did not materialize because the agreements were never executed. The lender did not make a site visit within the timeframes outlined in SBA policy after receiving four insufficient checks from the borrower. When the lender attempted to make a site visit about seven months later neither the borrower nor the collateral could be located. Because the lender did not take prudent action to ensure that distribution contracts had been executed and to secure the collateral, SBA made an erroneous payment when it purchased the guarantee. OIG recommended that the District Office seek recovery of \$84,911 from General Electric Capital Corporation on the guarantee paid.

The District Office did not agree with the recommendation stating that the liability on the loan should not be denied based on credit information approved by SBA. OIG found no evidence that SBA received or reviewed any of the supporting documents for the lender's credit analysis for this loan. SBA's approval of the loan application was primarily based on the lender's representation of the credit rather than actually analyzing supporting documentation.

Audit Report on Loan Splitting Issued. A final report on loan splitting was issued on September 30, 2002. The review was initiated based on a referral from the Houston District Office regarding the practice of splitting a single loan into two loans to the same borrower for the benefit of the lender. The objective of the review was to determine if split loans were originated in accordance with program regulations and assess the impact of split loans on the borrowers and SBA.

Although loan splitting does not appear to violate program regulations, there are some negative aspects to this practice that impact the borrowers and the Agency. Splitting one loan into two loans generally **increased the borrower's closing costs** by approximately \$200 due to additional expenses associated with the second loan. Also, the Section 7(a) loan production **performance data was inflated** because split loans are counted as two loans rather than one.

Finally, a few of the split loans examined had **maturities that exceeded term limits allowed** under program regulations.

OIG recommended that SBA implement procedures to: (1) require lender's to absorb additional costs associated with loan splitting; (2) adopt a method for counting split loans as one rather than two; and (3) remind participating lenders to ensure that appropriate maturities limits are observed for all Section 7(a) loans. SBA officials in the Houston District Office and Headquarters generally agreed with the recommendations.

Audit Report on an SBA-Guaranteed Loan Issued. On September 30, 2002, OIG issued an audit report on an SBA-guaranteed loan. The audit found that the lender disbursed \$600,747 in SBA-guaranteed loan proceeds to **refinance ineligible borrower debt and did not exercise prudent measures** to ensure loan proceeds were used as authorized. There was nothing in the loan file verifying existence of, or the terms and conditions of, the \$493,747 of debt that was refinanced. In addition, the lender disbursed \$107,000 in loan proceeds, to purchase equipment, to the borrower who deposited the check in his bank account. The closing documents and the purchase contract required that the proceeds be disbursed using a joint payee check. Furthermore, the purchase contract stated that title to the equipment being purchased would not transfer until the joint payee check cleared the seller's bank. OIG recommended that the Houston District Office seek recovery of \$450,559 from the lender, less any subsequent recoveries. The District Office agreed and the lender is in the process of repaying the amount requested.

Audit of Two Early Defaulted Loans Issued. On September 30, 2002, an audit report was issued a report on two early defaulted loans. The first loan was \$1.56 million to borrower #1 and the second loan was \$1.58 million borrower #2. The loans were selected as part of OIG's on-going program to audit SBA-guaranteed loans charged-off or transferred to liquidation status within 36 months of approval. The objective of the audit was to determine if the early loan defaults were caused by lender or borrower noncompliance with SBA's requirements.

OIG found that the lender **did not comply with SBA's policies and procedures** for the two related

loans. The lender did not ensure that borrower #1 complied with SBA regulations and material conditions of the loan authorization. Borrower #1 used loan proceeds for unauthorized and unsupported purposes, and the lender did not ensure that the borrower obtained lien waivers, a valid surety bond, and had the ability to pay additional construction expenses. These noncompliances reduced the amount of funds available to complete the project and contributed to the loan default. The lender became aware of the non-compliances and, in lieu of submitting the defaulted loan for SBA to honor the guarantee, attempted to complete the project and remedy the default by making a subsequent loan to borrower #2. Borrower #2 was formed by two of borrower #1's partners. The loan to borrower #2 did not meet SBA's eligibility criteria for change of ownership, was improperly made using preferred lending procedures, and did not include the required equity injection. Additionally, the loan did not meet refinancing criteria. The effect of the subsequent loan was to transfer the lender's loss to SBA. SBA paid approximately \$747,000 to honor the guarantee.

OIG recommended that the SBA Georgia District Office deny liability for the loan to borrower #2 and seek recovery from the lender of principal totaling \$747,308 plus interest and expenses paid by SBA. OIG also recommended that the lender's preferred lender program status be suspended and that SBA pursue civil enforcement remedies against the lender under the False Claims Act. The District Director agreed with our recommendations.

## ***Disaster Loan Program***

California Physician Indicted for False Statements and Conspiracy. A California physician attempting to start a practice in New York was indicted on three counts of **false statements** and one count of **conspiracy**. The charges were filed in connection with applications she submitted to the Federal Emergency Management Agency (FEMA) and SBA for disaster funding pursuant to Hurricane Floyd which allegedly damaged the physician's mother's home in Cortland Manor, New York. The physician submitted an application to FEMA on behalf of her mother claiming that the Cortland Manor residence was their primary residence, when in fact they were living at an apartment rented in New York City. After receiving a grant of \$1,308, the mother falsely claimed to FEMA

in an appeal for more funding that her daughter's (the physician) \$7,000 medical data scope was stored in the house and destroyed by the storm. The physician herself also applied for a business disaster loan from SBA in her own name for her medical practice, wherein she represented to SBA that she had approximately \$70,000 worth of medical equipment stored at the Cortland Manor residence that was ruined by the storm. The physician also claimed that she had opened a medical practice in Westchester, New York, and submitted a fraudulent lease to that effect. She was then approved for an \$88,400 loan, of which she only received \$10,000 due to her inability to keep the scheme going. The investigation revealed that there never was any medical equipment stored in the house, and that in fact the major item, a \$50,000 anesthesia machine, was damaged while it was being shipped to New York weeks before the hurricane. The physician was also charged with conspiring with her landlord to defraud SBA in connection with her mother's \$78,300 loan for the Cortland Manor residence after it was revealed that much of the damage to the house was pre-existing, and that the physician directed the landlord to alter invoices, which he then submitted to SBA to inflate the disaster loan disbursements. The physician was the second individual who was criminally prosecuted on this matter. The landlord previously pled guilty to a criminal information charging him with wire fraud and two counts of bank fraud. The investigation was initiated based on a complaint by a member of the public.

North Carolina Music Company and Its Owner Plead Guilty to Money Laundering. Both a Carolina Beach, North Carolina, music company and its owner pled guilty to one count of **money laundering**. The defendant, who was the former North Carolina Transportation Secretary, acting as attorney in fact for his father, obtained two disaster loans totaling \$617,200 for damages associated with Hurricanes Bonnie (1998) and Floyd (1999). The defendant's guilty plea was the result of a previous indictment on one count of mail fraud and six counts of wire fraud. The investigation disclosed that the principals, through the company, were operating an illegal gambling business that made it ineligible for disaster loans. The defendant also falsely claimed that equipment was damaged by the storms. Further investigation disclosed that loan proceeds were used to pay pre-disaster debt that violated the loan authorization agreements, and that the loan proceeds were either mailed or

electronically transferred to the account of his father. The defendant's son also pled guilty to a one-count criminal information for money laundering and agreed to testify against his father and grandfather in lieu of being indicted. Although the defendant's father was actively involved, he was not indicted due to the onset of Alzheimer's disease. The music company and the defendant also agreed to forfeit \$750,000 seized during this investigation. The indictment also included 268 counts associated with money laundering and illegal gambling pertaining to the FBI's part of the case. OIG initiated this investigation based on a request by the FBI and the U.S. Attorney's Office.

Advisory Memorandum on SBA Procedures for Repaying Agencies for Advances Issued. On September 3, 2002, OIG issued a report that **found SBA procedures for repaying agencies for advances needed improvement**. To illustrate, for four North Carolina disaster home loans reviewed, borrowers previously received Individual Family Grant Program (IFGP) funds from FEMA. During loan origination, SBA determined that three borrowers were not eligible for the IFGP funds, since they were eligible for the entire disaster loan with SBA. To correct this duplication, SBA loan checks were prepared as co-payable to the borrowers and to the IGFP of North Carolina. The borrowers were supposed to forward these checks to FEMA to reimburse erroneous IFGP payments. However, two of the three borrowers who received co-payment checks totaling \$19,800 cashed the checks instead of repaying their IFGP payments. The Associate Administrator for Disaster Assistance was briefed on the report and agreed to take action to implement OIG's recommendations.

## ***Government Contracting and Business Development Programs***

Defunct Pennsylvania Construction Company President Indicted for Making False Statements, Mail Fraud, and Wire Fraud. The president of a defunct Hunting Valley, Pennsylvania, construction company was indicted on September 24, 2002, in a superseding indictment, with one count of **making a material false statement** to the SBA, two counts of **mail fraud**, five counts of **wire fraud** and one count of **making a false statement** to customers, including the Department of Veterans Affairs. The defendant had previously been indicted on January 31, 2002, for

**making a false statement to a federally insured financial institution.** The mail fraud and wire fraud charges involved his construction company's bonding company statement to SBA. The false statement count related to his representing in his SBA Section 8(a) Annual Update Form and attachments that he had relocated to Pennsylvania along with his SBA Section 8(a) certified business and controlled the day-to-day operations. The indictment charges he never relocated to Pennsylvania from Michigan and that he had someone else run the daily affairs of the business. This person was not eligible to participate in the Section 8(a) program because he had already graduated from the program and would not be considered disadvantaged. His identity and role was never made known to SBA or the bonding company. The defendant and the person running the daily affairs obtained bonding for the company from an insurance company through an independent agent. The wire fraud charges and one count of mail fraud related to the two gentlemen creating false financial statements for the company that they submitted to the insurance company to obtain the bonding necessary for bids and contracts. As a result of defaults on contracts, the insurance company incurred losses of almost \$6 million. The other mail fraud count charged the defendant with falsely certifying to the Department of Veterans Affairs that he was paying and intended to pay his subcontractors on a timely basis from proceeds he received on a window replacement contract at the Veterans Affairs Medical Center in Coatsville, PA. The superseding indictment also charged that he submitted several sets of false financial statements to a bank to support a \$300,000 line of credit that the construction company had obtained. This case was investigated jointly with the Naval Criminal Investigative Service (NCIS), Department of Veterans Affairs OIG, the Defense Criminal Investigative Service and U.S. Customs Service. OIG's participation was based upon a request from NCIS.

Audit Report on the Section 7(j) Management and Technical Assistance Program Cooperative Agreement Administration Activities Issued. On September 30, 2002, OIG issued an audit report on the Section 7(j) Management and Technical Assistance program cooperative agreement administration activities. The objective of the audit was to determine whether pre and post award processes associated with **Section 7(j) program cooperative agreement awards were carried out in accordance with applicable policies**

**and procedures** to ensure the effective use of program funds. The audit found that: (1) SBA's reliance on unsolicited proposals limited its ability to effectively plan, process, and approve project awards; (2) documentation associated with proposal and financial reviews was incomplete; (3) award recommendations were not properly supported; (4) legal sufficiency review issues were not resolved prior to award; and (5) project reporting and monitoring require improvement. The extent of SBA's failure to follow established policies and procedures indicates a potential material weakness in the Section 7(j) program. We made twelve recommendations to correct the deficiencies identified in the report. Ten of the recommendations are addressed to the Associate Deputy Administrator for Government Contracting and Business Development (ADA/GC&BD) and two of the recommendations are addressed to the Assistant Administrator for Administration (AA/A). The ADA/GC&BD and the AA/A were asked to respond to the draft report but did not do so by the requested date. Accordingly, the recommendations will be addressed during the audit follow-up and resolution process.

## *Agency Management*

Advisory Memorandum Report on SBA's Information Security Program Report Issued. On September 12, 2002, OIG issued an Advisory Memorandum Report on SBA's Information Security Program Report. The Government Information Security Reform Act (GISRA) requires the Office of Inspector General (OIG) to perform an independent evaluation of the Small Business Administration's (SBA) information security program. This report presents the results of that evaluation in accordance with specific GISRA reporting instructions issued by the Office of Management and Budget (OMB). Generally, **SBA's information security program continues to improve** for high priority financial management and general support systems. However, **vulnerabilities continue to exist** in computer security program monitoring, computer incident response reporting, system access controls, computer security system testing, and disaster recovery and contingency planning. The report does not contain any recommendations and was included as part of the Agency's GISRA submission in accordance with OMB guidance.

Audit Report of SBA's Controls Over the Access, Disclosure, and Use of Social Security Numbers by Third Parties Issued. On September 30, 2002, OIG issued an audit report on SBA's controls over the access, disclosure, and use of Social Security Numbers (SSN) by third parties. The objective of the audit was to assess SBA controls over the use and protection of the SSNs it has collected from individuals. Specific objectives were to determine whether SBA: (1) makes legal and informed disclosures of SSNs to third parties; (2) has appropriate controls over other entities access and use of the SSNs that SBA has collected from individuals; (3) has adequate controls over access to individuals' SSNs maintained in its databases; and (4) has appropriate controls over contractors' access and use of SSNs that SBA has collected from individuals.

The audit found that SBA: (1) **makes legal and informed disclosures of SSNs** to third parties; (2) has **appropriate controls over other entities access and use of SSNs** that SBA has collected from individuals; and (3) has **adequate controls over access to individuals' SSNs** maintained in its databases. SBA does not, however, have appropriate controls over **contractors' access and use of SSNs** collected from individuals. Accordingly, additional steps are needed to limit the risks of unauthorized disclosure of SSN information. OIG made a recommendation to the Assistant Administrator for Administration (AA/A) to correct this deficiency. The AA/A generally agreed with OIG's assessment.

The activity Update is produced by SBA/OIG, Peter L. McClintock, Acting Inspector General.

OIG has established an e-mail address ([oig@sba.gov](mailto: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 such documents please contact:

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