



Office of Inspector General Small Business Administration

September 1998 Update

Business Loans

Audit of Section 7(a) Business Loans Finds Lenders in Non-Compliance with Required Procedures. An audit of 7(a) loans in Los Angeles found that lenders did not comply with required procedures in 11 of 30 loans reviewed, according to a report issued by the OIG as part of a national audit of lender processing of 7(a) loans. Los Angeles is one of eight districts randomly selected for review in the audit, with a random sample of 30 loans drawn from all loans made in the Los Angeles area from March 1996 through June 1997. The objective of the audit was to review lenders' compliance with 22 required procedures. The failure to follow these procedures increases the chance that ineligible or risky loans will be approved. The OIG will summarize the findings in a national report after the eight individual district reports are completed.

The noncompliance with procedures in the Los Angeles district involved **loan proceeds used for ineligible or unauthorized purposes, unverified capital injections, lack of IRS verification of financial data, borrowers with no repayment ability or poor credit history, improper fees, and failure to notify SBA when loans were cancelled.**

As a result of the lenders' improper actions, SBA inappropriately provided \$196,000 in guarantees for three loans and corrective actions are necessary to protect \$433,750 in guarantees on four other loans. The directors of the district office and the PLP processing center agreed with the recommendations for corrective action.

Minnesota Law Enforcement Official Indicted on Multiple Fraud Counts. The former Chief Deputy Sheriff of Carver County, Minnesota, was indicted by a Federal grand jury in Denver, Colorado, on August 27, 1998, on three counts of **mail fraud**, two counts of **wire fraud**, two counts of **making a material false statement**, and one count of **bank fraud**. The man had personally guaranteed a \$100,000 SBA loan through a participating non-bank lender for a mail box franchise in Colorado to be owned by his wife. A check disbursing \$80,000 of the loan proceeds was issued for the purchase of this franchise. The OIG's investigation revealed, however, that the man forged an endorsement on the check and used the funds for his personal benefit, and that he submitted a falsified Personal Financial Statement in support of his personal guaranty. On his financial statement, he allegedly failed to disclose several debts

and overstated his income. During the time period when the man was submitting the false loan documents, he had been arrested and was awaiting trial for allegedly misappropriating Drug Abuse Resistance Education funds in Carver County. He was ultimately convicted of these charges and is currently incarcerated in Federal prison. This investigation was initiated based on a referral from SBA's Denver District Office.

Mississippi Tractor Dealer Convicted for Making Material False Statement. The owner of a now-defunct tractor dealer in Shubuta, Mississippi, was convicted on September 9, 1998, on one count of knowingly **making a material false statement** to obtain a \$150,000 SBA-guaranteed loan. The trial jury found that the man represented 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. The OIG's investigation was initiated based on a referral from SBA's Jackson District Office.

Pennsylvania Businessman Pleads Guilty to Making Material False Statements. The president of a corporation that operated automotive brakes and muffler businesses in Philadelphia, Pennsylvania, pled guilty on September 8, 1998, to three counts of **making false statements** to SBA. He had applied for a \$252,000 SBA-guaranteed loan in 1996 to buy a new building for his automobile repair business. As part of the loan application, the man submitted purported copies of his 1994 and 1995 business tax returns, which the participating non-bank lender found to contain significant discrepancies when compared to information on file with the IRS. According to his indictment, each

tax return claimed considerably more income than he had reported to the IRS. Another count of the indictment charged that, in applying for the loan, he had failed to disclose his 1992 arrest for kidnapping and assault. The participating lender withdrew its loan commitment when the tax return discrepancies were discovered and referred the matter to the OIG for investigation.

New Jersey Waterbed Vendor Sentenced for Making False Statements. The owner of a now-defunct waterbed company in West New York, New Jersey, was sentenced on September 9, 1998, to 5 years probation, 6 months home confinement, and \$12,000 restitution. He previously pled guilty to one count of willfully **making false statements** to SBA. The man had failed to disclose in his 1995 application for an SBA-guaranteed loan that he had been arrested by the U.S. Customs Service in 1993 as he was departing for Colombia with \$50,000 in unreported currency. He had pled guilty and was on probation for that offense at the time of his SBA loan application. The man received a \$30,000 LowDoc business loan through a participating non-bank lender. After the loan was disbursed he closed the business, defaulted on the loan, and disappeared. In 1997, he was located and arrested by OIG agents. The participating non-bank lender referred this matter to the OIG for investigation.

Massachusetts Coffee Wholesaler Pleads Guilty to Making False Statements. The president of a Quincy, Massachusetts, company engaged in the business of wholesaling specialty coffees and related items, pled guilty on July 7, 1998, to five counts of **making false statements on loan applications to a Federally-insured financial institution.** The man admitted

providing false documents and making false statements to obtain two loans and a credit line during 1995. The larger loan, for \$143,000, was guaranteed by SBA. Among other things, he falsely claimed that he had an equity investment in his business, lied about his use of loan proceeds, and submitted balance sheets containing false financial information. The joint SBA/OIG and FBI investigation originated from a referral to the OIG by SBA's Boston District Office.

District of Columbia Recycler Convicted for Perjury and Making False Statements.

The president of a now-defunct waste-paper recycling company in Washington, D.C., was convicted on September 22, 1998, on one count each of **making false statements in a loan application to a Federally-insured bank, making false statements to SBA, and perjury.** The firm had received a \$296,014 SBA-guaranteed loan to purchase equipment to convert waste paper into fuel pellets, and approval of the loan was based on her projection of the company's income. The trial jury found that the woman made false statements in her loan application when she provided an altered document to support her income projections, 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 failed to list on her Personal Financial Statement that she was a personal guarantor on a loan from another lender. In response to the bank's request for support of her income projections, the jury found, 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 jury also found that she committed perjury by lying to the U.S. Bankruptcy Court about the alteration of this letter. The firm 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.

Co-Owner of Texas Automotive Machinists School is Sentenced.

The co-owner of a Houston, Texas school for Automotive Machinists was sentenced on September 30, 1998, to 1 year probation, \$25,000 restitution, and a \$5,000 fine. He was also ordered to make monthly loan payments to SBA. The co-owner previously pled guilty to one count of **conspiracy** to make false statements to a Federally-insured financial institution. As part of a plea agreement, the Government agreed to dismissal of the other charges on which he and his wife, and co-owner, had been indicted. Their company had obtained a \$240,000 SBA-guaranteed loan in 1991. The OIG's investigation found that the school's owners submitted loan disbursement requests to the participating bank lender that falsely cited \$69,877 of construction work that was never completed. The indictment also charged that the co-owner fraudulently endorsed loan disbursement checks totaling \$56,540. This investigation was initiated based on information developed during Operation Clean Sweep research at SBA's Houston District Office.

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Disaster Assistance

New Mexico Tire Company Owner Settles Government's False Claims Suit.

The owner of a tire sales and service business

in Melrose, New Mexico, paid the Government \$5,263 on February 19, 1998, to settle a civil fraud suit brought under the Justice Department's Affirmative Civil Enforcement program. The suit was filed in 1997 based on the results of an OIG investigation. In 1990 the man obtained a \$108,400 economic injury disaster loan having failed to disclose, in answer to the application question, that he had previously received Government financing. In 1978, under a different business name and in a different county, he had obtained a \$162,400 economic injury disaster loan. In 1983, he defaulted on that loan (filing for bankruptcy the next year). The SBA's Albuquerque District Office referred the matter for investigation in 1996, at which time the accrued interest had raised the loan balance to \$276,298. His SBA loan history was discovered in December 1995, when the man applied for a \$604,000 Section 504 loan to build a new franchised motel. Based on his prior failure to disclose pertinent information, the 504 loan request was denied. The Government's suit stated that, at the time of his 1990 loan application, SBA had neither the resources nor the technological capability to verify previous loan histories and therefore relied on full and truthful disclosure by its applicants. The suit alleged that the man knowingly concealed the history of his 1978 loan; it sought a \$10,000 civil penalty and costs pursuant to the **False Claims Act**. The Government's settlement agreement with him noted that, notwithstanding his \$5,263 payment, he denied the Government's allegations. At the time the OIG opened its investigation, he was current on repayment of the 1990 loan.

California Owner of Agency Indicted for Bank Fraud. The owner of a model and talent agency in Los Angeles, California,

was indicted on September 30, 1998, on four counts of **bank fraud**. He was previously indicted on seven counts of **making material false statements** to SBA. He obtained a \$42,700 disaster business loan following the 1992 civil unrest and a \$35,000 disaster home loan following the 1994 Northridge earthquake. The OIG's investigation, initiated based on information provided by SBA's Disaster Assistance Area 4 Office, found that the business was not looted during the civil unrest as the owner had claimed on his disaster loan application. He also allegedly submitted copies of altered tax returns to obtain approval of his disaster home loan application. The bank fraud investigation was initiated after it was discovered that the owner allegedly had misused a portion of the proceeds of his disaster home loan to purchase real property. The investigation also revealed that he had applied for a \$315,000 residential loan, allegedly falsely representing that he did not have an ownership interest in real property within the 3-year period prior to the date of the loan application. The investigation further revealed that he allegedly provided a fictitious W-2 Wage & Tax Statement Form to obtain approval of the loan. In addition, he obtained a \$25,000 Title I property improvement loan, administered and guaranteed by the U.S. Department of Housing and Urban Development (HUD). The investigation showed that the owner failed to disclose on his application for the Title I loan his indebtedness to SBA for his disaster loans and provided altered tax returns to obtain approval of the loan. This portion of the investigation was conducted jointly with HUD's OIG.

Five Individuals Connected with North Dakota Business School Charged with Conspiracy to Defraud SBA. A nine-count

indictment of five individuals on charges including **conspiracy** to defraud SBA in connection with a \$122,900 disaster loan was unsealed on October 5, 1998. The indictment charged that the five individuals participated in a scheme to obtain a loan for a business school in Grand Forks, North Dakota. One of the individuals charged, who at the time owned five other business schools, was operating and in the process of purchasing the business school when the Red River flooded it in April 1997. Her then husband was employed as her data processing manager and as an instructor. Also, he was the corporate secretary and another individual charged in the indictment was the controller for other companies she owned. The owner's brother, also charged, was a director of the business school. Also charged was a salesman for a computer store in Fargo. In addition to conspiracy, the indictment charged the five with **making false statements to SBA** regarding withholding taxes payable and computers purportedly purchased for the school. The business school and the other schools were closed in January 1998, and the business school made no payments on the disaster loan it received from SBA. The investigation leading to this indictment was a joint effort by the SBA/OIG, the U.S. Department of Education's OIG, and the IRS Criminal Investigations Division. It was initiated based on a referral from SBA's Disaster Assistance Area 3 Office through SBA's Fargo District Office.

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Surety Bond Guarantees

Audit of Surety Bond Guarantees Finds Inappropriate Fee Refund and Central Weakness in Surety Bond Guarantee

System. An audit of 48 bonds in FY 97 found 19 bonds had inappropriate fee refunds totaling \$99,330. The **inappropriate refunds occurred because of data entry errors, system conversion problems, and lack of controls for preventing and detecting data entry errors and inappropriate refunds**. The data entry errors that caused inappropriate refunds included duplicate recording of fee collections, creation of duplicate bond records, entry of incorrect premium amounts, cancellation of the wrong bonds, and a duplicate cancellation. The SBG system did not have edit checks to ensure correct surety premium amounts were entered, and there were no warning flags to identify cancellation dates that were an unreasonable period of time after bond approval dates. The SBG system did not have controls to detect refund errors such as reports to identify abnormal conditions.

The audit recommended that the Associate Administrator, Office of Surety Guarantees, (AA/SG) recover the \$87,325 still due SBA out of the inappropriate fee refunds of \$99,330. Other audit recommendations included developing data entry edit checks for the SBG system and developing reports to identify bonds with negative liability accounts balances or unreasonable fee revenues. The AA/SG agreed with the recommendations and has already begun their implementation

Audits of SBA's Preferred Surety Bond Companies Find Inappropriately Obtained SBA Bond Guarantees. The OIG issued two audits of claims submitted to SBA by two preferred surety bond companies. The audits, conducted by a CPA firm, were requested and funded by the AA/SG. The audits found that the **sureties did not always comply with SBA's policies and**

procedures for underwriting, claimed unallowable expenses, and calculated fees accurately but did not remit them to SBA in a timely manner. Specifically, the sureties issued bonds after work had commenced, issued bonds after the principals had defaulted on prior bonds, issued bonds for a single project that exceeded the statutory limit, misallocated a loss between two bonds, did not maintain all required documentation, and did not remit recoveries and surety fees to SBA in a timely manner. The audits identified inappropriate claims of \$496,544 and unremitted fees of \$72,514.

The audits recommended that the AA/SG seek reimbursement on ineligible bonds, deny payment on any future claims on the remaining ineligible bonds, direct the sureties to revise their policies and procedures, and obtain surety fees owed to SBA. The AA/SG concurred with the findings and recommendations for one of the sureties and agreed with the findings and recommendations for the other surety but stated that he may seek the legal advice of the Office of General Counsel prior to implementing some of the recommendations.

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Minority Enterprise Development

Audit Finds Ineligible 8(a) Sole Source "IDIQ" Contracts Awarded. A limited review of 157 sole source Indefinite Delivery/Indefinite Quantity (IDIQ) 8(a) contracts awarded by the Federal Telecommunications Service of General Services Administration in Kansas City, Missouri, (GSA-KC) found that GSA-KC should not have awarded, and SBA should not have accepted, the contracts into the 8(a) Program. Specifically, **the**

contracts did not meet FAR requirements for IDIQ contracts, did not comply with SBA's regulations that 8(a) contracts have a requirement, and may have provided a loophole whereby procuring offices could circumvent the competitive requirement by dividing one requirement into multiple contracts. As of March 2, 1998, the OIG estimated that GSA-KC could potentially place approximately \$400 million in orders against the 157 contracts. During the audit, two additional offers were made to SBA's Washington District Office with a cumulative value not to exceed \$6 million. After discussions with the auditor, these offers were not accepted into the 8(a) Program.

The report recommended that the Acting Associate Administrator, Office of Minority Enterprise Development, (AA/MED) identify any other inappropriately awarded sole source 8(a) IDIQ contracts and develop an agreement with GSA to ensure that no additional orders are placed against these contracts and no options are exercised. Also, the audit report recommended that SBA not accept the two additional GSA-KC offerings for sole source 8(a) IDIQ contracts made during the audit. The Acting AA/ MED agreed with the majority of the audit recommendations.

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Entrepreneurial Development

Inspection Report Assesses Performance Measurement in SBA's Small Business Development Center Program. The OIG issued an inspection report that assesses performance measurement efforts in the Small Business Development Center (SBDC) program. **To maximize use of**

existing data sources, SBA has two options for evaluating the SBDC program's economic impact and customer satisfaction. If SBA decides to continue to use the results of the national impact study sponsored by the SBDC Association, the OIG recommends that SBA (1) validate the study's methodology and arrange for the study to be conducted annually, (2) eliminate current requirements for SBDCs to report impact data directly to SBA, (3) discontinue collection of client service evaluations, and (4) require that a statistical sample of all SBDC clients be sent the customer satisfaction portion of the Association's national impact survey.

SBA's second option for evaluating SBDC performance is for the Agency to aggregate the impact data and the customer evaluations collected by the individual SBDCs. If SBA chooses this option, the OIG recommends that it (1) require only the data from the SBDCs that it plans to use for measuring program performance, (2) provide guidelines to SBDCs, in consultation with the Association, on how information is to be collected to ensure data integrity, and (3) revise the customer satisfaction questionnaire to ensure that it meets the feedback needs of both the Agency and the SBDCs.

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Small Business Investment Companies

Receivership of Corruptly-Run Specialized Small Business Investment Company (SSBIC) Pays SBA Another \$1 Million. During the year that ended on September 30, 1998, the receivership of a Southfield, Michigan, SSBIC, which was ordered as a result of information developed during the

SBA/OIG's joint investigation with the U.S. Secret Service, **paid SBA another \$1 million** generated from its "closing down" of the former licensee's business. This brings the **total recovered by SBA under the terms of the 5-year old receivership to \$5 million.** The SSBIC's former owner was previously sentenced to 1 day's imprisonment and forfeiture of \$50,000 to the Government for receiving an unlawful benefit during the time period he operated the SSBIC. The investigation found that from 1987 through 1992 he solicited and received money, or payment of his personal debts, from prospective SSBIC borrowers in exchange for making loans to their companies.

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Agency Management and Financial Activities

OIG Surveys Administrative Officers in Field Offices. The OIG conducted a survey of administrative officers and regional support staff on the effectiveness of communications between SBA headquarters and the field offices on administrative matters. The inspection found that the respective roles of the Offices of Administration, Field Operations, and Chief Financial Officer needed clarification; that some offices should improve the timeliness and accuracy of their responses to queries from field personnel; that field administrative personnel have developed an internal support network for obtaining answers to questions and keeping informed about issues and procedures affecting their work; and that there is a need for more training.

The OIG recommended that SBA clearly identify points of contact in headquarters

who have the expertise, authority, and resources to respond to administrative inquiries from the field. The OIG also recommended that the designated points of contact be held accountable for responding in a prompt and effective manner. Finally, the OIG urged SBA to develop a structured training program for administrative officers and regional support staff.

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.

Comments or questions concerning this update or request for copies of OIG audits, inspections, or other documents should be directed to David R. Gray, SBA/OIG, 409 Third Street, SW, Washington, DC, 20416-4110.

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