



Office of Inspector General U.S. Small Business Administration

January 2003 Update

Business Loan Programs

Colorado Bank President Signs Settlement Agreement and Release. The president of a Durango, Colorado, bank signed a Settlement Agreement and Release with the U.S. Attorney's Office, District of Colorado. Under the terms of this agreement, the bank repaid the Government \$238,683 (the amount SBA lost on two guaranteed loans made by the bank). In the agreement, the U.S. alleged that the bank was **negligent in making, servicing, and disbursing these loans, and that the bank and its officers made misrepresentations and failed to disclose material facts to SBA.** The bank denied these allegations, but acknowledged that actions of a former bank loan officer caused the bank's failure to comply with SBA regulations. SBA previously declined to renew the bank's preferred lender status based in part on the results of this investigation.

Husband of Colorado Commercial Painting Company Owner Indicted. The husband of the owner of a commercial painting company in Berthoud, Colorado, was indicted on January 6, 2003. The husband was charged with one count of **bankruptcy fraud** and one count of **conspiracy**. An arrest warrant was issued for him and he is considered armed and dangerous. The wife/owner obtained a \$100,000 SBA-guaranteed LowDoc loan. Shortly after receiving the loan she defaulted and filed bankruptcy. The SBA/OIG joint investigation with the Federal Bureau of Investigation (FBI) determined that the husband and wife then conspired to hide assets in excess of \$25,000 from the bankruptcy court. This indictment was based on information obtained during an investigation of the wife, who recently pled guilty to one count of **making a false statement** to a financial institution and one count of **bankruptcy fraud**.

Missouri Stucco and Drywall Company President/Owner Pleads Guilty to Making False Statements. The former president/owner of a stucco and drywall company in Kansas City, Missouri, pled guilty on January 9, 2003, by way of an Information and Plea Agreement to **making false statements** to SBA and a bank and **conversion of company health plan funds.** Count one of the Information charged that he made false statements to the bank and SBA by overvaluing the company's accounts receivable in the amount of at least \$311,000. The lender and SBA relied on this information in approving a \$200,000 SBA-guaranteed loan. The company defaulted on this loan, resulting in a loss of \$137,868 to the lender and SBA. Count two of the Information charged him with converting \$2,888 from the company health plan. Count three similarly charged him with converting \$1,000 from the plan later in 1998. The Information and guilty plea resulted from a joint investigation by FBI, the Department of Labor, the Pension and Welfare Benefits Administration, and SBA/OIG. This investigation was initiated by SBA/OIG based on a suspicious activity report filed by the bank and subsequent information uncovered by FBI.

Three New York Imaging Company Principals Indicted for Theft. Three principals of a defunct New York City electronic imaging company were indicted by a State grand jury in Trenton, New Jersey, on January 9, 2003. The indictment charged the three men with **theft by failure to make required disposition of property received.** Also indicted on the same charge were the president and vice president, respectively, of an East Rutherford, New Jersey, machinery dealer. The theft charge involved a scheme by the subjects and the chief financial officer (CFO) of the imaging company to illegally divert funds from a \$1 million SBA-guaranteed loan. The funds, purportedly for the purchase of machinery from the machinery dealer, were instead used

for unauthorized purposes. The CFO of the imaging company had previously pled guilty to the above violation and was sentenced to 7 years incarceration. This investigation, conducted jointly with the State of New Jersey's Division of Criminal Justice and the Environmental Protection Agency OIG was initiated based on information derived from another SBA/OIG investigation.

West Virginia Flooring Company President Sentenced

The president of a defunct hardwood flooring company in Elkins, West Virginia, was sentenced on January 22, 2003, to 12 months in prison and 5 years supervised release for committing **bank fraud**. He was also ordered to pay \$127,981 in restitution to the lender and a special assessment fee of \$100. The defendant obtained three SBA-guaranteed loans (two revolving lines of credit and one demand note) through the lender totaling \$780,000. The loan proceeds were to be used to support working capital needs while the business awaited payment from domestic and foreign customers. Under the terms of the revolving lines of credit, the corporation could receive up to 80 percent of the outstanding invoices. The bank loaned the corporation \$127,981 based on false invoices submitted by the president. He defaulted on all three loans. SBA paid the bank \$166,723 to purchase the guaranty on two of the loans, but refused to honor the guaranty on the third because the bank did not oversee the loan properly. The loss to the bank was \$241,768 for all three loans. This investigation was initiated based on a referral from the lender and was conducted jointly with FBI.

Ohio Bed and Breakfast Owners Sentenced. A former husband and wife of Sidney, Ohio, were each sentenced in December 2002, to 3 years of probation and each ordered to make restitution in the amount of \$25,000. The two had previously pled guilty to **conversion of collateral** pledged to SBA as part of the plea agreement. The indictment related to a \$200,000 SBA-guaranteed loan 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 that the borrower would provide as collateral the land and buildings, including their inventory. The investigation revealed that after the couple defaulted on the loan and filed for bankruptcy, they signed a contract to have the interior woodwork (trim, doors, and casings), an elaborate wood fireplace mantel, and a spiral staircase removed

from the house and sold for \$10,000. This investigation was initiated based on a referral from the SBA Columbus, Ohio, District Office.

Illinois Owners of a Restaurant-Maintenance and Repair Business Served with Writ of Garnishment. The former owners of a restaurant maintenance and repair business in Monee, Illinois, were served a Writ of Garnishment by SBA/OIG and FBI on January 10, 2003, that resulted in the seizure of seven cashier's checks totaling \$573,000. The checks were seized after they were brought to a Richton Park, Illinois, bank to be liquidated into cash by the two. On January 9, 2003, in the Northern District of Illinois, Eastern Division, utilizing legal precedence under the Federal Debt Collection Procedures Act, the Writ of Garnishment was issued by the U.S. District Court. Five of the seven cashier's checks made payable to one of the owners were issued by the bank on November 20, 2002, 1 day after the couple was notified of a Federal civil fraud complaint for **making a false claim to the SBA, making false statements to the SBA, and conspiracy**. The complaint demanded judgment against the couple in the amount of \$2,145,000, other civil penalties, interest, and costs. On May 5, 2002, another lender and SBA approved a \$954,000 SBA-guaranteed loan to a mergers and acquisition company to purchase the restaurant maintenance and repair business from the couple. According to the lawsuit, during the loan application process and as part of the purchase agreement, the couple signed a false and misleading non-compete clause, preventing them from competing with the buyer for a period of 5 years. The couple's promise to abide by the non-compete clause was false and misleading in that they never had any intention on complying with the provision. The lawsuit also claimed that the tax returns submitted during the loan application process by the couple represented revenue from the couple's businesses that were not part of the sale. The couple submitted the false and misleading non-compete clause and tax returns in order to induce SBA to approve the loan to the mergers and acquisition company. The investigation was initiated based on a referral from the second lender and was conducted jointly with FBI.

Virginia Soap Making Business President Pleads Guilty to Wire Fraud. The president of a defunct soap-making business in Woodbridge, Virginia, pled guilty on January 30, 2003, to one count of **wire fraud** per a plea agreement and he is scheduled to be sentenced in April 2003. He was indicted and charged with two counts of

wire fraud, three counts of **making material false statements**, and three counts of **making false statements to SBA**. The charges related to the false statements he made to obtain a \$290,000 SBA-guaranteed loan. A warrant for his arrest was issued following his indictment; however, OIG Washington Field Office Special Agents were to be unable to make the arrest because he had left the country. His attorney subsequently agreed to coordinate his return to the Richmond International Airport where SBA/OIG agents arrested him as he reentered the country from Canada. This investigation was initiated based on a referral from the Richmond, Virginia, District Office.

OIG Issues Audit Report of Early Defaulted Loan. On January 23, 2003, OIG issued an audit report on an early defaulted loan to My T Quick. The audit found that the lender did not use prudent lending procedures to approve and close a Section 7(a) loan to My T Quick. Standard Operating Procedure 50 10 (4) states that the ability to repay a loan from the cash flow of the business is the most important consideration in SBA's loan making process. The PLP lender, however, did not adequately determine repayment ability and misrepresented the borrower's equity injection. In addition, the borrower misrepresented material facts in applying for the loan. The borrower defaulted because sufficient cash flow was not available to service business debts. As a result, the SBA could owe the lender as much as \$650,000 if the guaranty is purchased.

OIG Issues Audit Report on SBA's Oversight of the Fiscal Transfer Agent (FTA) for the Section 7(a) Loan Program. OIG issued an audit report on SBA's oversight of the FTA for the Section 7(a) loan program on January 30, 2003. The objectives of the audit were to determine whether: 1) the Master Reserve Fund (MRF) was properly accounted for in accordance with Federal regulations; 2) the FTA properly performed its functions; and 3) the FTA contract was properly awarded, administered, and monitored. The audit disclosed the following.

1. The results of MRF operations were not properly accounted for in accordance with Federal accounting regulations and Federal financial management procedures. SBA neither knew the fiscal health of the MRF nor timely reported this information to Agency decision-makers. SBA had not implemented financial reporting procedures that would

identify the results of loan pooling operations (surpluses and shortfalls) within the MRF, nor analyzed the MRF for future potential revenues and projected shortfalls from loan pooling operations. The MRF also had not been treated in a manner similar to a trust fund and public funds held in the MRF were not registered with symbols and titles by the Department of Treasury in consultation with the Office of Management and Budget (OMB).

2. SBA has allowed the FTA to hold basis point fees and other fees collected on behalf of SBA although these fees are due immediately to SBA. This allowed the FTA to receive approximately 23 days of float interest per month on the fees and this was the compensation for providing the collection services. An estimated \$527,000 over 2 years was paid to the FTA. This practice is an inappropriate augmentation to SBA's appropriation as SBA had the FTA use the float collected on the fees as compensation for collecting these fees rather than paying the compensation from appropriated funds.
3. SBA did not award, administer, and monitor the FTA contract in a manner that fully protected the interests of the Federal Government or ensured that the Government received the best services for the least cost. Specifically: (a) the FTA contract was improperly extended beyond 5 years; (b) the legality of float compensation payments to the FTA was unclear and an unsound business practice; (c) accurate FTA contract costs were not tracked or maintained; (d) Federal regulations for administering the MRF does not exist; and (e) there were discrepancies in the terms and conditions for auditing the FTA by its Independent Public Accountant including meeting Freedom of Information Act requirements and the need to conduct "Statements on Auditing Standards 70" reviews.

OIG made 16 recommendations to correct the deficiencies identified in the report. The Chief Financial Officer generally agreed with the recommendations addressed to him. Comments provided by the Associate Deputy Administrator for Capital Access, Acting Assistant Administrator for Administration, and General Counsel did not state whether they agreed or disagreed with the recommendations addressed to them and actions to address the findings and recommendations will be evaluated during the audit resolution process.

Government Contracting and Business Development Programs

OIG Issues Audit Report on HUBZone Company Eligibility and Program Internal Controls. OIG conducted an audit of the eligibility of 15 HUBZone companies and a review of the HUBZone Empowerment Contracting program's internal controls. The objectives of the audit were to determine: (1) if 15 certified HUBZone companies met the four criteria for participation in the HUBZone program; and (2) whether the program office's internal controls over the selection and monitoring of participating companies were adequate to ensure that only eligible firms are certified and remain certified. The auditors found that 11 of the 15 subject companies were either not in compliance with HUBZone eligibility requirements or could not be contacted by phone or mail and had presumably gone out of business; and the program's internal controls were inadequate to ensure that only eligible firms are certified and remain certified. Therefore, there is little assurance that the program will provide increased employment, investment and economic development for depressed areas. Since ineligible companies could receive HUBZone contracts, the program is also vulnerable to Federal contracting fraud. OIG made three recommendations to correct the deficiencies identified in the report. The Chief Operating Officer and the Associate Administrator for HUBZone Empowerment agreed with the recommendations.

Agency Management

SBA Employee Suspended and Reduced in Grade for Improper Travel. An SBA employee was suspended for 30 days and reduced in grade from a GS-15 to a GS-13. Upon return from suspension, the employee will be transferred to another position in the Agency. The administrative action resulted from an OIG investigation that revealed various issues related to the employee's travel from his residence in one State to the employee's official duty station in another location between 1997 and 2001. The investigation revealed that the employee **violated the Federal Travel Regulations** and the SBA standard operating procedure on travel when making 30 such trips. The employee was also required to repay SBA over \$50,000 through salary offset for these erroneous travel claims.

SBA Deputy District Director Retires Amid Allegations of Improperly Receiving Gifts from SBA Partners. A deputy district director retired from the Federal Government while SBA personnel actions were pending. OIG received allegations that the deputy district director had **improperly received personal travel expenses and other gifts** from officials at certified development corporations (CDC). The OIG investigation showed that from 1997 through 2001, the deputy district director violated Federal regulations by improperly accepting gifts from officials at these CDCs concerning five trips he took to the National Association of Development Corporation (NADCO) conferences in various locations in the United States. The deputy district director received over \$4,300 in paid expenses for airfare, lodging, and golf fees. The deputy district director also made false claims on three travel vouchers concerning his trips to the NADCO conferences. This investigation conducted by SBA/OIG was done based on a referral from a district office.

OIG Issues Audit Report on SBA's Implementation of Its Cyber-Based Critical Infrastructure Protection Plan (CIPP). OIG conducted an audit of SBA's implementation of its CIPP to determine whether SBA has adequately implemented its CIPP. Specific objectives were to assess the adequacy of SBA's implementation activities in the areas of: (1) risk mitigation; (2) emergency management; (3) interagency coordination; (4) resource and organization requirements; and (5) recruitment, education, and awareness.

The audit found that SBA: (1) completed vulnerability assessments and security plans for 22 of the 37 critical information systems; (2) established an emergency management program to respond to computer incidents; (3) performed information system security reviews at private sector contractor locations where important services are provided through a cyber-based infrastructure; (4) included resource and organization requirements necessary to protect the cyber-based infrastructure in annual budget plans; and (5) implemented a training and education program for information technology security personnel and a security awareness training program.

SBA has not, however, updated and utilized its CIPP to manage SBA's critical infrastructure protection efforts. In addition, SBA has not implemented CIPP requirements for risk mitigation and the reporting of computer

security incidents as part of its emergency management efforts. OIG made four recommendations to correct the deficiencies identified in the report. The Chief Information Officer agreed with the recommendations.

OIG Issues Report on SBA's Federal and State Technology (FAST) Partnership Program. OIG issued its report on SBA's FAST program. The report examined the extent to which recipients under the FAST program were measuring performance of their program activities. The Consolidated Appropriations Act of 2001 requires SBA/OIG to conduct a review of the extent to which FAST recipients are measuring their performance and the overall management and effectiveness of the FAST program. In addition, the law requires OIG to submit to Congress a report based on this review during the first quarter of FY 2004. This report is intended to provide baseline information for the report to Congress and information that SBA can use in the early implementation stages of the program.

OIG Issues Audit Report on SBA's FY 2002 Financial Statements. OIG issued the audit of SBA's FY 2002 Financial Statements (Report 3-06) on January 30, 2003. SBA's independent auditors disclaimed an opinion on the FY 2002 and the restated FY 2001 financial statements. The auditors noted scope limitations on their work in the areas of disaster loan program modeling, pre-1992 loan guarantees, and the Master Reserve Fund. As a result, the auditors were unable to satisfy themselves as to certain financial statement and footnote amounts as described in the Independent Auditor's Report. The audit disclosed six reportable conditions, five of which the auditors deemed to be material weaknesses. In addition, the auditors disclosed that SBA was not in substantial compliance with the Federal Financial Management Improvement Act (FFMIA) and that the funds control shortcomings described in their independent auditor's report on Internal Control represent noncompliance with OMB Circular A-11.

In response to the report, the Chief Financial Officer stated that they are strongly committed to address all of the issues raised by the independent auditor and resolving them during the coming year. SBA also stated that they are committed to full compliance with all financial management laws, regulations, and policies.

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

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 such documents please contact:

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