



Office of Inspector General Small Business Administration

June 1998 Update

Business Loans

Inspection Report Finds SBAExpress Pilot Program Effective, but Identifies Need for Some Policy Clarification. The OIG issued an inspection report on the SBAExpress pilot program that found the program appears to be **meeting its overall objectives** and is considered by lenders to be **highly effective in increasing the capital available to small businesses**. The OIG did find, however, that language governing certain SBAExpress rules, regulations, and standard operating procedures leaves room for broad interpretation in two areas. First, it is unclear whether SBA considers credit scoring alone sufficient for loan underwriting analysis. Second, there is much ambiguity over whether promissory notes are

required for SBAExpress loans. The OIG recommended that the Office of Financial Assistance (OFA) review the language governing each of these areas and clarify SBA policy on those issues.

New Jersey Businessman Pleads Guilty to Making False Statements.

The owner of a waterbed company in West New York, New Jersey, pled guilty on June 17, 1998, to a one-count information charging him with 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. He received a \$30,000

LowDoc business loan through a Parsippany, New Jersey, participating non-bank lender. After the loan was disbursed he closed the business, defaulted on the loan, Texas Couple Charged With Conspiracy. A married couple who formerly owned a convenience store in San Antonio, Texas, was charged, in a superseding indictment on June 3, 1998, with **conspiracy** to defraud SBA. This new count was in addition to two previous counts of **making false statements** in their application to SBA for a \$131,100 handicapped-assistance business loan with which the couple had originally been charged. They were charged with devising a scheme to conceal facts that, if known by SBA, would have resulted in the declination of their loan application. Allegedly, they intentionally did not disclose to SBA that they had previously filed for bankruptcy and had already sold the business for which the loan was obtained. The joint investigation with the Social Security Administration's OIG was based on a referral from SBA's San Antonio District Office.

Wisconsin Consultant Sentenced for Making Material False Statement. A business consultant in Menomonee Falls, Wisconsin, was sentenced on June 4, 1998, to 4 months home confinement with electronic monitoring, 2 years probation, and \$38,944 restitution. She previously pled guilty to one count of **making a material false statement** to SBA to obtain a \$25,000 SBA-guaranteed loan. The woman admitted that she knowingly failed to disclose a recent criminal history and provided a false Social Security number on SBA Form 912, Statement of Personal History, in a LowDoc loan application for her consulting firm. The

and disappeared. In 1997, he was located and arrested by SBA/OIG agents. This matter was referred by the participating non-bank lender.

OIG's investigation found that she had been arrested on a local charge (forging company checks) the day before she applied for the loan, and she was convicted on that charge after obtaining the loan. The OIG initiated the investigation in response to a request from the U.S. Attorney's Office for the Eastern District of Wisconsin.

Investigation of Southern California Loan Brokerage Continues to Yield Results. The number of individuals charged with crimes in the wake of the investigation of a southern California loan brokerage company has risen to 12. The following individuals were charged in criminal informations:

- ① A Los Angeles, California, plumbing contractor was charged on April 22, 1998, with one count of **making a false statement to a Federally-insured lender**. He was charged with submitting altered individual income tax returns for the years 1988-90, as part of his application for a \$500,000 SBA-guaranteed loan. He subsequently defaulted on the loan, leaving an unpaid principal balance of \$440,595. On May 27, 1998, he pled guilty to the charge.
- ② The owner of an oriental rug firm in Beverly Hills, California, was charged on May 26, 1998, with one count of **fraudulent receipt of money from a bank transaction**. He was charged with falsely representing that the

purpose of his \$1,000,000 SBA-guaranteed loan from a participating lender bank was to purchase rug inventory, when he actually intended to use the loan proceeds to pay debts associated with a real estate business he

⑥ The former co-owner of a West Covina, California, gas station was charged on May 26, 1998, with one count of **making false statements to a Federally-insured lender**. He was charged with submitting altered individual income tax returns for the years 1987-89, as part of his application for a \$1,000,000 SBA-guaranteed loan. He and two of his co-borrowers (who were previously indicted in connection with this investigation) subsequently defaulted on the loan. After all liquidation efforts had been completed, SBA charged off a balance of approximately \$500,000.

Also in connection with this case, a seventh guilty plea has been entered, and a second defendant has been sentenced:

① The former owner of a gas station in Compton, California, pled guilty on April 22, 1998, to one count of **making false statements to a Federally-insured lender** by submitting altered individual income tax returns for 1987-89 with his application for a \$225,000 SBA-guaranteed loan. The man subsequently defaulted on the loan, leaving an unpaid principal

owned and to develop real estate. Neither expenditure was an eligible use of proceeds of an SBA-guaranteed loan. He pled guilty to the charge on June 1, 1998.

balance of \$225,000.

② The owner of a Manhattan Beach, California, gas station was sentenced on June 15, 1998, to 5 months in a halfway house, 5 months home detention, 5 years supervised release, and \$30,000 restitution. He previously pled guilty to one count of **making false statements to a Federally-insured lender** by submitting altered individual income tax returns for the years 1988-90 while applying for a \$350,000 SBA-guaranteed loan. The man also defaulted on his loan, leaving an unpaid principal balance of \$292,617.

The OIG's joint investigation with the FBI was initiated based on allegations from an anonymous complainant.

Kansas Business Loan Applicant Pleads Guilty to Making False Statement. A loan applicant on behalf of a Neodesha, Kansas, building materials manufacturer pled guilty on May 26, 1998, to **making a false statement** to SBA by signing an SBA loan agreement as president of the company. In 1993 the company applied for a \$630,000 SBA-guaranteed loan and began manufacturing foam-core building panels. However, it soon defaulted on repayment of the loan and

went out of business. The OIG's joint investigation with the U.S. Secret Service showed that the "president" and another individual misrepresented that the applicant was the 100% owner and president of the company, when in fact the other individual was the 100% owner and president at the time the loan was made. In 1997, both men were indicted on three false-statements counts; in return for his guilty plea, the Government agreed to dismissal of the other two counts against the loan Audit of Declined Disaster Loans Finds Loan Decisions Consistent With Regulations. An audit of declined disaster loans found that decisions to decline loan applications were **generally consistent with regulations**.

The audit was requested by the Associate Administrator for Disaster Assistance (AA/DA) to determine whether the decline rate was higher than necessary due to inappropriate eligibility decisions made by SBA disaster employees. A review of 97 declined applications identified only 1 for which the declination was questionable. The application was declined because the loan officer decided that the applicant's available cash was not sufficient to service the disaster loan. The audit also found that the Agency's decline rate could have been reduced if unqualified applicants were declined during the initial screening process. In the sample, immediate decline procedures were not used for 10 of 97 applications that did not meet minimum household income levels. This test is usually applied by FEMA in the course of teleregistration. In addition to lowering the decline rate for accepted applications, the use of immediate decline procedures may save

applicant. The charges against the real president were dismissed after his March 21, 1998, death. The OIG initiated this investigation based on a referral from SBA's Kansas City District Office.

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Disaster Assistance

money and reduce loan officer workload. Applications accepted for processing, even if later declined, cost a minimum of \$121 per application for disaster loss verification.

The audit recommended that the AA/DA summarily decline home loan applications at intake when applicants do not meet the minimum income test. The AA/DA agreed with this recommendation.

California Resident Sentenced for Making False Statements and Misusing Social Security Number. A Culver City, California, resident was sentenced on June 3, 1998, to 5 months incarceration, 5 months in a halfway house, and \$22,037 restitution to SBA. He previously pled guilty to one count of **making material false statements** to SBA and one count of **misuse of a Social Security number (SSN)**. The man was approved for a \$33,000 disaster home loan following the 1993 Los Angeles winter storms, but SBA canceled the loan before any funds were disbursed once its tax verification program identified discrepancies between 1990-91 individual income tax returns submitted to SBA and the IRS.

The OIG's investigation confirmed that the tax return "copies" submitted to SBA had been altered to overstate the applicant's income. The investigation also found that another "recipient" (with almost the identical name) of a \$25,000 disaster home loan, following the 1994 Northridge earthquake, was actually the same person. The application package for that loan also included altered 1991-92 individual income tax returns and a fictitious SSN. The OIG opened the investigation based on a referral from SBA's Disaster Assistance Area 4 Office.

North Carolina Resident Sentenced for Ohio Contractor Indicted for Grand Theft. The president of a Coal Grove, Ohio, concrete contractor was indicted on two felony counts, **grand theft by deception** and **grand theft**, on May 29, 1998, in the Lawrence County, Ohio, Court of Common Pleas. The firm had obtained disaster loans totaling \$60,300 for damage resulting from a February 1997 flood. The OIG's joint investigation with the Coal Grove Police Department disclosed that, between November 1997 and January 1998, the firm's owner requested and obtained \$27,700 of additional disaster loan proceeds by falsely stating that he had a water well damaged beyond repair by the flooding and that consequently he was paying excessive utility bills. The investigation earlier found that he had illegally obtained more than \$5,000 worth of water from the Village of Coal Grove without its consent. He had allegedly constructed a series of water pipes and valves to bypass the water meter owned by the Village of Coal Grove. When questioned about how a concrete contractor could go without

Stealing Federal Property. A resident of Surf City, North Carolina, was sentenced on June 23, 1998, to 1 year incarceration, 3 years supervised release, \$6,300 restitution, and a \$100 special assessment. He previously pled guilty to one count of **stealing Federal property**. The man admitted converting to his own use an improperly delivered \$6,300 U.S. Treasury check intended for a Surf City disaster victim. The OIG initiated this investigation based on information received from the Disaster Assistance Area 2 Office.

using any village water for more than a year, the man reportedly explained that he had been getting water from the well (which he had told SBA had been damaged beyond repair a year earlier).

Los Angeles Resident Indicted for Making False Statements. A resident of Los Angeles, California, was indicted on June 2, 1998, on 11 counts of **making false statements** to SBA and other Federal agencies and 3 counts of **making false statements to a Federally-insured financial institution**. The OIG's joint investigation with the IRS revealed that the woman submitted fictitious Federal tax returns and altered and forged IRS tax transcripts in support of applications for loans, including a \$153,000 disaster home loan approved by SBA following the Northridge earthquake. The OIG initiated the investigation based on a referral from SBA's Disaster Assistance Area 4 Office, which detected discrepancies associated with the tax verification documents she submitted after the first \$25,000 was disbursed.

Subsequent investigation determined that she had submitted similar fictitious tax returns to obtain a loan guaranteed by the Department of Housing and Illinois Construction Company Owner Indicted for Making False Statements.

The president and owner of a construction company in Moline, Illinois, was indicted on June 17, 1998, on four counts of **making material false statements** in connection with a \$151,000 SBA physical-damage disaster loan made to an Orion, Illinois, campground after the Midwest flood of 1993. The man allegedly caused the omission of his name (he was an officer of the company which owned the campground and had a controlling interest in it) on the loan application question asking for the names of the applicant's managers and officers, so as to avoid having to disclose that he had been convicted of and imprisoned for fraud and was still on supervised release. After the loan was approved but before SBA had disbursed any funds, a construction agreement was submitted outlining the terms under which the construction company would replace and repair the campground's disaster-damaged property. The OIG's investigation determined that he caused that document to be falsified in order for the construction company to realize \$70,000 more in profit. Also, according to the indictment, he falsely represented that the loan proceeds would be used solely to rehabilitate and replace disaster damage suffered by the campground and then used disaster loan proceeds to pay off its pre-existing debt, an ineligible use. This investigation was initiated based on a referral from SBA's Disaster Assistance Area 4 Office.

Urban Development and to obtain a home mortgage from a Federally-insured lender.

California Businessman Sentenced for Filing False Claim and Making False Statement. The owner of a nurse registry in Los Angeles, California, was sentenced on June 8, 1998, to 15 months incarceration, 5 years supervised probation, and restitution of \$161,691 to SBA and of \$50,000 to a southern California bank. He previously pled guilty to one count of **filing a false claim** with SBA and one count of **making a false statement to a Federally-insured lender.** The investigation, based on a referral from SBA's Disaster Assistance Area 4 Office, revealed that the man submitted fraudulent applications for disaster-related business loans to a bank and SBA. He obtained a \$50,000 interim loan from the bank; then he obtained an \$89,600 economic injury loan and a \$72,800 physical damage loan from SBA. (Of the SBA loan proceeds, \$50,000 was to be used to repay the bank loan; however, he admitted diverting that amount.) In each of the loan applications, the man claimed his business was located in a building damaged by fire during the 1992 civil unrest in Los Angeles. The investigation disclosed, however, that his business sustained no damage because he actually operated the nurse referral service out of his residence, which was not affected by the civil unrest. False documents submitted with the loan applications included a lease, a telephone installation invoice, and an estimate of the cost of replacing his business' files. The SBA disaster loans

went into default after only two payments on each loan were made, and SBA charged off both loan balances in 1993. The man did not make any California Doctor Pleads Guilty to Making False Statements. A Beverly Hills, California, medical doctor who had received home and business disaster loans pled guilty on June 8, 1998, to two counts of **making a false statement** to SBA. The following day, he signed an agreement to pay a \$1,500,000 civil settlement to the Government. The doctor claimed to have incurred both personal and real property damage at his residence following the 1994 Northridge earthquake, when in fact the property was a rental and the personal property damage was actually incurred by his tenant. Also, the doctor submitted an invoice that overstated the extent of real property damage incurred at the rental. The SBA/OIG conducted this investigation at the request of the U.S. Attorney's Office after a Medicare fraud investigation uncovered indications that the doctor may have made a false statement to obtain his SBA loans. He was indicted in February 1998 for allegedly overbilling Medicare by more than \$216,000 and was freed on \$250,000 bail. The U.S. Attorney's Office subsequently learned that, after he was advised that his second indictment (on the SBA violations) was imminent, the doctor had withdrawn \$2.39 million from his savings account. In anticipation of his potential flight, a criminal complaint based on the SBA violations was issued, and he was arrested the same day. During a search incident to the arrest, the \$2.39 million was seized as evidence of his intent to flee. A bail revocation hearing was held on May 7, 1998, and his bail was

payments on the interim loan, which the bank charged off in 1994.

revoked. He remains in custody pending sentencing.

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Government Contracting and Minority Enterprise Development

Audit of Section 8(a) Program Administration Finds Program Criteria Not Uniformly Applied. On June 18, 1998, the OIG issued a Section 8(a) audit of four National Oceanic and Atmospheric Administration (NOAA) contracts classified as manufacturing contracts under Standard Industrial Classification (SIC) code 3571 (Electronic Computers). The audit was conducted to determine if SBA applied the criteria in Title 13, Code of Federal Regulations (CFR) Part 121, Section 406, in determining whether the four contractors were qualified to provide the computer workstations and related equipment as the manufacturers, because the equipment supplied bore the trademarks and logos of large computer manufacturing companies. The audit found that **SBA had not applied the manufacturing criteria**. Further, even if SBA had applied the criteria, the regulations allow for subjective judgments when assessing whether a contractor is a manufacturer, and SBA has not provided any interpretative guidance for applying the regulatory requirements. As a result, SBA manufacturing regulations may be

applied inconsistently or not at all, and there is no assurance that SBA is developing and assisting small business manufacturers as intended by the Section 8(a) program. For example, the audit found that large businesses supplying the basic computer system received the majority of contract funds.

The report recommended that the Associate Deputy Administrator for Government Contracting and Minority Enterprise Development (ADA for GC/MED) provide definitive guidance and definitions to evaluate the manufacturing criteria. The ADA for GC/MED agreed with the recommendation and plans to solicit comments from the business community, particularly businesses in the computer industry.

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- Issuance of 6 audit reports with significant recommendations concerning loan processing, disaster-funded loan servicing personnel, electronic disbursement of disaster loan funds, disaster loan origination and servicing, use of the Credit Alert Interactive Voice Response System, and disaster home loan processing;
- Initiation of 3 more audits concerning disaster loan approval rates, disaster home loan servicing, and early defaulted disaster loans;
- 92 closed investigations, with 92 indictments and 85 convictions; and
- \$15.6 million in total dollar results, for a return on investment of about \$4.5 for every \$1 spent.

The letter went on to alert the Congress that the special funding would run out at

OIG Management Activities

OIG Sends Letter to Capitol Hill Outlining Disaster Oversight Accomplishments and Alerting Congress That Funding Will Soon Be Exhausted. In an effort to keep the Congress fully informed of critical issues, the OIG sent a letter to select members of the Congress on May 29, 1998, outlining the **OIG's accomplishments in the area of disaster oversight** since 1994. Special no-year funding was made available to the OIG in that year to bolster its oversight efforts in this burgeoning, high-risk program area. Together with some additional funding in subsequent years, \$4 million in total will have been spent on this initiative by the end of FY 1998. The letter outlined the following accomplishments:

the end of the current fiscal year; it stated in part:

Once the special funds earmarked for disaster oversight are gone, the level of SBA OIG effort will, of necessity, ultimately revert to FY 1994 levels. Other important SBA initiatives requiring OIG oversight (privatization of the business loan program, the HUBZone and Small Disadvantaged Business programs, and Government Performance and Results Act performance reporting) will preclude the OIG from directing existing resources to the disaster oversight effort. Unfortunately, history indicates that the need for disaster loans remains constant. The growth in the disaster loan portfolio over the past 5 years alone has been phenomenal, with an increase from \$3.9 billion in FY 1993 to \$7.1 billion in FY 1997.

Office of Inspector General Holds Annual Training Conference in Phoenix,

Arizona. The OIG held its **annual training conference for professional staff** during the week of June 8, 1998, in Phoenix, Arizona. Acting Inspector General Karen S. Lee presided over the plenary session, after which the attendees received career-specific training.

The Investigations and Inspection and Evaluation (I&E) Divisions received training in Cyberfraud and the Internet; Auditing and I&E were trained in the COSO (internal controls) Framework; Management & Legal Counsel and Auditing Divisions had Effective Negotiation training. Analysis of Statements Using the Scan Technique, Search and Seizure, Discovery and Employee Cases, and CPR were topics dedicated to Investigations Division, and the I&E Division and Security Operations staff attended Interview Skills training. All OIG staff received an overview of Digital Signatures and Financial Institution Examinations, as well as an update on Government Contracting and Minority Enterprise Development and Capital Access programs.

Editor's Notes:

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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.

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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:

WWW.IGNET.GOV

The Activity Update is produced by the SBA/OIG, Karen S. Lee, Acting Inspector General.

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