Office of Inspector General
Small Business Administration

November 1996 Update

Business Loans

Study of "Best Practices" of Section 7(a) Lenders Issued. The OIG **issued an inspection report on the "best practices" of Section 7(a) lenders.** The report focuses on the credit management procedures identified in case studies of nine successful lenders as the most effective means for controlling risk. Although not all the procedures may apply to every Section 7(a) lender, the OIG believes that by encouraging such practices, SBA will be able to improve the effectiveness of its lending partners while keeping loan losses to a minimum.

Among other things, the OIG found that the successful lenders in the sample

- rely more on evaluating an individual borrower's situation than on automated screening methods such as credit scoring;
- generally avoid using third-party loan packagers, who prepare prospective borrowers' Section 7(a) applications for a fee, because of concerns over the quality of the loans and/or supporting documentation;
- require the borrower to pledge both personal and business assets as collateral, despite the availability of the SBA guarantee;
- centralize final lending decisions to ensure consistency and control over originating loan officers' actions;
- assign risk ratings to new loans and periodically reassess those ratings through the life of the loans;
- proactively watch for warning signs of future loan repayment problems, such as the borrower's failure to renew hazard insurance; and
- identify past due loans early and initiate vigorous collection efforts.

Although the report contains no formal recommendations, the OIG suggests that the Agency incorporate these best practices into its guidance for new lenders and its monitoring criteria for existing lenders.

Audit Uncovers Improper Loan Made to Missouri Company. A Missouri firm with **no prospects for export business was approved for a $1.1 million international trade loan** by SBA's St. Louis District Office and its non-bank lender. Two other, smaller, guaranteed loans were also made by the non-bank lender to this same company. All three loans went into liquidation 7 months after approval.

The OIG's Auditing Division reviewed the questionable loans because of their early defaults and because the St. Louis District Director reported a possible conflict of interest by one of the lender's representatives. Although the auditors found no basis for a conflict of interest, they did find that the loan origination was defective because neither the non-bank lender nor the District Office established that the loan would enhance exports. The audit report recommended that SBA's St. Louis District Office take steps to ensure that eligibility for international trade loans is established before loan approval is given.

In a related issue, OIG auditors found that the lender collected excess interest in the amount of $29,000 for a period beyond the 120 days approved by SBA. The audit report recommended that the lender be required to forward SBA's 75 percent share of the excess interest, or $22,000. SBA's St. Louis District Office had no objection to the draft audit findings or recommendations. Final management agreement is pending.

<u>Guilty Pleas to Money Laundering and Racketeering in New York Defense Contractor Case</u>. A Syracuse, New York, warfare-simulation software development company and its chief executive officer (CEO) each pled guilty on November 21, 1996. The CEO pled to one count of **money laundering**, and the corporation--through its attorney--pled to being a **criminal enterprise under the Racketeer Influenced and Corrupt Organization statute**, both in connection with a $750,000 SBA-guaranteed loan. In return for the guilty pleas, the Government agreed to dismissal of the other charges against them listed in a 54-count indictment alleging that they defrauded the U.S. Navy, the participating bank, investors, and creditors of $8 million. The investigation found that the company and its CEO had failed to disclose a significant debt when applying for the loan and then used loan proceeds to pay off the debt. The OIG conducted this investigation jointly with the Defense Criminal Investigative Service, which brought the case to the OIG's attention.

<u>Two Connecticut Businessmen Convicted of Fraud</u>. Two brothers--officers of a Chester, Connecticut, manufacturer of wire products--were both recently convicted. One brother was convicted on November 7, 1996, on one count of **bank fraud** for submitting false information while applying for a $300,000 SBA-guaranteed loan. The second brother negotiated a guilty plea on October 30, 1996, to one count of being an **accessory-after-the-fact** to his brother's false statement used in obtaining the loan. In applying for the loan, the first brother did not disclose the existence of previous loans and fraudulently offered certain items of unavailable machinery and equipment as collateral. When OIG special agents confronted the second brother with a copy of a Statement of Personal History (SBA Form 912) that claimed he had not been convicted of a crime, he admitted that he did not tell them the statement was false. The joint OIG/FBI investigation was based on a referral

from SBA's Hartford District Office.

Former New York Bank Directors Convicted on Conspiracy and Bank Fraud Charges. The former president and chairman of the board of a now-defunct SBA participating lender headquartered in Watertown, New York, and a former counsel to the bank were convicted on October 23, 1996, on charges of **conspiracy**, **bank fraud**, and the acceptance and payment, respectively, of **money as an inducement and reward for bank transactions**. The OIG investigation revealed that the bank's president had agreed to refer the bank's legal work to the attorney's law firm in return for one-sixth of the legal fees collected. The bank officer received more than $332,000 from the scheme. In furtherance of the conspiracy, he caused the bank to make loans totaling $1,879,500 to the attorney and his associates, allowed other individuals to borrow money from the bank for transfer to the attorney, and permitted the attorney to represent both parties in connection with most of these loans. As a consequence of these arrangements, the loans, several of which were guaranteed by SBA, were not properly secured and not repaid. Having lost $13 million on bad loans, the participating lender bank, which had been a major community lender to small business, was declared insolvent and seized by the Office of the Comptroller of the Currency (OCC) in 1993. The OIG investigation was conducted jointly with the OCC, the Resolution Trust Corporation, and the FBI and was based on a referral from SBA's Syracuse District Office.

Former Georgia Tax Accountant Sentenced for Submitting False Documents. A former Decatur, Georgia, tax accountant was sentenced on October 24, 1996, and ordered to pay SBA $81,688 restitution. Now a resident of Montego Bay, Jamaica, he also was sentenced to 5 years probation and is prohibited from returning to the United States for the first 3 years. He had previously pled guilty to one count of **submitting false documents to SBA** in connection with a $154,000 SBA-guaranteed loan to his sole proprietorship. The OIG's investigation established that he submitted altered copies of tax returns for the years 1986-88, thereby substantially overstating his income for the purpose of procuring his loan. The accountant also submitted as collateral for the loan a "deed to secure debt" on which his wife's signature had been forged. The OIG initiated the investigation based on a referral from SBA's Atlanta District Office.

Ohio Medical Equipment Manufacturer Pleads Guilty to Bank Fraud. The president of a now-bankrupt manufacturer of medical equipment in Chardon, Ohio, pled guilty on October 18, 1996, to one count of **bank fraud**. In return, the Government agreed to dismissal of three other felony charges on which he had been indicted. An OIG investigation determined that at the time the company president was negotiating to obtain a $700,000 SBA-guaranteed loan, and during the subsequent loan disbursement period, he concealed from SBA and the participating lender bank his intent to sell a substantial portion of the business assets. He also diverted a majority of the proceeds from those sales to pay off other debts and caused $100,000 to be fraudulently wired from another bank to the participating lender. During a May 1996 interview by an OIG special agent, the company president made material false statements by stating that officials of the participating lender had known about and approved the sale of assets. This investigation was initiated based on a referral from SBA's Cleveland District Office.

Indiana Businessman Sentenced for Making False Statement. A Muncie, Indiana, businessman was sentenced on October 11, 1996, to 3 months home detention, 2 years probation, and $115,000 restitution to SBA. He had pled guilty to one count of **making a false statement** to obtain a $400,000 SBA-guaranteed loan. The SBA/OIG's joint investigation with the FBI disclosed that the man falsely certified that the loan proceeds were to be used as operating capital for his machine and foundry company when he actually intended to (and subsequently did) use a substantial portion of the loan proceeds for his personal benefit. This investigation was initiated based on a referral from SBA's Indianapolis District Office.

Illinois Equipment Manufacturing Company Indicted for Making False Statements. A manufacturer of grain wagons and other farm equipment in Arthur, Illinois, was indicted on October 23, 1996, on one count of **making a false statement** to obtain a $1,000,000 SBA-guaranteed loan. In a loan application document submitted in June 1993, the company stated that it had not discharged any hazardous waste onto its property (a question regarding compliance with environmental laws is included in the application), when it knew that hazardous waste had been unlawfully buried on its property. The corporation was also indicted on three counts of **unlawful disposal of hazardous solvents and paint wastes**. This indictment was a result of the OIG's joint investigation with a task force headed by the Environmental Protection Agency's Office of Criminal Enforcement.

Washington Manufacturing Company President Pleads Guilty to Bank Fraud and Money Laundering. The former president of a Port Angeles, Washington, crane manufacturer pled guilty on October 10, 1996, to one count of **bank fraud** and one count of **money laundering**. The OIG's joint investigation with the FBI and the IRS found that the man made false statements about his criminal history, his Social Security number, and his cash injections into his company to obtain a $100,000 SBA-guaranteed business loan. Once the loan was disbursed, the businessman also misused approximately $12,000 of the loan proceeds for personal expenses, including payment of his rent and his credit card bills. The loan defaulted after he fled the Port Angeles area with his firm's investors' funds. OIG and FBI agents subsequently arrested him. The OIG's investigation was initiated after SBA's Seattle District Office referred an inquiry from the Washington State Attorney General's Office.

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Disaster Assistance

Virgin Islands Resident Pleads Guilty to Making False Statements. A resident of St. Croix, U.S. Virgin Islands, pled guilty on November 6, 1996, to one count of **making false statements to SBA** . The SBA/OIG's joint investigation with the Federal Emergency Management Agency's (FEMA) OIG developed evidence that the man's application for a $10,000 disaster home loan contained false claims for lost property, a false bill of sale for an automobile, and falsified property rental agreements. The applicant received the loan and a $1,290 grant from FEMA to cover purported damage from Hurricane Marilyn. The investigation was based on a referral from the temporary SBA Disaster Assistance Office in St. Croix.

<u>Additional Results From Ongoing Investigation of Two California Brothers Acting as Loan Packagers</u>. In the latest results from the continuing investigation of two California loan packagers, one more of their business' clients entered a guilty plea and another was sentenced. Both actions involve applications by clothing manufacturers for economic injury disaster loans filed in the wake of the 1992 civil unrest in Los Angeles, California.

❶ The owner of one company pled guilty on October 15, 1996, to one count of **filing a false claim** with SBA. She submitted fictitious income tax returns for 1990-91 with her application for a $300,000 loan. Based on the financial information in those returns, which significantly overstated her business income, SBA disbursed $61,500 to her. She has failed to make a single payment on this loan.

❷ The owner of another company was sentenced on October 21, 1996, to 5 years probation, 2,000 hours community service, $116,300 restitution to SBA, and a $2,500 fine. He had pled guilty to **filing a false claim** with SBA. With his application for a $500,000 loan, the businessman submitted altered copies of tax returns which significantly overstated his business' income. He also submitted a schedule of liabilities that included numerous creditors with whom he had never actually done business.

These actions resulted from a joint OIG/Secret Service investigation of falsified loan applications prepared by two southern California disaster loan packagers; the case was opened as a result of a tip from a concerned citizen and a referral from SBA's Disaster Assistance Area 4 Office.

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The Activity Update is produced by the SBA/OIG, James F. Hoobler, Inspector General.

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

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