



Office of Inspector General U.S. Small Business Administration

March 2010 Update

Business Loan Programs

Review of 7(a) Recovery Act Loans. The OIG conducted an audit of 7(a) loans disbursed pursuant to the American Recovery and Reinvestment Act of 2009 (Recovery Act) to determine whether the loans were originated and closed in compliance with SBA policies and procedures and to identify any evidence of suspicious activity. In order to provide the Agency with early notification of material deficiencies in the Recovery Act loans and with the loan approval process, the OIG issued Notices of Finding and Recommendation (NFR) as problems were identified. The last of four NFRs related to this audit was issued on March 31, 2010.

- Material Origination and Closing Deficiencies Identified in SBA and Lender-Approved Recovery Act Loans. The OIG reviewed a sample of 30 SBA-approved and 30 lender-approved Recovery Act loans. The three previous NFRs related to this audit identified 4 SBA-approved loans with deficiencies in change of ownership transactions; 14 lender-approved loans disbursed without required borrower immigration certifications; and 3 lender-approved loans that were not eligible for SBA guaranties. This final [NFR](#) identified miscellaneous material origination and closing deficiencies in 3 SBA-approved loans and 1 lender-approved loan. The inappropriate approval of these loans, which totaled \$2.4 million, both increased the risk of loss to SBA should the loans default and reduced the availability of SBA loans to other lenders and eligible borrowers.

The OIG recommended that SBA (1) revise its standard operating procedures to require key employees of an applicant business to complete SBA Form 912, Statement of Personal History; (2) provide counseling and training to the SBA

loan officers who approved two of the loans in question; (3) implement appropriate system controls to automatically identify the outstanding balances of all SBA loans made to a borrower to ensure SBA lending limits are not exceeded upon the approval of a subsequent loan; and (4) require the lender who approved the fourth loan to bring the loan into compliance with SBA requirements or, if this is not possible, flag the loan as having an equity injection deficiency for consideration during the purchase review should the loan default and purchase be requested.

Audit of Premier Certified Lenders in the Section 504 Loan Program. On March 23, 2010, the OIG issued a [report](#) on an audit of the underwriting practices and compliance of Premier Certified Lenders (PCL) in the CDC/504 Loan Program. This program is administered through cooperative agreements with non-profit organizations, called Certified Development Companies (CDCs), who work with private sector lenders to provide financing to eligible for-profit businesses. CDCs typically originate CDC/504 loans and forward them to SBA for approval; however, lenders granted PCL status are authorized to approve, close and service CDC/504 loans, with SBA reviewing the loan requests only for eligibility. The audit was initiated based on concerns that PCLs were engaging in risky underwriting practices and that five CDCs were paying their executives excessive compensation.

To determine whether PCLs exercised prudent underwriting practices, the OIG reviewed a statistical sample of loans disbursed in Fiscal Year (FY) 2008 by three of the largest PCLs. The OIG found that PCLs may not have used prudent practices in approving and disbursing 68 percent of the sampled loans, totaling nearly \$8.9 million, due to (1) poor loan underwriting and (2) eligibility or loan closing issues. Projecting the sample results to the universe of CDC/504 loans disbursed in 2008 by the three PCLs, the OIG

estimated that at least 572 loans, totaling nearly \$254.9 million in CDC/504 loan proceeds, had weaknesses in the underwriting process, eligibility determinations, or loan closing. Of this amount, the OIG estimated that a minimum of 183 loans, totaling \$56.4 million or more, were made to borrowers based on faulty repayment analyses. The OIG also estimated that lenders disbursed \$209 million or more to borrowers who had eligibility and/or loan closing issues.

Regarding CDC executive compensation, the OIG found that 4 of the 5 identified CDCs were among the top 10 highest in terms of dollars paid for executive compensation. In terms of percentage of gross receipts spent on executive compensation, 3 of the 5 CDC's ranked among the top 10 highest of the 56 CDCs that had gross receipts over \$1 million. SBA regulations require that any excess funds remaining after payment of staff and overhead expenses be retained by the CDC as a reserve for future operations or for investment in other local economic activity. Therefore, high compensation expenditures reduce the amount of funds for the reserve or for economic development activity.

The OIG recommended that SBA revise its standard operating procedures to require lenders to use (1) the actual cash flow method to determine borrower repayment ability for business using accrual accounting, (2) historical salary levels to estimate salaries of the borrower's officers, and (3) historical sales data to make sales projections. A process also needs to be developed to ensure that corrective actions are taken in response to the Agency's onsite reviews to ensure these conditions do not continue, and/or guidance for these reviews is modified, as appropriate, to ensure that reviewers properly assess lender determination of borrower repayment ability and eligibility. The OIG also recommended that SBA clarify how CDCs should evaluate eligibility when the Federal budget reduction public policy goal is used to qualify a borrower for a loan, and consider establishing guidelines on the level of excess funds that CDCs should retain as a reserve or invest in other local economic and development activities.

Colorado Business Owner Sentenced. On March 5, 2010, the part owner of a Cortez, Colorado, construction company was sentenced to 37 months in prison, 60 months supervised release, and \$975,424 in restitution. He previously pled guilty to one count of

submitting a false loan application. In order to receive two SBA-guaranteed loans totaling \$1.35 million, he hid his criminal history, which would have precluded him from receiving the loans. Criminal history records showed that he had pled guilty to embezzling over \$115,000 from a New Mexico trade association while serving as its Executive Director, and had also pled guilty to a third-degree assault charge. This case was initiated based on a referral from the Federal Bureau of Investigation (FBI) and was investigated jointly with the FBI.

Disaster Loans

Florida Businessman Charged. On March 17, 2010, the manager of a North Palm Beach, Florida, construction company was charged via a criminal information with one count of making a false statement to the SBA. He applied for a \$239,300 SBA economic injury disaster loan (EIDL) for his construction company after Tropical Storm Fay hit Florida in August 2008. It is alleged that he misrepresented the status of several pending foreclosures in order to obtain approval of the loan and provided SBA with altered title reports to hide those foreclosures, as well as other undisclosed adverse items. The OIG is conducting this investigation jointly with the FBI.

Louisiana Resident Sentenced. On March 17, 2010, a Louisiana resident was sentenced to 36 months probation, restitution to the SBA in the amount of \$58,550, and a fine of \$2,000. He previously pled guilty to one count of theft of public funds for misrepresenting to the SBA that he had contracted for repairs to his residence for damages caused by Hurricane Katrina when, in fact, had only received an estimate for the repairs. Based on the misleading documentation, SBA approved a disaster loan in the amount of \$106,300, of which \$63,500 was disbursed. He also submitted to SBA three fictitious checks, payable to a home improvement contractor, to show that renovations were performed on his property. The SBA OIG conducted this investigation jointly with the U.S. Department of Agriculture OIG.

Former Washington Business Owner Sentenced. On March 29, 2010, the former owner of a now defunct disaster restoration contractor in Longview, Washington, was sentenced to 48 months in prison, 60 months supervised release, \$4,935,974 in restitution, and 120 hours of community service. He previously

pled guilty to one count of mail fraud, one count of bank fraud, and one count of money laundering. The investigation found that over several years, he submitted inflated and/or falsified invoices and false competitor estimates to an insurance company for disaster restoration work his company performed. The false invoices caused the insurance company to pay the restoration company over \$3 million more than it was entitled. As a result, the restoration company's financial statements reflected highly inflated profits. When the business was sold, the buyer submitted the inflated financial statements to a lender in support of a \$1,999,800 SBA-guaranteed loan to fund a portion of the sale. The former owner then used the fraudulently obtained loan proceeds to purchase a \$1.785 million home, which he agreed to criminally forfeit as part of the guilty plea. The OIG conducted this investigation jointly with the Internal Revenue Service, Criminal Investigations Division.

Small Business Investment Company Program

Guilty Plea in Fraud Scheme. On March 15, 2010, a man pled guilty in U.S. District Court for the Southern District of New York for his role in a long-running fraud scheme that involved he and other co-conspirators defrauding a number of government programs for their own benefit and the benefit of other residents of an incorporated village in Rockland County, New York. He was initially indicted in 1997, but fled from the United States to Israel prior to the original indictment being unsealed. He was subsequently arrested in the United Kingdom and extradited back to the United States. The investigation revealed that he and his co-conspirators defrauded SBA's Small Business Investment Company (SBIC) program, a program designed to provide venture capital to small, minority-owned businesses, by fraudulently obtaining and using SBIC funds for their own benefit or the benefit of village institutions, rather than for privately-owned small businesses. The defendants also defrauded programs of the Department of Education, the Department of Housing and Urban Development, the IRS, and the Social Security Administration. The SBA OIG is conducting this investigation jointly with the FBI and investigative units from the other affected agencies. One defendant remains at large. The others have all been convicted and sentenced.

This monthly update is produced by the SBA OIG, Peggy E. Gustafson, Inspector General.

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