

**AUDIT OF AN EARLY DEFAULTED LOAN TO
ALEXANDER'S AUTO SALVAGE, INC.**

AUDIT REPORT NO. 1-13

March 27, 2001

The finding in this report is the conclusion of the OIG's Auditing Division based on testing of the auditee's operations. The finding and recommendations are subject to review, management decision, and corrective action in accordance with existing Agency procedures for follow-up and resolution. This report may contain proprietary information subject to the provisions of 18 USC 1905 and must not be released to the public or another agency without permission of the Office of Inspector General.

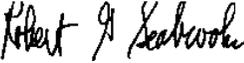


**U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
Washington, DC 20416**

AUDIT REPORT
ISSUE DATE: MARCH 27, 2001
REPORT NUMBER: 1-13

Date: March 27, 2001

To: Allison B. Randolph III, District Director
Louisiana District Office

From: 
Robert G. Seabrooks, Assistant Inspector General
For Auditing

Subject: Audit of an Early Defaulted Loan to Alexander's Auto Salvage, Inc.

Attached is a copy of the audit report. The report contains one finding and two recommendations. Portions of the report were modified as a result of comments made by the lender. We have synopsized the lender's comments and your comments in the report and included them as an attachment.

The finding in this report is the conclusion of the Office of the Inspector General based upon the auditor's testing of the auditee's operations. The finding and recommendations are subject to review and implementation of corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution.

Please provide within 30 days from the date of this report your management response to the recommendations on the attached SBA Forms 1824, Recommendation Action Sheet.

Should you or your staff have any questions or wish to discuss the issues further, please contact Garry Duncan, Director, Credit Programs Group, at 202-205-7732.

Attachments

**AUDIT OF
EARLY DEFAULTED LOAN
TO
ALEXANDER'S AUTO SALVAGE, INC.**

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BACKGROUND

The Small Business Administration (SBA) is authorized under section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of government guaranteed loans. SBA guaranteed loans are made by participating lenders under an agreement (SBA Form 750) to originate, service, and liquidate loans in accordance with Administration rules and regulations.

In September 1996, Hibernia National Bank (lender) approved loan number [FOIA EX. 4] for \$200,000 to Alexander's Auto Salvage, Inc. (borrower). The purpose of the loan was to construct a building, purchase machinery, equipment, and inventory, and provide working capital. [FOIA EX. 4]. The loan had an unpaid principal balance of \$200,000.

Alexander's Auto Salvage was established in 1964 to engage in automobile parts salvage: to sell used cars and parts and provide automobile repair and wrecker services. The principal took over the business in 1994 and incorporated it in August 1996.

AUDIT SCOPE AND OBJECTIVE

This report provides the results of our audit of the SBA guaranteed loan. The District Office referred the loan to the Office of Inspector General (OIG), Investigations Division, for review. The Investigations Division requested assistance from the OIG Auditing Division who initiated the audit.

The audit objective was to determine if the early loan default was caused by lender or borrower noncompliance with SBA's requirements. The SBA and lender loan files were reviewed and district office, lender, and borrower personnel were interviewed. Borrower invoices maintained by the lender and borrower bank records were reviewed and analyzed. Audit fieldwork was conducted between September 1999 and March 2000. The audit was performed in accordance with generally accepted Government Auditing Standards.

RESULTS OF AUDIT

Finding Improper Lender Processing Procedures were used to Approve a Loan

The lender did not follow SBA requirements in approving and disbursing the loan. The lender did not evaluate the borrower's credit history or inform SBA of adverse credit information. In addition, the lender did not disburse the loan proceeds prudently, report disbursements accurately, or ensure loan proceeds were used for authorized purposes. As a result, SBA approved a loan to a non-creditworthy borrower who misused the loan proceeds. If the loan guarantee is honored, SBA's potential loss would be \$120,000.

Lender did not obtain a borrower credit report

We found no evidence that the lender, before approving the loan, obtained a business credit report, contacted outside sources about the borrower or was aware of adverse credit information about the borrower. The loan was approved, in part, based on “the customer’s clear credit history.” The borrower’s credit history, as a corporation was clear as it had been incorporated for less than 30 days prior to the lender’s loan approval. The credit history of the business before incorporation was, in fact, not clear due to a bankruptcy and Internal Revenue Service (IRS) tax liens. This information was not disclosed in the loan application.

We obtained a business credit report, dated January 2000, and Bankruptcy Court records that showed that the borrower, while operating as a sole proprietorship, filed for bankruptcy under Chapter 13 in October 1989 and subsequently re-filed under Chapter 7 in August. The report also showed that the IRS filed tax liens against the business assets in September 1990. The tax liens were due to the borrower’s failure to pay payroll taxes. According to Dun & Bradstreet, a business credit report obtained prior to loan approval would have disclosed the business’ questionable credit history [FOIA EX. 5]. Section 120.150, Title 13 of the Code of Federal Regulations (CFR) requires that applicants be creditworthy and states, in part, that SBA will consider the character, reputation, and credit history of the applicant.

Adverse credit information not provide to SBA

SBA was not notified by the lender of IRS tax liens totaling about \$300,000. The IRS tax liens were for unpaid payroll taxes covering the period March 1984 through December 1989. The lien against the collateral was the result of a judgement issued in May 1991 in favor of Merchants & Farmers Bank and Trust Company. The lender became aware of the tax liens and judgment based on documents received from its attorney on October 29, 1996. The lender received the information, a result of the attorney’s due diligence efforts, after loan approval. After learning of the tax liens, the lender closed the loan and disbursed the proceeds in December 1996.

The loan agreement states that the lender should be in receipt of evidence that there has been no adverse change which would warrant not disbursing the loan proceeds. A loan officer in the Louisiana District Office stated that the Federal tax liens and the judgment were material adverse information and that the lender’s actions were not prudent.

Loan proceeds were used inappropriately

The borrower used loan proceeds inappropriately. Some examples of the inappropriate uses were:

- Interim loan proceeds totaling \$100,000 (\$75,000 for equipment and \$25,000 for working capital) were not used as authorized. A review of the borrower’s subpoenaed bank records showed that the borrower failed to deposit \$50,000 of the \$100,000 interim financing in the business’s checking account (which was with the lender) and admitted to an SBA investigator that the funds were used for ineligible and unauthorized purposes.

- After the borrower defaulted, the lender made a surprise visit to the borrower and discovered that a building addition to be built with \$40,000 of loan proceeds was never constructed. The lender subsequently agreed not to include the \$40,000 when requesting SBA to honor the guarantee.
- Our review of receipts provided to the lender in support of loan disbursements showed that \$25,300 was for equipment purchases by a related business, Alexander Paint and Decorating. There was no evidence in the file that the lender challenged these receipts.
- The borrower stated that loan funds were used for renting space and operating an affiliate business, paying family members and business associates for unspecified professional services, and personal expenses of the owner.

The loan agreement required that the proceeds of the loan be used for specific purposes and further stated that prior to disbursement of any funds, the lender must be satisfied that construction was completed in accordance with the plans and specifications and there are no labor and material liens. For the working capital, the authorization required the lender to obtain written justification for disbursements, including canceled checks, paid invoices, and receipts.

Lender did not disburse loan proceeds properly

A review of the loan authorization, the settlement sheets (SBA Forms 1050), and the lender's records disclosed differences between the authorized use of loan proceeds, the amounts reported on SBA Form 1050, and how the funds were actually disbursed. The following table illustrates the differences identified.

ITEM	Per A&LA (a)	Per Settlement Sheets (b)	Per Lender Records (c)	Difference (b minus c)
Inventory	\$ 51,000	\$ 51,000	\$ 21,000	\$30,000
Working Capital	\$ 50,000	\$ 56,380	\$ 50,252	\$ 6,128
Equipment	\$ 59,000	\$ 59,120	\$ 95,248	(\$36,128)
Construction	\$ 40,000	\$ 33,500	\$ 33,500	- 0 -
Totals	\$200,000	\$200,000	\$200,000	- 0 -

The lender disbursed the loan proceeds, executed the settlement sheets, and had a copy of the loan authorization. Therefore, the lender should have been aware of the differences between what it disbursed, how it reported the disbursements, and the requirements of the loan authorization.

Section 120.140 of 13 CFR states that lenders must act ethically and exhibit good character. Among examples of unethical behavior cited in the CFR is "Knowingly misrepresenting or making a false statement to SBA." [FOIA EX. 5].

In addition to the aforementioned problems, disbursements of working capital which totaled in excess of \$50,000 were not supported, as required. The loan agreement required that working capital be advanced based on written justification and only after prior working capital disbursements are accounted for by presentation of canceled checks, paid invoices, and receipts. In a memorandum dated August 26, 1997, a lender official concluded that documentation of disbursements was poor and not in compliance with SBA requirements.

Loan agreement requirements were not met

In addition to the non-compliances previously mentioned, we noted that the lender did not ensure that the requirements for construction and taxes were met. Specifically, the lender did not:

- disburse interim funds based on completion of construction,
- obtain evidence that construction had been completed in accordance with final plans and specifications and that there were no labor or material liens, and
- did not make interim and final inspections of the construction effort or obtain a certificate of completion from an architect or engineer.

Each of the aforementioned items was a requirement of the loan agreement. Because the lender did not ensure the requirements were met, the borrower was able to spend the loan proceeds designated for construction on other items. The lender was not aware of these facts until after the loan default.

Concerning the taxes, the lender did not obtain evidence that all of borrower's taxes were current and that a depository plan for future withholding taxes was in effect. As previously stated, the borrower had tax liens and judgments against its assets for unpaid payroll taxes. In addition, we noted that the borrower issued checks totaling approximately \$44,977 to family members and the company secretary to pay employee salaries.

The loan agreement required that, "prior to disbursement, Borrower provide evidence that all taxes of Borrower are current and that a depository plan for future withholding taxes is in effect."

RECOMMENDATIONS

We recommend that the District Director, Louisiana District Office, take the following actions:

- 1.A. Determine the financial impact of the lender's noncompliance on the guarantee and initiate a recommendation to the Administrator for the denial of the guarantee or require a lender repair, as appropriate.
- 1.B. Remind the lender of its obligation to comply with SBA regulations, policies, and procedures for originating loans.

Auditee's Response

The lender disagreed with our conclusion that it failed to notify SBA of tax liens against the borrower. The lender stated that the tax liens were against the former business owned by the borrower's father and, therefore, were not applicable to the borrower. Concerning the disbursement of loan proceeds, the lender agreed that there were differences between the amounts authorized, reported in the SBA Forms 1050, and the lender's records, but disagreed with our calculations. The lender believes the differences either were not material or improved SBA and the lender's collateral position. The lender did not address the issues of (1) obtaining a credit report for the borrower, (2) the borrower's inappropriate use of loan proceeds, and (3) the noncompliance with the authorization and loan agreement.

Evaluation of Auditee's Response

The lender's comments do not address whether it should have obtained credit history information about the borrower. The borrower was incorporated less than 30 days before the loan's approval and operated the business before and after incorporation. Therefore, it would have been prudent for the lender to obtain credit information about the borrower prior to the incorporation. As stated in the finding, such a review would have disclosed questionable credit information.

The tax liens and the judgment, [FOIA EX. 6], were also against the business property located at [FOIA EX. 4]. Initially, this property was collateral for the loan and, therefore, they were applicable to the loan. The tax liens show an undesirable pattern of operation that a prudent lender should have considered prior to loan approval and disbursement.

An additional point not mentioned in the finding was the lender's failure to verify how [FOIA EX. 6] obtained ownership of the business. The lender's credit memorandum stated that [FOIA EX. 6] inherited the assets of his father's auto salvage business. This is not correct as his father is currently alive and has been active in the business operations. Prudent lending requires obtaining evidence that applicants own the business and assets being financed.

In the lender's response, the calculation of the use of loan proceeds inaccurately shows that the loan agreement authorized about \$216,000 in loan proceeds and that the SBA Forms 1050 reported disbursements of only about \$177,000. The fact that there are differences between the authorized amounts and the reported amounts, using either the lender's calculations or the OIG calculations, supports our contention that the lender did not comply with the loan authorization requirements and did not account for the loan proceeds.

The lender did not address the borrower's inappropriate use of the loan proceeds and the lender's lack of compliance with the loan authorization. We accept this as agreement that the conditions are correct as reported.

Management Response

[FOIA EX. 5]

Evaluation of Management's Response

[FOIA EX. 5]



Appendix A

[FOIA EX. 6]

December 15, 2000

James W. Hudson, Audit Manager
U.S. Small Business Administration
Office of Inspector General
Washington, DC 20416

RE: Alexander's Auto Salvage, Inc.
Loan # [FOIA EX. 4]

Dear Mr. Hudson:

Hibernia National Bank received its PLP certification in January 1997 and has been a leading source for small businesses seeking SBA guaranteed loans in the greater New Orleans area and throughout Louisiana for the past three years. Hibernia normally services the SBA loans we originate within the guidelines of the SBA's Standard Operating Procedures, and the District Office with which we work will support this statement.

The subject loan was originated by Calcasieu Marine Bank and subsequently closed and funded by Hibernia Bank after Hibernia merged with Calcasieu in August 1996. The original servicing officer was an employee of Calcasieu that was let go by Hibernia shortly after our merger with Calcasieu. I took over servicing once the borrower defaulted under the terms of the loan.

The OIG's draft of its Audit Report on Alexander's Auto Salvage, Inc. indicates Hibernia failed to notify the SBA of tax liens, judgments and a bankruptcy proceeding involving the borrower and guarantor. This is an erroneous conclusion. It is apparent from the enclosed copies of Federal Tax Lien Notifications and judgement that the alleged failure by Hibernia to disclose adverse credit information is incorrect. It appears based upon the findings of the audit conducted by the OIG's Audit Division that the OIG has confused Alexander's Auto Salvage, Inc. (the Borrower) and [FOIA EX. 6] with Alexander's Auto Salvage and [FOIA EX. 6]. Alexander's Auto Salvage, Inc. was a separate and distinct legal entity from Alexander's Auto Salvage, and [FOIA EX. 6] Alexander. The tax liens are against [FOIA EX. 6] not [FOIA EX. 6].

We also reviewed the table included in the Audit Report that compiles information obtained from the loan authorization, the settlement sheets and Hibernia's records and found it to contain some miscalculations. The following represents our review of these same records:

September 20, 1996
Page 2

ITEM	PER A&LA	PER 1050's	PER OUR RECORDS	DIFFERENCE
Inventory	\$51,000	\$40,000	\$21,000	\$19,000
Working Capital	\$50,000	\$53,898	\$50,252	\$3,646
Equipment ¹	\$75,000	\$59,120	\$95,248	(\$36,120)
Construction	\$40,000	\$24,500	\$33,500	(\$9,000)

¹ The SBA subsequent to the issuance of the Authorization and Loan Agreement authorized an increase in the amount disbursed for equipment from \$50,000 to \$75,000. Please see the enclosed letter dated November 1, 1996.

Although disbursements in excess of \$50,000 were made for working capital without adequate support, we believe the \$3,000 in excess disbursements were insignificant in amount. Additionally, although there were significant variations between the use of loan proceeds contained in the Authorization and Loan Agreement for inventory, equipment and construction we believe we only improved our position and that of the SBA as to the value of our collateral at the time the funds were disbursed. We increased our reliance on the equipment and the building, and decreased our reliance on the inventory which consisted of salvage vehicles.

We would appreciate the OIG's Audit Division's inclusion of the referenced changes identified above in their final Audit Report.

Should you have any questions please do not hesitate to call me.

Sincerely,

[FOIA Ex. 6]

Enclosures

Management Response

Sent: February 6, 2001
To: James W. Hudson
From: [FOIA EX. 6]
Subject: Response to Audit Report

[FOIA EX. 5]

REPORT DISTRIBUTION

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