REDACTED FOR FOIA

AUDIT OF AN EARLY DEFAULTED LOAN TO

[EX. 4]

AUDIT REPORT NO. 1-10

March 9, 2001

This 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.

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

AUDIT REPORT
ISSUE DATE: MARCH 09, 2001
REPORT NUMBER: 1-10

To: Alberto G. Alvarado, District Director
Los Angeles District Office

From: Robert Seabrooks, Assistant Inspector General
For Auditing

Subject: Audit of an Early Defaulted Loan to [ex 4]

Attached is a copy of the subject audit report. The report contains two findings and two recommendations addressed to your office. Your comments have been synopsized and included in the report. Your comments indicate that you agree with the audit results and recommendations.

We have referred this matter to our Office of Investigations for appropriate follow-up. Since this report may contain proprietary information subject to the provisions of 18 USC 1905 and might comprise possible investigative work, the contents must not be released to the public or another agency without permission of the Office of Inspector General.

The recommendations are subject to review and implementation of corrective action by our office in accordance with the existing Agency procedures for follow-up. Please provide your management responses to the recommendation by April 10, 2001, using the attached SBA Forms 1824, Recommendation and Action Sheet. Any question or discussions of the issues contained in the report should be directed to Garry Duncan at 202-205-7732

Attachments

AUDIT OF
EARLY DEFAULTED LOAN TO
MVP SPORTS CAFE

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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 SBA rules and regulations.

The Money Store Investment Corporation (lender) approved loan [Ex. 4] to [Ex. 4] (borrower) under the Preferred Lenders Program (PLP) on [Ex. 4] The purpose of the loan was to establish a [Ex. 4] California. The loan proceeds were to be used for leasehold improvements, working capital, equipment, furniture, fixtures and supplies. The loan was originally approved for [Ex. 4] but was twice increased. The first increase to [Ex. 4] was due to a relocation of the business and the second increase to [Ex. 4] was to cover construction overruns.

The PLP loan carried a 75 percent SBA guarantee. The first disbursement occurred on [Ex. 4] with the last disbursement in [Ex. 4] The borrower defaulted on the loan in [Ex. 4] 9 months after the first disbursement. SBA purchased the guarantee for [Ex. 4]

AUDIT SCOPE AND OBJECTIVE

The loan was judgmentally selected for review as part of the Office of Inspector General's ongoing program to audit SBA guaranteed loans that defaulted within 36 months of origination.

The audit objective was to determine if the reason the borrower defaulted early on the loan was due to lender or borrower non-compliance with SBA requirements. During the audit, we reviewed the SBA and lender loan files, and the borrower's records. We also interviewed contractor, vendor, district office, and lender personnel. Fieldwork was accomplished from June 1999 through February 2000. The audit was performed in accordance with generally accepted Government Auditing Standards.

RESULTS OF THE AUDIT

The audit showed that the lender contributed to the early default of the loan by not properly ensuring that over [Ex. 4] of equity was injected as required. The borrower also contributed to the loan default by providing misleading information regarding equity injection and misusing loan proceeds.

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FINDING 1 – The Lender did not Follow SBA Lending Procedures

The lender did not comply with the equity injection provision of the Authorization and Loan Agreement nor adhere to lender established procedures for monitoring collateral. As a result, the lender's evidence that the borrower injected [ex.4] into the business was questionable and about two thirds of the value of the collateral was missing when the loan was liquidated. The borrower defaulted on the loan 9 months after the first disbursement of loan proceeds causing SBA to purchase the guarantee for [ex. 4]

Equity Injection

The lender did not take adequate measures to ensure that the borrower injected the appropriate amount of equity into the business. The Authorization and Loan Agreement required the lender to obtain evidence that the borrower injected [ex. 4] into the business prior to the first loan disbursement. The lender, however, accepted questionable and poor quality documentation as evidence of the borrower's equity injection, some of which was obtained after the loan was disbursed. As a result, the lender did not properly ensure that [ex. 4][1] was injected into and available for use by the business.

In support of the equity injection, the lender accepted photocopies of the front sides of twenty checks totaling [ex. 4] which represented prior payments for equipment and leasehold improvements. The photocopied checks were reduced in size and stamped as "poor original" by the lender. Moreover, a review of the issuing bank's records showed that the dates and amounts on the photocopied checks were altered. Several photocopied checks were dated after the bank processed the original checks, written to different payees, and the amounts were much greater than the amounts shown in the bank records. For example:

- A copy of check number [4] submitted in the amount of [ex. 4] appeared in the borrower's bank statement for only [ex. 4]
- A copy of check number [4] submitted in the amount of [ex. 4] appeared in the borrower's bank statement for only [ex. 4] and was dated 8 days after the bank processed the actual check.
- Check number [4] was submitted twice as proof of equity in the amounts [ex. 4] and [ex. 4] but was issued in the amount of [ex. 4]

The lender could have detected these misleading modifications if legible copies of both sides of the original checks were obtained and reviewed. The twenty photocopied checks submitted in the amount of [ex. 4] were actually issued for [ex. 4] (See Appendix A for a list of the 20 checks submitted in support of equity injection.)

The audit also disclosed photocopies of 4 equity injection checks totaling [ex. 4] which were dated after the first disbursement in violation of the loan agreement. Three of the checks totaling [ex. 4] are not part of the twenty checks mentioned above. All 4 checks were drawn on

[1] The equity injection of [ex. 4] comprised [ex. 4] which are discussed above and [ex. 4] of collateral which is discussed in the next section.

FOIA Ex. 4

the bank account of the borrowing business, making it impossible to distinguish the source and nature of the checks without additional documentation, which was not found in the lender's loan files.

Collateral

The loan was to be secured by equipment valued at [ex.4] at the time the loan was approved. The collateral supposedly included equipment provided by the borrower as part of the equity injection (66%) and equipment that was purchased with SBA loan proceeds (34%). According to the lender, its general policy is to monitor collateral by reviewing invoices and using a construction consultant to take pictures of the collateral to verify that it exists and is used by the business. The construction consultant hired by the lender for this loan, however, stated that he was hired only to monitor the progress made in leasehold improvements, not to monitor the collateral securing the loan.

The lender's loan file did not contain evidence, in the form of pictures or otherwise, that collateral was adequately monitored. For example, as proof of collateral purchased with borrower equity prior to loan disbursement, the borrower gave the lender two paid invoices for equipment purportedly purchased with a cashier's check for [ex.4] The invoices, however, were dated almost two years prior to the date on the cashier's check. Further, the vendor for the equipment that was actually purchased with the cashier's check provided us with thirteen invoices totaling [ex.4] that were different from the two found in the lender's files. According to the vendor, the borrower picked out the equipment he wanted during a nine-month period after the loan was disbursed and was given a check for the [ex.4] balance remaining on the cashier's check.

In another example, the borrower provided documentation to the lender to support over [ex.4] of equipment reportedly purchased from an affiliated company. Bank records showed that a [ex.4] check disbursed by the lender to an affiliate of the Borrower for the purchase of equipment was deposited into the borrower's bank account rather than the affiliate's account. This indicates that the check may not have been used to purchase equipment as reported to the lender and there was no evidence in the lender's loan files that the equipment existed or was used in the business. The remaining [ex.4] of equipment was allegedly purchased with cash.

We found that at least 42 percent of the line items of equipment intended to secure the loan was missing at the time the loan was liquidated. An exact number and value of the missing items could not be determined because general descriptions of the collateral contained in the loan files did not clearly distinguish it from other property and the serial numbers of the equipment taken as collateral were not recorded. Consequently, the lender records did not show how much of the [ex.4] of equipment actually existed or was used in the business.

At liquidation, the available collateral sold for [ex.4] According to SBA's SOP for loan liquidations, recovery on collateral in a forced sale is assumed to be 50% of its book value. Using this formula, the liquidated collateral had a book value of [ex.4] and the missing collateral's book value was [ex.4]

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Recommendation

We recommend that the Los Angeles District Office take the following actions:

1A. Recover [ex. 4] less any prior recoveries, from the lender for loan number [ex. 4]

1B. Remind the lender, in writing, of its obligation to comply with SBA regulations, policies, and procedures for originating, servicing, and liquidating SBA guaranteed loans.

Management Response

The Los Angeles District Office agreed with the findings and recommendations. The District Office plans to send the lender a letter demanding the remittance to SBA of the [ex. 4] less any prior recoveries. The District Office will also remind the lender of its obligations to comply with SBA regulations, policies, and procedures for originating, servicing, and liquidating SBA guaranteed loans.

Evaluation of Management Response

The district office comments and actions are responsive to the recommendations.

FINDING 2 – The Borrower Circumvented Loan Disbursement Procedures

The Borrower obtained [ex. 4] in loan proceeds intended for the general contractor, a subcontractor, and an affiliated company by circumventing loan disbursement procedures designed to prevent the misuse of proceeds.

In accordance with the terms of the settlement sheet (SBA form 1050), loan proceeds were disbursed by issuing joint payee checks in the name of the contractor and the borrower. At the borrower's request, however, the general contractor endorsed [ex. 4] in disbursement checks for deposit into the borrower's bank account. Also deposited into the borrower's bank account were [ex. 4] in loan proceeds disbursed to an affiliated company for the purchase of equipment (see discussion in previous section).

To induce the lender to disburse the proceeds, the borrower, on several occasions, submitted false documentation as proof of payments to the contractors. In one instance, the borrower submitted ten unconditional lien waivers representing [ex. 4] in payments to the general contractor for leasehold improvements, but the general contractor's records showed that only [ex. 4] was received from the borrower. In another instance, the borrower submitted eight unconditional waivers totaling [ex. 4] in payments to a subcontractor who received only [ex. 4] from the borrower.

We were unable to determine what the borrower did with the [ex. 4] due to the limited records that were available for review.

FOIA ex. 4

Appendix A

Checks Submitted by the Borrower in Support of Equity Injections

Table 1				Table 2			
Checks Submitted by Borrower				Checks Paid by Borrower's Bank and Appearing on Bank Statements (Canceled Checks)			
Check No.	Bank Ref. No,	Check Date	Amount	Check No.	Bank Ref. No,	Process Date	Amount
A	b	c	d	e	f	g	h
1							
2							
3							
4							
5							
6							
7	FOIA				FOIA		
8	EX. 4				EX. 4		
9							
10							
11							
12							
13							
14							
15							
16							
17							
18							
19							
20							
TOTAL			[ex.4]	TOTAL			[ex.4]

Note:
A comparison of the data submitted in the tables above shows that the checks in Table 1 do not reconcile to those in Table 2. The data in Table 1 was submitted by the borrower along with invoices as evidence of equity injections. The data in Table 2 is taken from the borrower's bank statements and based on the same bank account number as the checks in Table 1.

Other Irregularities:

- Check number [4] was submitted twice in different amounts (Table 1).
- Nine checks ([ex. 4]) in Table 1 have the same reference number as the same check in Table 2, but different amounts. A bank representative stated that reference numbers are unique to each check.
- Three checks in Table 1 have the same reference number as different checks in Table 2:
  1. Check number [4] in Table 1 has the same reference number as check number [4] in Table 2
  2. Check number [4] in Table 1 has the same reference number as check number [4] in Table 2
  3. Check number [4] in Table 1 has the same reference number as check number [4] in Table 2

  As stated previously, reference numbers should be unique to each check.
- Check number [4] was written after the disbursement date of [ex. 4] making this a violation of the equity injection requirement of the loan authorization.
- The dates on nine of the photocopied checks ([ex. 4]) were dated after the bank processed the original checks.

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U. S. SMALL BUSINESS ADMINISTRATION
LOS ANGELES DISTRICT OFFICE
330 N. BRAND
GLENDALE, CALIFORNIA 91203

Appendix B

February 22, 2001

Robert G. Seabrooks
Assistant Inspector General For Auditing
Office of the Inspector General
United States Small Business Administration
409 3rd Street, S.W.
Washington, D. C. 20416

RE: Audit of Early Defaulted Loan to [ex.4]

Dear Mr. Seabrooks:

Thank you for your letter of January 31, 2001 and the Report attached thereto. In response to the information contained therein, meetings have been held involving our District Director, the Acting Deputy District Director, the Assistant District Director for Economic Development, the District Counsel, and the Chiefs of both the Finance Division and the Liquidation Division of the Los Angeles District Office (LADO). Based upon the information provided by you and our review of our "limited" loan file, we concur in your recommendations and we will take appropriate action to comply therewith.

Our review of the loan file, the Equity Injection issues, the Loan Increase issues, the collateral issues, the 327 (Modification or Administrative Action) related to the Purchase Examination, Counsel's comments related thereto, and the information provided by you in your Draft Report, underscores that SBA should take action to recover [ex. 4] from the Lender, less any prior recoveries.

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After review of your Report and after our Post Purchase Review, we fully agree that recovery by this Agency of the [Ex.4] is quite appropriate under the circumstances.

Like you, we believe that the Lender did not follow prudent SBA lending procedures, the Lender did not take adequate measures to ensure the Borrower's equity injection, the Lender failed to appropriately review checks submitted by the Borrower in support of the Borrower's expenditures, and the Lender failed to monitor the collateral which was to secure this loan. Recovery of the purchase amount is quite appropriate in this case.

In that regard, we are preparing to send First Union Bank (formerly The Money Store) a letter demanding the remittance to SBA of the [Ex.4] payment made by SBA in honoring its Guarantee(less any prior recoveries). In accordance with your recommendations we are also sending First Union Bank a reminder letter concerning its obligation to comply with SBA regulations pursuant to your Recommendation number 2 of the Draft Audit that we "Remind the lender, in writing, of its obligation to comply with SBA regulations, policies, and procedures for originating, servicing, and liquidating SBA guaranteed loans."

While we totally agree that such items should be brought to the attention of this Lender, we also note that the loan to [Ex.4] was a PLP loan. Because the loan is a PLP loan, our local District Office here in Los Angeles never saw the file in advance of the loan approval. Nor are PLP loan files reviewed during the servicing stage with regard to compliance with loan disbursements, loan liquidation, and adherence to collateral requirements. Therefore, it may also be a good idea (and you may want to make it a part of your recommendations) for the PLP Center to remind this and other lenders in writing of their obligations.

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I look forward to hearing from you with regard to our proposed actions. Your Auditors obviously have access to more information than we do at this time and that information may be needed by us should this Lender decide to contest our demand for repayment. Thank you.

Terry R. Gibson
District Counsel

Cc: AA/Office of Financial Assistance
AA/Office of Field Operations
Alberto G. Alvarado, DD, LADO
John L. Brown, Acting DDD, LADO
Lorenzo J. Flores, ADD/ED, LADO
Rick Kresser, Chief of Finance, LADO
Monte Hogan, Chief of Liquidation, LADO
[ex. 6] Loan Specialist, Liquidation Division
[ex. 6] Attorney

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Appendix C

AUDIT REPORT DISTRIBUTION

Recipient	Number of Copies
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Center Director, Sacramento Loan Processing Center	1
General Counsel	1
Associate Administrator for Financial Assistance	1
Associate Administrator for Field Operations	1
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General Accounting Office	1