U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416

Management Advisory Memorandum
Report No. 16-11

DATE: March 17, 2016

TO: Maria Contreras-Sweet
Administrator

Douglas Kramer
Deputy Administrator

Martin F. Andrews
Acting Director, Office of Financial Program Operations

FROM: Troy M. Meyer /s/
Assistant Inspector General for Audit

SUBJECT: *SBA Loan Number* [Ex. 4], [Ex. 4]

This management advisory memorandum relates to our Office of Inspector General (OIG) High-Risk 7(a) Loan Review Program and is intended to provide the Small Business Administration (SBA) with early notification of issues identified as part of our review. The objectives for this program are to determine if (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with SBA's rules, regulations, policies, and procedures; and (2) material deficiencies exist that warrant recovering guaranteed payments made to lenders.[1]

This memorandum includes one recommendation that SBA agreed to implement. This recommendation can be closed upon SBA providing evidence that it has recovered the recommended amount from the lender. Please provide us within 90 days your progress in implementing the recommendation.

Background

The purpose of this memorandum is to inform you of issues we identified during our ongoing review of high-dollar/early-defaulted (HD/ED) 7(a) loans purchased by SBA. As part of this review, we selected HD/ED loans using a scoring system developed by OIG to prioritize loans based on the risk of loss to SBA. We also considered other factors, such as the outstanding balance of the loan, the period to default, and whether SBA had completed all purchase review actions during the selection process.

As part of the Preferred Lender Program (PLP), SBA authorized the lender, California Bank & Trust, to process, close, service, and liquidate SBA-guaranteed loans with limited review by SBA.

[1] Appendix I describes our scope and methodology.

On November 9, 2011, California Bank & Trust approved an SBA loan number for $2.7 million with a 75 percent SBA guaranty to [Ex. 4] doing business as (dba) [Ex. 4] (borrower and tenant) for leasehold improvements to construct a high-end fitness center at the [Ex. 4] (landlord).[2] This fitness center was to include a rooftop pool, spa, locker room, sauna, and a multi-purpose cardio and circuit training room.

Both the borrower and the landlord were to share in the construction costs to build the fitness center, with the borrower providing the exercise equipment. The borrower's share of this project was to be financed by the $2.7 million SBA loan and a $1.6 million equity injection. The original construction cost estimate for leasehold improvements of $5 million was provided in the lender's credit memorandum dated July 22, 2011.[3] However, per the construction contract executed on June 1, 2012, this estimate had increased to almost $9.2 million. The borrower's share of the construction costs at this time was estimated to be approximately $4.4 million, with the landlord responsible for the other $4.8 million under a separate contract. By October 2012, construction costs alone had more than doubled from the original estimate of $5 million to $12.3 million.[4] After this cost increase, the borrower's portion of construction costs rose to $7.5 million. The rise in construction costs also resulted in the lender increasing the borrower's required equity injection from $1.6 million to $2.8 million.[5] (Table 1 below provides a breakdown of these construction cost increases.)

Table 1. Construction Costs Between Landlord and Borrower and Increases

Date	Landlord Share of Construction	Borrower Share of Construction	Total Costs*
08/05/2011	$1,700,000	$3,305,000	$5,005,000
06/01/2012	$4,795,138	$4,385,481	$9,180,619
10/31/2012	$4,791,422	$7,543,409	$12,334,831

*Based on construction contract cost estimates in the lender loan file

To address these rising costs, the landlord issued a separate loan to the borrower for $2.75 million so it could pay its portion of the construction. Ultimately, the borrower paid for construction costs totaling approximately $7.5 million from three different sources: the SBA loan of $2.7 million, the loan from the landlord of $2.6 million, and its equity contributions of $2.2 million.

The borrower did not open for operation and defaulted on the SBA loan on May 7, 2013, after making only five interest payments. SBA purchased the loan on June 23, 2014 for approximately $2 million.

Results

Lender Did Not Monitor Project Progress

The lender did not comply with material SBA requirements regarding new construction of and improvements to an existing building. We determined that the construction contract, dated

[2] The [Ex. 4] is a luxury, boutique hotel located in San Diego, CA.
[3] The borrower was responsible for $3.3 million of these costs, of which SBA's loan financed $2.7 million.
[4] Other costs incurred included equipment purchases and other related fees (i.e. appraisal fee).
[5] The borrower's equity injection of $2.8 million was intended to finance construction costs, equipment purchases, and other project-related costs (i.e. appraisal fee).

June 1, 2012, noted that construction had commenced, even though the contractor had not received final plans and specifications that clearly defined the entire scope of work. Additionally, the contractor's total cost of $9.2 million, including the borrower's $4.4 million portion, was unreliable as the scope of work had not been defined. Specifically, the contract stated that multiple subcontractor bids were still being actively solicited, pending final plans and specifications, which could increase the contract cost.

SBA procedures state that prior to the commencement of any construction, the lender must obtain a copy of the final plans and specifications from the borrower. Additionally, SBA requires that along with a copy of the contract, the lender obtain an agreement that the borrower will not order or permit any material changes in the approved plans and specifications without prior written consent of the lender.[6] Finally, the SBA loan authorization states that the lender must take all normal construction loan safeguards appropriate for the loan.

Nevertheless, we confirmed that the lender did not obtain final plans and specifications for the project. Further, while change orders occurred, we found no evidence that the lender obtained an agreement with the borrower requiring its approval of any contract change orders or that these change orders were approved by the lender. Complying with SBA requirements in these areas was critical, as the estimated cost for construction had already increased from $5 million to $9.2 million at the time the contract was executed. Further, as previously noted, the construction costs increased to $12.3 million prior to loan closing.

We also determined that the lender did not perform oversight of the construction progress in accordance with SBA requirements. Specifically, the lender did not perform interim or final site inspections to verify that the work was performed as planned. SBA procedures state that the lender must make interim and final inspections to determine that construction conforms to the plans and specifications. Evidence in the loan files supported that the lender intended to hire a construction control company to perform project cost reviews, project work inspections, and disbursement control for the construction loan. Instead, the lender relied on statements from the borrower and lien waivers from the contractor to supply them with critical information about the progress of the project. Based on the borrower's statements and the lien waivers, the lender disbursed one lump sum payment of $3.9 million on November 7, 2012, approximately 5 months after execution of the construction contract.[7]

The use of a lien waiver in lieu of the required site inspections and documentation, however, was not sufficient to verify that the construction progress conformed to the plans. For example, the lender's post-default site visit on July 25, 2013, approximately 8 months after loan closing, confirmed that construction had been slow and was still ongoing. Specifically, a significant amount of work remained on the two main workout floors and the floor that would include the lockers, whirlpools, and saunas. The lender's noncompliance with SBA's requirements to effectively monitor the progress of this construction project placed SBA and its guaranteed loan at substantial risk.

[6] SOP 50 10 5(D), *Lender and Development Company Loan Programs*, October 1, 2011: These construction loan provisions apply when the construction component of an SBA-guaranteed loan is more than $350,000.
[7] The $3.9 million was funded by (1) the $2.7 million SBA loan and (2) a cash injection of $1.2 million from the borrower.

Lender Did Not Remedy Adverse Changes to the Project and Borrower's Financial Condition

The lender also failed to address and mitigate adverse changes affecting both project control and the borrower's financial condition, further compounding the risk to SBA. As noted above, the construction costs more than doubled from $5 million to $12.3 million prior to loan disbursement. This increase resulted from construction delays and cost overruns. Given that the borrower was unable to provide funds to complete its share of the construction, it received financing (Mezzanine Loan) from the landlord in the amount of $2.75 million on October 11, 2012.[8] The conditions of this loan resulted in both borrower and lender relinquishing any further control over the construction project. Specifically, upon funding the loan, the landlord automatically became the construction manager for the completion of the project including all landlord work, tenant improvements, and shared cost improvements. Further, the borrower was not allowed to communicate with the contractor or visit the construction site without prior consent of the landlord.

This adverse change prevented the lender from complying with SBA's requirements for construction loans. The SBA loan authorization stated that the guarantee is contingent upon the lender having no evidence of any unremedied adverse change in the financial condition, organization, management, operation, or assets of borrower or operating company that would warrant withholding or not making further disbursements.[9] Nevertheless, the lender disbursed the loan in full on November 7, 2012.

The lender also did not effectively monitor the financial condition of the borrower prior to loan disbursement, which also put SBA at a risk of loss. At origination, the lender determined that the borrower could rely on revenue generated by its affiliates to service all debts, including the new location. Once construction costs began to rise, however, the principal of the borrower was required to inject an additional $1.2 million into the project. The borrower funded this equity increase by transferring $1.2 million from its affiliate.[10] This transfer exhausted the cash available to the borrower, and the lender did not discuss how this adverse change in cash would impact the borrower's ability to cover operational costs and debt during the start-up period.[11] Adequate working capital was especially important given that the borrower was a start-up (opening a new location) and the facility was still under construction and not operating.

After the loan was disbursed, the lender noted the negative impact of the cash transfer and increase in construction costs on the borrower's financial condition. Specifically, in March 2013, an amendment to the lender's credit memorandum stated that cash for the affiliates and owner of the borrower had been depleted based on the 2012 financials. As a result, the borrower had no further financial resources, and it became even more critical to ensure the [Ex. 4] location opened. The lender's negligence in monitoring both this project and the borrower's financial condition resulted in loan disbursement with the business never opening for operation. Ultimately, the SBA-guaranteed loan helped fund luxury improvements, including a rooftop pool and spa, for the exclusive use by the landlord and its clientele.[12]

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[8] Mezzanine financing is debt capital that gives the lender the rights to a company's assets if the loan is not paid back on time and in full. It is generally subordinated to debt provided by senior lenders such as banks and venture capital companies.

[9] The guaranty is contingent upon the lender having no evidence of any unremedied adverse change since the date of the loan application, or since any preceding disbursement.

[10] The affiliate was [Ex. 4], another fitness center owned by the principal of the borrower.

[11] We also noted that another affiliate, [Ex. 4], had ceased operations in October 2011 due to losing its lease.

[12] The lender eventually abandoned most of the collateral (leasehold improvements) as the removal, repair of the site, and liquidation costs would exceed their value.

Inadequate Support for Equity Injection

Finally, we noted that the lender did not provide evidence to support the source for $1.5 million of the borrower's required $2.8 million equity injection. While the borrower funded construction project expenses from the borrower's bank account, loan documentation did not include bank statements along with cancelled checks to show the original source of these funds. This was especially important because the borrower's facilities were still being constructed, and the April 2012 interim financial statement showed sales of only $48,000.[13]

SBA procedures require the lender to verify the injection prior to disbursing loan proceeds. Verifying a cash injection requires evidence, such as a check or wire supporting that funds were moved into the borrower's account. It also requires a copy of the bank statements for the account from which the funds are being withdrawn.[14] As a result, the loan file did not include adequate support to ensure that a significant portion of the equity injection was not borrowed, which could affect the borrower's ability to repay the SBA loan.

SBA requirements state that lenders must analyze each application in a commercially reasonable manner, consistent with prudent lending standards.[15] In addition, SBA will not purchase the guaranteed portion of a loan when a lender does not provide sufficient credible evidence to support it made the loan in accordance with SBA loan program requirements and prudent lending practices.[16] Further, SBA is released from liability on the guaranty (in whole or in part) if the lender fails to comply with any material SBA loan program requirement, failed to make, close, service, or liquidate a loan in a prudent manner; or the lender's improper action or inaction has placed SBA at risk.[17] Consequently, the lender's material noncompliance with SBA requirements while making and closing the loan to the borrower for this construction project resulted in a loss to SBA of over $2 million.

Recommendation

We recommended that the Director of the Office of Financial Program Operations:

1. Require California Bank & Trust to bring the loan into compliance and, if not possible, seek recovery of $2,046,465 from California Bank & Trust on the guaranty paid by SBA for the loan to [Ex. 4].

[13] Revenue was generated from pre-sale of memberships-a temporary location in the [Ex. 4] was opened for marketing and early membership enrollment while the club was under construction.
[14] Statements are required for each of the 2 most recent months prior to disbursement showing that the funds were available.
[15] SOP 50 10 5(D), *Lender and Development Company Loan Programs* (October 1, 2011).
[16] SOP 50 57, *7(a) Loan Servicing and Liquidation* (March 1, 2013).
[17] Title 13 Code of Federal Regulations Part 120.524, *Business Credit and Assistance*.

Management's Response

Please indicate your response by checking the appropriate box below and providing the appropriate supporting documentation to OIG within 30 days from the date of this memorandum.

☒ Management substantially concurs with the memorandum and recommendation.

☐ Management does not concur with the memorandum and recommendation. Please give reasons for management's non-concurrence.

<u>Explanation of proposed action and target date for final action</u>:

After review, OFPO concurs with the recommendation to recover funds from the lender. The lender has been notified and the loan has been forwarded to HQ for denial review process. Target date for final action is March 14, 2017.

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Please contact us if you would like to discuss this memorandum or any related issues.

cc: Nicolas Maduros, Chief of Staff
Melvin F. Williams, Jr., General Counsel
Martin Conrey, Attorney Advisor, Legislation and Appropriations
Tami Perriello, Chief Financial Officer
LaNae Twite, Director, Office of Internal Controls

Appendix I: Scope and Methodology

This memorandum presents the results of our review of SBA Loan Number [Ex. 4], [Ex. 4] as part of our ongoing High Risk 7(a) Loan Review Program. Our objectives for this program are to determine if (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with SBA's rules, regulations, policies, and procedures and (2) material deficiencies exist that warrant recovering guaranteed payments made to lenders. To answer the objectives, we reviewed origination and closing actions as documented in SBA and lender loan files. We assessed these actions against all applicable SBA requirements. We also reviewed information in SBA's Loan Accounting System.

We used an internally-developed and evolving OIG scoring system to prioritize loans for review based on known risk attributes. These risk attributes identify loans that have a higher potential for lender noncompliance and suspicious activity by loan participants. These attributes include, but are not limited to, the time lapse between loan approval and its transfer to liquidation, loan amount, equity injection, loan packager involvement, and the use of loan proceeds.

We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency's quality standards for inspection and evaluation. These standards require that we adequately plan inspections; present all factual data accurately, fairly, and objectively; and that we present findings, conclusions, and recommendations in a persuasive manner. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our evaluation objectives.

Use of Computer-Processed Data

We relied on information from SBA's Mainframe Loan Accounting System to score loans using an internal scoring system developed by OIG. Previous OIG engagements have verified that the information maintained in this system is reasonably reliable. Further, data elements associated to reviewed loans were verified against source documentation maintained in SBA and lender loan files. As a result, we believe the information is reliable for the purposes of this program.