

AUDIT OF AN EARLY DEFAULTED LOAN TO

[FOIA Ex. 4]

AUDIT REPORT NO. 0-05

February 14, 2000

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.

**AUDIT OF AN
EARLY DEFAULTED LOAN TO**

Ex. 4

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

AUDIT REPORT
ISSUE DATE: FEBRUARY 14, 2000
REPORT NUMBER: 0-05

To: Charles E. Anderson, District Director
Georgia District Office

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

Subject: Audit of an Early Defaulted Loan to [FOIA Ex. 4]
[FOIA Ex. 4]

Attached is a copy of the subject audit report. The report contains one finding and two recommendations addressed to your office. Your comments and the comments of the lender have been synopsized and included in the report. Your comments indicate that you agree with the audit results and that the amount to be recovered from the lender should be increased. We have adjusted the report accordingly.

The recommendations are subject to review and implementation of corrective action by your office in accordance with existing Agency procedures for follow-up. Please provide your management response to the recommendations within 30 days from the date of this report using the attached SBA Forms 1824, Recommendation and Action Sheet.

Any questions or discussion of the issues contained in this report should be directed to Garry Duncan at 202-205-7732.

Attachments

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.

On June 7, 1996, Heller First Capital Corporation (lender) approved loan number [FOIA Ex. 4] to [FOIA Ex. 4] (borrower). The loan was made to restructure long-term debt, pay accounts payable, make capital improvements, and provide working capital. The loan was disbursed in [FOIA Ex. 4] defaulted in September, and was placed into liquidation in July 1997 with a principal balance of \$965,000. †

[FOIA Ex. 4] was established to plan and stage business, social, and fund-raising events. In 1992 it became the parent company of [FOIA Ex. 4] which focused on riding lessons, boarding horses, and hosting horse shows.

AUDIT SCOPE AND OBJECTIVE

This report provides the conclusions of an audit of a SBA guaranteed loan. The loan was judgmentally selected for review as part of the Office of Inspector General's ongoing program to audit SBA loans charged off or transferred to liquidation within 36 months of origination (early default).

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 personnel, and the borrower were interviewed. Since all borrower records had been destroyed, invoices maintained by the lender and subpoenaed bank records were analyzed. The audit was conducted between April through September 1999 in accordance with Government Auditing Standards.

RESULTS OF AUDIT

The reason for the loan default could not be determined because the borrower's records could not be reviewed because they had been destroyed. An analysis of the loan file, however, disclosed that the lender did not evaluate a discrepancy between an Internal Revenue Service (IRS) verification of the borrower's Federal taxes and financial statements used to support the loan approval. SBA inappropriately paid \$485,051 (net) to honor the guarantee of a loan that should not have been made.

Finding Financial Discrepancies were not Evaluated nor Reported to SBA

The loan was not originated in accordance with SBA rules and regulations or prudent lending practices. The lender did not evaluate nor notify SBA of a known discrepancy between the tax returns submitted by the borrower in support of his loan application and a verification

response from the IRS. The IRS verification showed that the tax returns submitted with the application had not been filed.

Criteria for verifying financial data

The loan agreement required the lender to ensure that the tax returns submitted with the application conform to the information submitted to the IRS. This action must be taken prior to disbursing the loan proceeds. Further, the lender was not in compliance with Policy Notice 9000-941 that requires SBA to be notified as soon as a material discrepancy between the financial data submitted by the borrower and the IRS verification is identified. The notice also states that a guarantee will not be given until the discrepancy is resolved.

Impact on the SBA guarantee

Section 120.524, Title 13 of the Code of Federal Regulations (March 1, 1996) states that SBA is released from the payment of a loan guarantee if:

- the lender has failed to comply materially with any of the obligations of the regulations, the Loan Guaranty Agreement or the Authorization, or
- the lender fails to disclose a material fact regarding a guaranteed loan in a timely manner.

Recommendations

We recommend that the Atlanta District Office take the following actions:

- 1A. Recover \$485,051 from the lender for Loan Number [FOIA Ex. 7]
- 1B. Remind the lender of its obligation to comply with SBA regulations, policy, and procedures for originating loans, particularly in the area of:
 - Informing SBA of material discrepancies between borrower financial data and IRS information.
 - Obtaining evidence that loan guarantee applicants' taxes are current.

District Office comments

The District Director concurred that lack of investigation and reporting to SBA of the deficiency were not prudent acts by the lender and that the subsequent disbursement was improper. He also agreed with the recommendations. The District Director added that based upon the most current information, the amount paid to Heller was \$485,051, about \$111,000 more than stated in the audit report, and that recovery would be at the higher amount (see Appendix A).

Evaluation of District Office comments

The District Director's comments are responsive to our recommendations. We have changed the audit report to reflect the revised amount paid to Heller. ' 1

Lender comments

The lender responded that the loan was originated within all SBA rules and regulations and that the audit report inaccurately concluded that Heller's failure to notify SBA of the negative IRS verification caused the loss. Further, the OIG's conclusion that Heller failed to disclose a material fact with a resulting loss is overstated. The loan default was caused by several factors including illness of the borrower, disappointing Olympic revenues, and poor management. The lender agreed that the response from the IRS did not verify the borrower's taxes, that they did not address nor fully understand the tax verification requirement, and that a determination could not be made that the response was received prior to the funding date or reviewed before loan closing. It was also pointed out that personnel involved in closing the loan are not available for questioning and the IRS verification procedures and results were not always perfect (see Appendix B).

Evaluation of lender's comments

The lender's question as to whether the IRS verification was received prior to loan closing is not relevant. At the time this loan was made, SBA policy precluded closing loans prior to receiving the IRS response.

The lender's response supports the following facts reported in the finding:

- the lender had not determined why the borrower's tax returns could not be verified, and
- the lender did not notify SBA of the IRS negative response.

We concluded, along with the District Office, that these were considered material non-compliances with SBA's requirements and prudent lending practices. Such actions, therefore, would have resulted in the loan not being disbursed.

Although other factors may have impacted on the loan default, the fact remains that the loan should not have been disbursed.



SMALL BUSINESS ADMINISTRATION
Georgia District Office
Peachtree Center-Harris Tower
233 Peachtree St. NE
Atlanta, Ga. 30303

February 7, 2000

TO: Robert G. Seabrooks, Assistant Inspector General for Auditing

FROM: Charles Anderson, District Director Georgia District Office

RE: Audit of an Early Defaulted Loan to [redacted] FOIA Ex. 4 [redacted]

A handwritten signature in black ink, appearing to be "C. Anderson", written over the "FROM:" line.

We have analyzed this application submitted by Heller First Capital Corp. and have determined that the prime documents used in the recommendation of approval by the processing loan officer and subsequent approval by the chief of the finance division were the 1992, 1993 and 1994 tax returns. These three documents showed sufficient historical cash flow to repay the loan being applied for.

It is unfortunate to hear that the lender became aware that the applicant did not file the three tax returns with IRS. We understand this information was received in response to the lender's filing of the IRS Form 4506 which is in compliance with paragraph 4(f) 10 of the Authorization on this loan. Apparently, this deficiency was neither investigated nor reported to SBA as required by prudent lending practices. Subsequently, the loan was improperly disbursed even with this deficiency known by Heller First Capital Corp.

Our file reveals that the loan was purchased from Heller First Capital by a Treasury check in the amount of \$747,544.52. This represented the Agency's 75% interest in the loan. Subsequently, the collateral was sold by Heller and produced a check to the Treasury in the amount of \$262,493.48. From this it is our position that Heller owes the Treasury the difference in the amount of \$485,051.04 and not the \$373,759 cited in your letter. We are fortunate to have the final figures in this case to enable us to accurately calculate the actual loss. Your figures were based on known facts at the time.

In summary, except for the amount owed to the agency, we agree with the two recommendations set out in your draft of January 13, 2000.



[6]

VIA FEDERAL EXPRESS
AND U.S. MAIL

January 26 , 2000

Mr. Gary Duncan
Mr. Robert G. Seabrooks
Assistant Inspector General for Auditing
U.S. Small Business Administration
Office of Inspector General
Washington, DC 20416

Re: **Audit of Early Defaulted Loan to**
[FOIA Ex. 4]

Dear Mr. Seabrooks:

We have received a copy of the Draft Audit Report on [FOIA
Ex. 4] and have several general comments set forth
below.

The intent of the audit, as we understood it, was to determine if the early loan default was caused by lender or borrower non-compliance. As the audit concludes, the reason for the loan default could not be determined (page 1, paragraph 6, line 1). As we advised the auditor during his visit, although we could not be sure, we understood the loan default was likely a result of several factors, including but not limited to, the unexpected significant illness of the borrower, disappointing Olympic revenues, including a unique "equine" sickness, and ultimately, poor management by the borrower during a financial crisis. Ms. [Ex. 4] set forth under oath in her bankruptcy pleading that "Following the closing of [Ex. 4] loans with [Ex. 4], there were unanticipated delays in obtaining the licenses and permits needed to host many of the larger events for which the Special Events Facility was designed. [Ex. 4]'s resulting inability to host several events in turn resulted in [Ex. 4]'s inability to make all of its payments to [Ex. 4]"

By way of short background, this was a GP loan with discounted collateral coverage of 1.07:1, and debt coverage of 1.37. According to borrower's

FOIA Ex. 4

bankruptcy files, [Ex. 4] had been owned and operated as an equestrian facility for fifteen years. [Ex. 4], business was teaching riding lessons, boarding horses, hosting horse shows and other equine activities. The owner/manager, [Ex. 4] was an aggressive young woman who was recognized for her contribution to the equine industry in [Ex. 4]. Our financing was primarily debt refinancing (to pay off notes which were ballooning within the year). Our loan reduced interest expense and had a realistic principal amortization. Our loan, we thought, was easily serviced by the borrower's existing cash flow. Unfortunately, this did not occur.

The conclusion of the draft audit set forth that the failure to notify the SBA there was a negative IRS tax verification caused a loss. This in and of itself is not accurate. While there is no question that in 20-20 hindsight, this loan, even with good collateral, in a good location did not liquidate quickly or with the recovery we had hoped. [Ex. 4], the borrower, made efforts to make this work (i.e., brought in a general manager, introduced new programs and revenue enhancements, all of which did not materialize). [Ex. 4] fought us in bankruptcy every step of the way, and the lift the area had hoped for from the [FOIA Ex. 4] did not materialize.

As you are aware, Heller did request, out of its Dallas office, verification of [FOIA Ex. 4] tax returns (this was requested prior to completion of the underwriting) and our files do reveal (although with no date) a fax from the IRS indicating that the IRS was unable to verify those returns. Whether this verification was received in Dallas prior to funding, or reviewed at all, we cannot say for sure. We can say, in hindsight, that had we seen this, we would have at least stopped and asked more questions. The people involved in closing this loan are not with us anymore so we do not know for sure, but we can say that during this period, in early 1996, the IRS verification procedures and results nationwide were not always perfect. It was not out of the question to have IRS verification take several months, come back with differing results as a result of a handwritten number error or not at all.

Accordingly, the conclusion that we failed to disclose a material fact and a loss resulted is overstated. [Ex. 4] did not, we admit, address or fully understand the tax verification but this loan, a GP loan, was originated within all SBA rules and regulations.

H Heller Financial

We are not privy to the full IG audit but we wonder what, if any, results were obtained from subpoena on the borrower, or her third party professionals (auditors, attorneys, etc.). Did the borrower commit a fraud in misrepresenting her financial history to lender or was the IRS verification an error, either through oversight, or a mistake (i.e., a misstated number, the 9 looks like a handwritten 4, to me).

We would welcome the opportunity to fully review the entire IG audit, workpaper and files. Please let me know if that can be arranged.

Cordially,

FOIA Ex. 1

Deputy General Counsel

AUDIT REPORT DISTRIBUTION

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