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

AUDIT REPORT
ISSUE DATE: JULY 26, 2000
NUMBER: 0-22

TO: Judith Russell, District Director
Illinois District Office

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

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

Attached is a copy of the subject report. The report contains one finding and two recommendations addressed to your office. In your memorandum, dated July 13, 2000, you stated that you agreed with the recommendations and that corrective action is planned for the first recommenation and has already been addressed for the second recommendation.

The finding included in this report is the conclusion of the Office of Inspector General Auditing Division based upon the auditors 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 your management response to the recommendations within 30 days from the date of this report on the attached SBA Form 1824, Recommendation Action Sheet. The SBA From 1824 should be mailed to

Audit Manager
SBA OIG/Altanta Field Office, Suite 1803
233 Peachtree Street, NE.
Atlanta, Georgia, 30303

Should you or your staff have any questions, please contact Garry Duncan at 202-205-7732.

Attachment

FOIA EX. 4

AUDIT OF
EARLY DEFAULTED LOAN
TO
[Ex. 4]

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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 Small Business Administration rules and regulations.

On [ex. 4] The Money Store Investment Corporation (lender) approved a $269,000 loan to [ex. 4] (borrower) for the purchase of land and a building in [ex. 4] Illinois. [ex. 4] was started in 1989 to [ex. 4] The loan closed in August 1996, defaulted in [ex. 4] and was placed in liquidation in August 1997 with a principal balance of $271,188. The loan was charged off in February 2000 with a balance of $217,692.83.

AUDIT SCOPE AND OBJECTIVE

This report provides the results of our review of the 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. SBA and lender loan files were reviewed and district office and lender personnel were interviewed. Fieldwork was accomplished from July 1999 through November 1999. The audit was conducted in accordance with Government Auditing Standards.

RESULTS OF AUDIT

FINDING Loan Closing Procedures were not Prudent

The audit disclosed that the lender, to assist in the purchase of real estate, inappropriately used funds designated for accrued real estate taxes and imprudently disbursed the balance to the borrower's principals. The principals did not pay the taxes. As a result, when the loan defaulted, SBA's recovery was reduced by the amount of the unpaid taxes plus interest and penalties.

Funds were used inappropriately

The lender had to use funds designated for accrued real estate taxes to close the purchase because the loan amount was not sufficient to cover all costs. The loan amount was less than the cost of the building, and with the addition of the guarantee fee and the settlement costs. the total funds needed to complete the purchase exceeded the borrower's available funds. The calculations are as follows:

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Building contract Sales Price	$269,900	
Settlement charges due from borrower	1,596	
Total due from borrower		$271,496
Deposit by borrow (equity injection)	7,000	
Loan Amount (less guaranty fee)	262,947	
Total paid by borrower		$269,947
Balance due from borrower		$ 1,549
Less Adjustments:		
Taxes accrued from 1/96 to 8/96	$ 14,051	
2nd payment for 1995 taxes	12,672	
Total adjustments		$ 26,723
Net to be paid to borrower		$ 25,174

At settlement, the closing attorney issued two checks totaling $25,173.77 to the principals of the borrower. By disbursing the tax proceeds to the principals, the lender had no assurance that the taxes would be paid. Both the lender and we have concluded that the taxes were not paid.

After the loan defaulted, the lender found that there were delinquent real estate taxes totaling about $126,000 and that this amount included the 1995 and 1996 taxes for which the principals received funds (real estate taxes within the State of Illinois are paid in two installments 1 year in arrears). When the building was sold at sheriff sale, it had an estimated liquidation value of $187,500 before deduction for taxes. After the sale and the deduction for the taxes, interest, fees, and expenses, the lender and SBA received net proceeds of $60,743.

The Loan Guaranty Agreement (SBA Form 750) executed by SBA and the Lender states, in part, "Lender shall . . . and take such other actions which shall, consistent with prudent closing practices, be required in order fully to protect or preserve the interest of lender and SBA in the loan." For this loan the lender's actions were not prudent as the funds designated for taxes were used for non-tax purposes and were disbursed to the principals in lieu of the borrower.

The lender stated that as of the date of this loan closing, it had no policy for the escrow of tax credits. Subsequently, the lender claims to have initiated escrow policy and procedures for taxes applicable to real estate transactions in the State of Illinois.

Recommendations

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

1.A. Recover $26,723 from the lender as a repair to loan number [Ex. 4]

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1.B. Review The Money Store Investment Company's policies and procedures to ensure that there is currently a policy and procedure for escrowing borrower real estate taxes and it is implemented.

Management Response

The District Director agreed with the recommendations and stated that her office would take all steps necessary for the recovery of the $26,723 for payment of real estate taxes. She also stated that her office had been assured that the lender has changed its policy to ensure that such funds are escrowed and had obtained documentation that the lender has a written policy in place (see Appendix A).

Evaluation of Management's Response

The response from the district office director is acceptable.

Auditee's Response

The auditee stated that it believes the loan amount was adequate to close the transaction. and that only $1,549 of the tax credit was used to close the loan. The auditee also stated that the disbursement of the tax credits to the principals in lieu of the borrower was an oversight by the closing agent, and that it, the lender, was led to believe the funds were given to the borrower. According to the auditee, the borrower was informed of the nature of the tax credit and that it was the borrower's responsibility to pay the tax bills, once they were received. Additionally, the auditee states that it is unaware of any SBA requirement at that time to establish a tax escrow (see Appendix B).

Evaluation of Auditee's Response

The auditee does not disagree with the facts presented in the finding, but does disagree with our conclusions that the loan amount was insufficient and that the lender actions were not prudent. The lender's comments indicate agreement that a portion of the tax credits was necessary to close the loan. This fact shows that the loan amount was insufficient. The lender's comments also imply that the disbursement of the tax credits to the principals was not a correct action by the closing agent. This supports our conclusion that the action was not prudent. This imprudent act resulted in a reduction in SBA's recovery during the liquidation process. Therefore, the lender should be held responsible and should compensate SBA for the additional loss.

U.S. Small Business Administration
Illinois District Office

Memo

To: Robert G. Seabrooks
Assistant Inspector General for Auditing

From: Judith A. Roussel,, District Director

Date: July 13, 2000

Re: Audit, [Ex. 4]

Please be advised that the Illinois District Office agree with the recommendations of the Inspector General's Office.

The District Office will immediately proceed with the following course of action:

1. Take all steps necessary for the recovery of the $26,723 for payment of Real Estate taxes.

2. We were aware of this problem with this lender, having adjusted previous purchases and were assured that they had changed their policy to ensure that such funds would be escrowed in the future. We have now obtained documentation that their written policy is in place. (copy attached)

Should you or your staff have any questions, please contact [Ex. 6] our Assistant District Director for Economic Development at [Ex. 6]

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Policy for Escrow of Property Tax Credits
Cook County, Illinois

In Cook County, Illinois, no tax credit funds may be disbursed as cash to the borrower at the closing.

Tax credits to borrower for real estate taxes, accrued but not payable on the date of the closing, are required to be placed in a Tax Credit Holding Account with the title company. This account is for the benefit of the borrower to pay the taxes when they become payable and either borrower or lender shall instruct escrow holder to disburse funds directly to Cook County Tax Collector. Borrower's or Lender's request for disbursement shall be accompanied by the appropriate tax bills for the property.

Lender's Instructions to the closing agent shall include an attachment instructing the closing agent in this regard. The attachment is to be executed by the borrower, Lender and the escrow holder.

FIRST UNION®

First Union Small Business Capital
707 3rd Street
West Sacramento, California 95605
Tel 916 617-1100
Fax 916 617-1090

July 10, 2000

Robert G. Seabrooks, Assistant Inspector General
U.S.Small Business Administration
Office of Inspector General
409 3rd Street, S.W.
Washington Office Center
Mail Code: 4111
Washington, D.C. 20416

Re: Draft Audit Report
Early Defaulted Loan to [Ex. 4]

Dear Mr. Seabrooks:

This letter is a response to the draft audit report for the loan above referenced. The matter at issue is related to the tax credit from seller to borrower for taxes accrued but not yet payable. Your letter states that the lender had to use funds designated for accrued real estate taxes to close the purchase because the loan amount was not sufficient to cover all costs.

The loan provided the borrower $262,947.00 towards the purchase price of $269,900.00. Loan funds were also disbursed to pay the SBA Guaranty Fee. We required the borrower to inject a total of $6,953.00 toward the purchase of the building and $3,047.00, which was the amount estimated for "soft costs". Soft costs generally include such expenses as appraisals, environmental reports, packaging fee, title insurance, attorney's fees and other similar costs that are required in connection with the transaction.

Your draft report includes an overview of the closing statement. In review of that information, it is noted that only $1,549.00 of the tax credit was used to close the loan. While it is true that the balance of the tax credit was disbursed to the borrower for payment of the taxes, once they became due, we maintain that the loan amount was adequate to complete the transaction and that the borrower would have been required to bring in the $1,549.00 to close the transaction, had it not been for the existence of the tax credit.

The disbursement of the tax credit funds to the principals instead of to the corporate borrower, was an oversight by the closing agent. The settlement statement received by us for review and approval prior to the close of the transaction showed funds "to Borrower" in the amount of $25,173.77. Without viewing the actual checks issued at the closing, we assumed that the funds would be disbursed to [Ex. 4] per the borrower name on the settlement statement

Additionally, we were under advice by our Illinois counsel that purchasers in real estate transactions in Cook County customarily received the tax credit at the closing. We were also advised that our counsel always explained to the borrowers and their attorneys the nature of the tax credit and that it is the

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borrower's responsibility to pay the tax bills, once they are received. Additionally, we are unaware of an SBA requirement at that time, either in the SOPs or the Authorization and Loan Agreement, to establish a tax escrow.

[Ex. 4]

In summary we believe the loan amount was adequate, in conjunction with the borrower's injection, to close the transaction. We also believe that, had it not been for the existence of the tax credit, the borrower would have deposited $1,549.00 to the escrow to close the transaction. If the taxes had been payable at the closing, as they are in most jurisdictions, the tax credit would not have been an issue and no funds would have been disbursed to the principals. We believe that the reason for the loan default was unrelated to the underwriting, processing or closing of this loan.

If you have comments or questions regarding this response, please do not hesitate to contact me at [Ex. 6] or write to me at:

First Union Small Business Capital
707 3rd Street, 2nd Floor North, MO5243
West Sacramento, CA 95605
Attention: [Ex. 6]

Sincerely,

[Ex. 6]

AVP, Loan Compliance

cc: [Ex. 6]

FOIA Ex. 6

Appendix C

Audit Report Distribution

Recipient	Number of Copies
Associate Deputy Administrator for Capital Access	1
Associate Administrator for Field Operations	1
Associate Administrator for Financial Assistance	1
Financial Administrative Staff Attention: Jeff Brown	1
General Counsel	2
General Accounting Office	1