



**STATEMENT OF**

**PEGGY E. GUSTAFSON**  
**INSPECTOR GENERAL**  
**U.S. SMALL BUSINESS ADMINISTRATION**

**BEFORE THE**

**COMMITTEE ON SMALL BUSINESS AND**  
**ENTREPRENEURSHIP**  
**U.S. SENATE**

**MARCH 29, 2012**

**PEGGY E. GUSTAFSON  
INSPECTOR GENERAL  
U.S. SMALL BUSINESS ADMINISTRATION**

---

**INTRODUCTION**

Chair Landrieu, Ranking Member Snowe, and distinguished members of the Committee, thank you for giving the Small Business Administration (SBA) Office of Inspector General (OIG) an opportunity to discuss the President's Fiscal Year 2013 Budget Proposal for the OIG and its oversight activities of SBA programs and operations.

The OIG was established within SBA by statute to promote economy, efficiency, and effectiveness and to deter and detect waste, fraud, and abuse in these programs and in SBA operations. Every year, our staff of approximately 110 employees—which includes criminal investigators, auditors, attorneys, and program analysts—conducts criminal investigations, audits, and other reviews, resulting in numerous indictments, convictions and guilty pleas by fraud perpetrators and many recommendations to the agency for improvement of elimination of wasteful or inefficient practices.

During Fiscal Year (FY) 2011, the OIG issued 24 reports containing 136 recommendations for improving SBA operations, reducing fraud and unnecessary losses, and recovering funds. In addition, OIG investigations led to 69 indictments and 47 convictions of subjects who defrauded the government. In all, OIG efforts resulted in more than \$120 million in office-wide dollar accomplishments during FY 2011.

**BUDGET REQUEST**

The SBA was established to maintain and strengthen the nation's economy by protecting the interests of and assisting small businesses, and by helping families and businesses recover from disasters. While SBA's programs are essential to strengthening America's economy, the Agency faces a number of challenges in carrying out its mission, including fraudulent schemes affecting all SBA programs, significant losses from defaulted loans, procurement flaws that allow large firms to obtain small business awards, excessive improper payments, and outdated legacy information systems. Of note, in recent years, SBA's disbursements for guaranties on defaulted loans have increased significantly. In FY 2007, SBA paid about \$1 billion for guaranties on defaulted loans. In FY 2010, such disbursements were almost \$5 billion, and in FY 2011, guaranty disbursements totaled \$3.4 billion. The OIG has found that defaulted loans, especially those that default in the early stages, are often indicative of problems with the loan origination, to include lender negligence or fraud. Moreover, as a result of statutory changes in 2010, the size of loans that SBA guarantees more

than doubled from \$2 million to \$5 million. With this increase in loan value, the OIG believes that additional fraud schemes will occur with greater loss of taxpayer dollars.

To address these risks, the OIG is requesting a \$3.1 million increase over the FY 2012 enacted level. For FY 2013, the OIG requests a total of \$20.4 million—a direct appropriation of \$19.4 million and \$1.0 million to be transferred from the SBA’s Disaster Loan program account for work on disaster program issues.

The additional resources are needed by the OIG to effectively target early defaulted loans for fraud and lender negligence and to increase the capacity of our investigative personnel. In particular, the additional resources will allow the OIG to:

- **Establish a dedicated Early Defaulted Loan Review Group to identify problem loans.** When lender negligence is found, this group will recommend non-payment of the guaranty (or recovery if the guaranty is already paid), target the most offending lenders to attain corrective actions, and identify trends for operational improvement by SBA. When suspected fraud is identified, those loans will be investigated. The additional resources will be used to hire auditors, investigators, and analysts and pay for related travel and other expenses.
- **Enhance investigative capacity.** As discussed below, the OIG handles an average of 250 criminal and civil fraud investigations per year and annually obtains multiple indictments and convictions and recoveries of tens of millions of dollars; however, resource constraints have precluded the OIG from initiating or continuing a number of investigations. For example, over the last four years, the OIG has administratively closed 272 allegations—with potential losses estimated at over \$172 million—which may have met prosecutorial thresholds but could not be further investigated due to a lack of resources. Also, over the last three years, the OIG proactively identified over 688 suspect loans—with values estimated at over \$636 million—that contained characteristics typical of problem loans. Due to limited resources, these loans could not be further reviewed to identify lender deficiencies or indications of fraud. In comparison, as of December 31, 2011, the OIG had 127 open cases related to SBA loan programs (other than disaster loans) with potential dollar losses of about \$316 million. Additional investigative support personnel (i.e. non-criminal investigators or financial analysts) will increase investigative capacity and allow more effective utilization of existing investigative resources in a cost-effective manner.
- **Enhance the OIG’s Hotline operations.** During FY 2011, 550 Hotline complaints were received by the OIG. Also during FY 2011, 169 complaints were referred to the OIG’s Investigations Division and 168

complaints were referred to SBA or other Federal investigative agencies. As of September 30, 2011, 163 complaints were being reviewed by Hotline staff for possible referral or other resolution. The OIG currently has one professional staff member assigned full-time to the Hotline functions. Additional staff resources are required to adequately analyze incoming complaints for possible referral for investigation or other resolution.

The funding requested for FY 2013 also will enable the OIG to continue to address critical areas and issues, including:

- Working an active caseload of about 250 criminal and civil fraud investigations of potential loan and contracting fraud and other wrongdoing. Many of these investigations involve multiple suspects. (Continuing the success of the OIG in prosecuting complex, multimillion dollar fraudulent financial schemes, during FY 2011, OIG investigations resulted in 69 indictments, 47 convictions, and more than \$60 million in civil fraud settlements, potential recoveries, fines, and loans/contracts not being approved or being canceled.)
- Conducting audits and reviews of high-risk SBA activities with a focus on systemic, programmatic, and operational vulnerabilities. (During FY 2011, the OIG issued 24 reports with 136 recommendations for improving the Agency's operations, recovering improper payments, and reducing fraud and unnecessary losses in SBA programs.)
- Contracting with an Independent Public Accountant to perform the audit of the SBA's financial statements.
- Providing oversight and monitoring of the SBA's Information Technology (IT) security and application development activities including new systems under development and the Agency's compliance with the Federal Information Security Management Act (FISMA). OIG reports have identified systemic problems with SBA's IT systems.
- Performing required background investigations for SBA employees to achieve a high level of integrity in the Agency's workforce and adjudicating SBA employees and contractors for issuance of Personal Identity Verification (PIV) cards pursuant to Homeland Security Presidential Directive 12 (HSPD-12) background investigation requirements.
- Reviewing proposed revisions to SBA regulations, policies and procedures, and other directives with an emphasis on strengthening internal controls to preclude wasteful, confusing, or poorly-planned initiatives.

- Promoting debarments, suspensions, and other administrative enforcement actions to foster integrity in SBA programs. (During FY 2011, OIG investigations and recommendations contributed to 54 administrative enforcement actions.)
- Conducting name checks and, where appropriate, fingerprint checks on program applicants to prevent known criminals and wrongdoers from participating in SBA programs. (During FY 2011, loans not approved as a result of the OIG's name check program totaled more than \$24 million.)

## **LOAN PROGRAMS**

The SBA faces a heightened risk of losses and improper payments due to expedited loan processing initiatives and its considerable reliance on outside financial institutions over which the Agency does not always exercise adequate oversight. This trend has been exacerbated by significant increases in loan volume and loan defaults in recent years. For instance, in FY 2007, SBA paid about \$1 billion in loan guaranties, while in the past 2 years SBA has paid over \$8 billion in guaranty claims. OIG activities relating to SBA lending in the past several years have been about the same as they were in FY 2007 because resources have remained largely unchanged for the OIG during this time-period.

The Agency's business loan programs include: (1) the 7(a) program, in which the SBA guarantees loans to small businesses made by lenders; and (2) the Section 504 program, in which the SBA guarantees repayment of debentures that are sold by Certified Development Companies (CDCs) to investors to create funds for loans to small businesses. The majority of loans made under the 7(a) program are made with little or no review by the SBA prior to loan approval because the Agency has delegated most of the credit decisions to lenders originating these loans.

Audits of early defaulted loans and improper payments have noted a number of lender errors in originating loans, whereby the loans do not meet SBA's requirements. In those instances, SBA should not pay the guaranty but frequently does. Furthermore, OIG reviews have detected vulnerabilities in recent changes to the SBA's Standard Operating Procedure for the 7(a) program. These changes include a new provision that allows financing of large amounts of intangible assets, including goodwill, in change-of-ownership transactions where the entire equity injection can be provided in the form of seller take-back financing. The OIG also has identified management challenges relating to the Agency's controls in the guaranty purchase process, oversight of lenders and CDCs, oversight of loan agent participation in the 7(a) program, and improper payments under the 7(a) program.

In addition, numerous OIG criminal investigations have identified fraud by borrowers, loan agents, lenders, and other participants in SBA business loan programs. Criminals fraudulently obtain—or induce others to obtain—SBA-guaranteed loans through a variety of techniques, such as submitting fraudulent documents, making fictitious asset claims, manipulating property values, using loan proceeds contrary to the terms of the loans, and failing to disclose debts or prior criminal records. The result is a greater chance of financial loss to the Agency and its lenders.

An example of a recent, significant case involving fraud in the lending process is summarized below:

- In November 2011, a federal grand jury indicted Jade Capital & Investments, LLC, and its owners. They were charged with a scheme to fraudulently obtain business loans guaranteed by the SBA, with resulting losses alleged to be over \$37 million. The indictment alleges that from February 2005 until October 2011, Joon, Loren, and Nick Park submitted SBA loan applications and supporting documentation to loan originators and underwriters on behalf of their clients. The indictment alleges that the loan packages contained fraudulent personal financial statements and/or monthly bank statements which overstated the net worth and equity injection of the borrowers and falsely enhanced the creditworthiness of the borrowers and their businesses. On February 28, 2012, Nick Park pleaded guilty to conspiracy to commit bank fraud, in connection with the scheme, with resulting losses of at least \$1.3 million.

By definition, fraud is a knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment. Those that commit fraudulent acts under SBA programs are responsible for their actions; however, we believe there are steps that can be taken to limit opportunities for fraudsters and to increase safeguards to identify fraud. The following proposals would provide SBA OIG and other law enforcement entities additional tools to combat fraud in lending programs:

- *Increasing the Statute of Limitations and Penalties for Fraud in the Disaster Loan and 7(a) Guaranteed Loan Programs.*

The proposed change would enhance prosecution of fraud in two of SBA's largest programs—the disaster loan program and the 7(a) loan guaranty program. The proposal would: (1) increase criminal penalties and (2) extend the applicable statute of limitations to provide the Government with the same period of time to investigate and prosecute this type of fraud as is provided for other Federal lending fraud. This would be accomplished by changing the definition of “financial institution” in 18 U.S.C. § 20 and the scope of 18 U.S.C. § 1014, as discussed below.

- *Changes to Penalty Provisions in Section 16 of the Small Business Act for Fraud.*
  1. Revise section 16(a) to (1) include fraud by loan packagers and agents who cause a borrower to make a false statement to the Agency, and fraud in the 504 Certified Development Company (CDC) program under the Small Business Investment Act of 1958 (provisions currently only apply to programs under the Small Business Act); and (2) increase criminal fines for fraud under SBA's financial assistance programs to be consistent with 18 U.S.C. § 3571.
  2. Revise section 16(b) to clarify the scope of the section and to increase fines for crimes covered by the section consistent with the fines imposed under Title 18.
  3. Revise language in certain provisions in section 16(c) to cover fraud against lenders participating in SBA financial assistance programs. This clarifies existing language, which only applies to fraud against SBA, and makes the provision more consistent with the increased lending responsibilities that SBA has delegated to lenders. The revision also increases criminal fines to be consistent with Title 18, and updates certain caps in low-dollar fraud cases, which will greatly assist prosecutors in negotiating plea agreements for defendants that cooperate by informing on other wrongdoers.
  
- *Changes to Section 16 of the Small Business Act to Impose Criminal Penalties for Fraudulently Inducing Fees from an Applicant for SBA Assistance.*

The proposal would add a new section 16(g) to the Small Business Act, which would criminalize fraudulent statements made by loan brokers to applicants for SBA. This section would address situations where loan brokers and other parties knowingly make fraudulent statements in order to induce small businesses to pay them fees for the preparation of application packages to obtain SBA financial assistance or admission to SBA programs.

- *Changes to Title 18 to Permit Injunctive Relief to Prevent and Establish Criminal Penalties for the Misuse of SBA's Name, Initials, Seal, or Logo.*

The SBA OIG has received a number of complaints about individuals and companies that falsely claimed to be affiliated with SBA in order to take unfair advantage of small business owners or forge SBA documents to perpetrate fraud. SBA currently lacks any viable remedy to deter this misconduct. Title 18 currently imposes criminal penalties on parties who falsely represent an association with numerous Federal agencies and permit injunctive relief to prevent such misconduct. 18 U.S.C. § 709. SBA, however, is not covered by this section.

- *Authority of SBA to Require Registration of Loan Agents.*

Based on past reviews and investigations, the SBA OIG believes the development of a registration and tracking system to monitor the participation of agents and packagers in the guaranteed loan program will reduce fraud and enable SBA to better its programs more effectively. The proposed amendment would require SBA to establish a system for loan agent registration. This system would help the SBA identify patterns of fraud for purposes of lender oversight and prosecution of offenders, when appropriate.

The SBA OIG urges the Committee to take up these proposals.

In 2010, the individual amount of 7(a) loans subject to an SBA guaranty was increased from \$2 million to \$5 million. Also, Section 504 loans were increased from \$2 million to \$5 million for regular projects and from \$4 million to \$5.5 million for manufacturing-related projects. These higher loan limits are likely to attract additional attention by criminals and increase the consequences of improper decisions by lenders and the SBA.

Through the Disaster Loan program, the SBA makes direct loans to homeowners and businesses harmed by disasters to fund repair or replacement of damaged property and to businesses to provide needed working capital. This program is vulnerable to fraud and unnecessary losses because: (1) loan transactions are often expedited in order to provide quick relief to disaster victims; (2) lending personnel hired in connection with a disaster declaration may lack sufficient training or experience; and (3) the volume of loans may overwhelm available SBA resources' ability to exercise careful oversight of lending transactions. OIG reviews of the SBA's loan processing activities have disclosed significant problems in making, disbursing, servicing, and liquidating disaster loans, as well as an excessive rate of improper payments. OIG investigations have led to numerous convictions of disaster loan borrowers for making fraudulent statements to obtain loans or misusing loan proceeds. The OIG has identified a management challenge relating to improper payments in the Disaster Loan program.

Under the Small Business Investment Company (SBIC) program, the SBA licenses and funds venture capital firms that provide financial assistance to small businesses. The SBA is at risk for significant losses in this program due to: the deterioration in the economic environment; the decline in asset values of participating securities; and the increasing amount of debenture obligations made by the Agency. Past OIG investigations have identified fraud by certain SBIC managers and others participating in this program.

Previous audits have identified a conflict of interest between the SBA Office of Capital Access (OCA) and the Office of Credit Risk Management (OCRM), which reports to OCA. This is because the OCA's mission, to promote the growth of the loan programs and encourage lenders to join and remain in the 7(a)

program, at times conflicts with the mission of the OCRM, which is to oversee lender performance and compliance and initiate corrective actions against lenders, when necessary. As a result, audits have found that the OCRM has not always taken effective actions against certain lenders with significant performance and compliance problems.

Similarly, OIG audits have identified a conflict between the SBA Office of Financial Assistance (OFA), which also reports to OCA and shares a similar mission with OCA to promote the loan program, and the agency centers that conduct “guaranty purchase reviews” (reviews of lender requests for payments of loan guarantees for compliance and negligence issues). The reports have identified a concern as to whether the purchase centers are objectively and effectively making loan guaranty purchase decisions on defaulted loans, and whether the OFA is inappropriately overruling center decisions to deny or limit guaranty payments. As a result, lenders are not always being held accountable for material violations of SBA loan program requirements.

SBA has not taken action to separate the OCRM from the OCA or to put the OCRM in charge of guaranty purchase reviews. Accordingly, we propose an amendment to the Small Business Act to make the OCRM an independent office and to give the OCRM responsibility for overseeing the purchase centers. In addition to eliminating any conflicts of interest, we believe this proposal will expedite the Agency’s recovery of improper payments and improve communications between the OCRM and the purchase centers to provide for more effective lender oversight. For example, when the OCRM’s analysis shows that a lender is not performing well, loans by this lender should be flagged so that the purchase centers can undertake greater scrutiny when undertaking guaranty purchase reviews. Similarly, if the purchase centers are seeing problems with a number of guaranty purchase requests submitted by a particular lender, that information should be provided to the OCRM so that appropriate lender oversight actions can be taken.

## **PREFERENTIAL CONTRACTING PROGRAMS**

The OIG is concerned about continued fraud and improper activity in the preferential contracting programs, particular the Section 8(a) Business Development, Historically Underutilized Business Zones (HUBZone), and Service-Disabled Veteran-Owned (SDVO) programs. While SBA helps eligible socially and economically disadvantaged 8(a) firms compete in the economy through various business development activities, SBA has delegated its 8(a) contract execution functions to procuring agencies through partnership agreements. These partnership agreements establish the responsibilities between SBA and the procuring agencies for oversight, monitoring, and compliance with procurement laws and regulations governing 8(a) contracts.

Most SBA OIG investigations of procurement fraud involve false statements by those who seek to exploit SBA programs for their personal gain by either: (1) falsely claiming to meet eligibility criteria; or (2) fraudulently using an eligible business as a “pass-through” so that an ineligible company will actually perform the work and receive most of the profits. If ineligible companies improperly profit from preferential contracting through fraud and illegal conduct, legitimate companies necessarily have fewer opportunities to benefit from these programs.

An example of a recent significant case is summarized below:

- On October 13, 2011, Theodoros Hallas pled guilty to one count of conspiracy to commit wire fraud in connection with his role in a conspiracy with Rajesh Kumar Malik to misrepresent their eligibility to obtain set-aside contracts. The investigations of Malik and Hallas led investigators to uncover a bribery, kickback, and money-laundering scheme that resulted in the October 4, 2011 arrests of four Virginia men, including two longtime employees of the U.S. Army Corps of Engineers. These individuals were charged in an indictment that accuses them of taking part in a conspiracy involving more than \$20 million in bribes and kickback payments and the planned steering of a \$780 million government contract to a favored contractor. To date, several of those arrested have entered guilty pleas. Additionally, the Government has seized for forfeiture or recovery approximately \$7.2 million; 16 real properties; 5 luxury cars; and multiple pieces of fine jewelry. Money judgments in favor of the U.S. totaling \$1.396 million also are pending court order.

Despite our success in bringing to justice many who have committed fraud in SBA preferential contracting programs, one significant impediment to prosecution stems from the fact that, in many of these cases, there has been no financial loss to the government. Unlike a case where a contractor has falsified invoices for goods or services that were not provided, in many cases of preferential contracting fraud, the government does obtain the particular good or service that it paid for and sought to procure.

Without an associated and definable loss to the government, criminal prosecutors are sometimes reluctant to pursue action against these companies or, if they do pursue them, may only be able to obtain limited sentences. For example, in one HUBZone case in Kentucky that we were successful in getting a prosecutor to accept, we obtained a guilty verdict, but the sentence was only a \$1,000 fine and two years probation. This light sentence was based upon Federal sentencing guidelines, which require that, in determining the extent of loss, a credit must be applied for any benefit (i.e., goods and services) that the government obtains as a result of the defendant’s wrongdoing.

To enhance criminal prosecution and civil recovery against those that commit fraud in obtaining or performing set-aside contracts, the SBA OIG has developed a legislative proposal to revise section 16(d) of the Small Business Act. Most

significantly, this proposal would make explicit that in criminal or civil fraud prosecutions arising under SBA preferential contracting programs, the amount of loss to the government would equal the amount paid on the contract.

In addition, the OIG proposal would:

- (1) Impose penalties for false statements not already covered by the section, including fraudulent statements made to obtain a contract set aside for SDVO companies or to obtain grants or cooperative agreements under the Small Business Innovation Research and Small Business Technology Transfer programs;
- (2) Enhance prosecution of “pass-through contract” cases by adding a section that would provide that companies that submit invoices or requests for payment on preferential contracts would be deemed to certify that they are performing the required percentage of work on the contracts, and that false certifications would result in criminal penalties;
- (3) Add provisions to cover false statements made to get into an SBA program, such as the 8(a) program, or false statements made to SBA in connection with the protest of a proposed contract award; and
- (4) Revise the definition in the Small Business Act of a service-disabled veteran to require that a person has been determined by the Department of Veterans Affairs or the Department of Defense as being service disabled (the current definition merely covers someone with a service-connected disability, without requiring that either agency has verified this condition.)

## **CONCLUSION**

The SBA OIG will continue to focus on the most critical risks facing the SBA. Our resources are directed at key SBA programs and operations, to include financial assistance, government contracting and business development, financial management and information technology, disaster assistance, agency management challenges, and security operations. We also will continue to partner with the Agency to ensure that taxpayer and small business interests are protected and served well by reviewing proposed regulations and initiatives, pursuing debarment and administrative enforcement actions, and providing fraud awareness briefings. We value our relationship with this Committee and with the Congress and look forward to working together to address identified risks and the most pressing issues facing the SBA.