

AUDIT OF AN EARLY DEFAULTED LOAN TO

[Ex. 4]

AUDIT REPORT NO. 0-12

March 28, 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.



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

AUDIT REPORT
ISSUE DATE: MARCH 28, 2000
REPORT NUMBER: 0-12

To: Sandra Sutton, District Director
Santa Ana District Office

From: *Robert Seabrook*
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 one finding and two recommendations addressed to your office. Your comments have been synopsisized and included in the report. Your comments indicate that you agree with the audit results and recommendations. The lender did not provide a response to the draft audit report.

We have referred this matter to our Office of Investigations for appropriate followup. 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 your office in accordance with the existing Agency procedures for follow-up. Please provide your management responses to the recommendations using the attached SBA Forms 1824, Recommendation and Action Sheet. Any questions or discussions of the issues contained in the report should be directed to Garry Duncan at 202-205-7732.

Attachments

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 SBA rules and regulations.

In [Ex. 4] First Union Small Business Capital (formerly The Money Store) (lender) approved loan number [Ex. 4] (borrower). The \$628,000 loan was processed under Preferred Lender Program (PLP) procedures for a borrower to complete a [Ex. 4] CA. The purpose of the loan was to make leasehold improvements, pay construction and performance bond costs, purchase business machinery and equipment, and provide working capital. SBA provided the lender with a guarantee of 75 percent of the loan amount, and the owner of the business, [Ex. 6] guaranteed the loan. The borrower sold the business in [Ex. 4] and defaulted on the loan in [Ex. 4] without notifying the lender that the business was sold. SBA purchased the 75 percent loan guarantee in April 1998.

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 guaranteed 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 and lender personnel were interviewed. The borrower's invoices were analyzed and its building contractor and moving and storage agent were interviewed. The fieldwork was accomplished between July and October 1999. The audit was conducted in accordance with Government Auditing Standards.

RESULTS OF AUDIT

Finding The Lender and Borrower did not Follow Loan Origination Guidelines

Our audit showed that the lender did not comply with SBA requirements for securing and disbursing the loan. We also found that the borrower made an inaccurate statement on the loan application and submitted invoices for personal expenses to support loan disbursements. As a result, SBA lost \$479,890 when the defaulted loan guarantee was purchased.

The lender did not comply with SBA loan origination requirements

The lender did not adequately secure the loan although the guarantor had sufficient assets for full collateralization. The lender also violated SBA requirements by (i) reimbursing borrower expenses that were incurred up to 14 months before the loan was approved and (ii) not following-up on indicators that the borrower had sold the business.

Loan not adequately secured SBA Standard Operating Procedure (SOP) 50 10 3, Chapter 2 requires a lender to obtain adequate collateral to secure a loan to the extent that worthwhile assets are available from the applicant. The lender violated this requirement when only a [ex. 4] valued at \$85,000 was used to secure the \$628,000 loan. The guarantor's personal financial statement listed other assets such as [ex. 4, b] [ex. 4, b] Other lender documents indicated the borrower owned [ex. 4] The lender did not use any of these assets to secure the loan.

Lender reimbursed ineligible expenses The Settlement Sheet (SBA Form 1050) requires the lender to certify that disbursement of the loan proceeds was made to reimburse the borrower for expenditures made after the loan approval date. Contrary to the certification, the lender approved and disbursed \$370,428 to the borrower for expenditures made up to 14 months before the loan was approved.

Lender did not follow-up on the sale of the business The lender did not follow-up on numerous indications that the borrower sold his business. Although the business was sold in [ex. 4] the lender reported it was not aware of the sale until February 1998. During the audit, we found lender documents that indicated the lender learned of the proposed sale of the business several months prior to the loan default. For example:

- > In June 1997, the lender paid the borrower's Certified Public Accountant \$39,976 for various services including a service described as "Review Potential Sale of Business".
- > In September 1997, the lender's loan service representative faxed a note to the loan officer that the general contractor reported the business had been sold and the borrower was moving out of the country in the next six months.

Inaccurate borrower statements

The borrower's loan application certified that the business was not involved in any pending lawsuits. Our audit, however, disclosed that during the loan application and approval process the borrower had four pending [ex. 4] lawsuits including:

- > A lawsuit filed in [ex. b] [ex. b]

- A lawsuit filed in [Ex. 4] Ex. 4]
- A lawsuit filed in [Ex. 4] Ex. 4]
- A lawsuit filed in [Ex. 4] Ex. 4]

Borrower misrepresented payment invoices

The loan agreement authorized use of loan proceeds to make leasehold improvements to the borrower's leased medical office. With each disbursement, the lender certified that loan proceeds were used for such authorized purposes. In addition, the Code of Federal Regulations, Title 13 (13CFR), paragraph 120.130(e), prohibits the use of proceeds for a purpose that does not benefit the small business. Therefore, use of proceeds for personal purposes were not permitted.

The borrower employed a general contractor to perform both business and personal construction work. The borrower then submitted invoices for reimbursement of business expenses that were actually expenses related to remodeling his home and storing personal goods. Invoices and canceled checks for the ineligible personal expenses totaled \$152,812 including:

- A bill for reimbursement totaling \$117,500 which listed 92 expenditures for construction of the borrower's office that were actually personal expenses made before loan approval. The general contractor stated that the bill was altered because the original invoice was for work performed at the borrower's personal residence.
- An invoice for \$18,873 for office construction costs which the general contractor stated he had not prepared.
- Five invoices totaling \$10,103 dated late 1996 and early 1997 for furniture, appliances, and other items that were actually delivered to the borrower's residence and for plumbing and tile work performed prior to the loan being approved.
- Two invoices totaling \$6,336 for moving and storage costs which the vendor ([Ex. 4]) reported consisted of personal items such as linens, dishes, living and dining room furnishings, and guns put in storage during the remodeling of the borrower's residence.

Impact on the SBA guarantee

We concluded that the lender's non-compliance with SBA loan origination and disbursement requirements allowed the borrower to obtain loan proceeds that he was ineligible to receive. Section 120.524 of 13CFR states that SBA is released from liability on a loan guarantee in whole or in part:

- If the lender has failed to comply materially with any of the provisions in the regulations or the loan guarantee agreement.
- If the lender's improper action or inaction placed SBA at risk, SBA is released from the guarantee liability.
- If SBA determines that any of the above events occurred in connection with the loan, SBA is entitled to recover any monies paid after purchasing the guaranteed portion of a loan.

Recommendations

We recommend that the Santa Ana District Office take the following actions:

- 1a. Ensure that the lender repays the SBA guarantee of \$479,890 for loan number [ex. 4] as required by the November 1, 1999 SBA letter.
- 1b. Remind the lender of its obligation to comply with SBA regulations, policies, and procedures for originating and disbursing loans, particularly in the areas of securing loans and reimbursing personal expenses.

Management Response

The Santa Ana District Office agreed with the finding and recommendations. The District Office issued a letter to the lender on November 1, 1999 formally demanding repair of the remaining principal balance for this loan. The District Office will remind the lender of its obligation to comply with SBA requirements for originating and disbursing loans (see Appendix A).

Evaluation of Management Response

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

FOIA Ex. 4

U.S. SMALL BUSINESS ADMINISTRATION
200 W. SANTA ANA BLVD. #700
SANTA ANA, CA 92701



March 15, 2000

Robert Seabrooks
Assistant Inspector General for Auditing
Office of the Inspector General
Washington, DC 20416

Reference:

[FBI A EX 4]

Dear Mr. Seabrooks:

We have reviewed the draft audit report received March 2, 2000 regarding an audit of an early defaulted loan to [Ex. 4] and submit the following response to the results of the audit:

THE LENDER AND BORROWER DID NOT FOLLOW LOAN ORIGATION GUIDELINES -

We concur with the findings of the Office of Inspector General that lender did not comply with SBA requirements for securing and disbursing the loan. Based upon information obtained during the audit, we also concur that Borrower made inaccurate statements on the loan application. Although we agree that personal invoices were submitted to support loan disbursements, it is not clear at this time who prepared the ineligible, possibly fraudulent, invoices for disbursement. It appears that SBA will suffer a loss on the defaulted loan if a repair is not paid by lender; however, the exact amount of loss is not yet known.

THE LENDER DID NOT COMPLY WITH SBA LOAN ORIGATION REQUIREMENTS -

We concur with the findings of the Office of Inspector General that lender did not take all available collateral. We also concur that lender may have violated SBA policy by reimbursing borrower for expenses incurred fourteen months prior to loan approval and failing to follow-up on indicators that borrower sold the business.

LOAN NOT ADEQUATELY SECURED -

It is the opinion of lender that the collateral taken together with the character and occupation of borrower fully protected the loan. At default, however, the collateral taken did not adequately protect the loan. We concur that lender should have taken additional collateral as required by SBA standard operating procedures and lender was remiss failing to do so.

LENDER REIMBURSED INELIGIBLE EXPENSES -

We concur that lender approved and disbursed loan proceeds for expenditures made prior to loan approval date, in violation of the certification found on SBA Form 1050, the Settlement Sheet. It is not clear, however, if SBA policy allows for PLP lenders to approve such disbursements on behalf of the SBA.

LENDER DID NOT FOLLOW-UP ON THE SALE OF BUSINESS -

Based upon the findings of the audit, lender should have been aware of borrower's sale of the business during the loan disbursement period. The District Office loan file does not contain certain documents found by the IG auditor during his investigation in the lender's file. If the lender confirmed the sale, alternative actions should have been taken to insure repayment of the loan. If it can be proven that lender was aware of the sale or impending sale, lender could be liable for repair on this issue.

INACCURATE BORROWER STATEMENTS -

We concur that borrower's application did not reveal pending lawsuits or any judgments.

FBI A EX 4

BORROWER MISREPRESENTED PAYMENT INVOICES-

Based upon the audit findings, we concur that borrower misused loan proceeds for ineligible purposes.

LOSS TO SBA, RECOMMENDATIONS and INVESTIGATIVE REFERRAL-

We agree with the recommendation to repair lender for the balance owing on the SBA guaranteed loan to [EX-6] An SBA Administrative Action was approved recommending repair. A demand letter for repair was sent to lender on or about November 1, 1999. Lender is reviewing the matter. We have sent a follow up letter to lender and anticipate a reply by month end. [

[FOIA EX. 5, 6]

We will remind lender of its obligation to comply with SBA regulations, policies and procedures for originating and disbursing loans.

We concur with the conclusion that matters discussed in this report should be investigated by the Investigative Division. District Counsel previously referred this loan to the Office of Inspector General for criminal investigation on July 7, 1998.

We appreciate the opportunity to respond to the draft audit report. If you or your staff have any questions concerning this loan, please feel free to contact Portfolio Management Team [EX-6] [EX-6]

Sincerely,

Rachel Baranick

Rachel Baranick
Deputy District Director

FOIA EX. 5, 6

AUDIT REPORT DISTRIBUTION

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