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

AUDIT REPORT
ISSUE DATE: January 20, 2000
NUMBER: 0-04

To: Antonio Valdez, District Director
Fresno District Office

/s/ Original Signed

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

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

Attached is a copy of the subject report. The audit identified no instances of non-compliance by the lender but borrower misrepresentations did contribute to the early default. We have referred this matter to our Office of Investigations for appropriate followup. Because this matter may be investigated, we made a more limited distribution of the report.

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 the permission of the Office of Inspector General. Should you or your staff have any questions, please contact Garry Duncan at 202-205- [FOIA ex. 2]

Attachment

AUDIT OF

AN EARLY DEFAULTED LOAN TO

[FOIA ex. 4]

AUDIT REPORT NO. 0-04

JANUARY 20, 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 is 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
EARLY DEFAULTED LOAN TO
[FOIA 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 March 1997, Heller First Capital Corporation (lender) approved loan number [FOIA ex. 2] to [FOIA ex. 4] (borrower). The $443,000 loan was processed under Certified Lender Program procedures and SBA provided the lender with a guarantee of 75 percent of the loan amount. The loan was made to purchase the land, improvements, business machinery, and equipment assets of a service station and convenience store located in [FOIA ex. 4] CA. The loan was disbursed in March 1997. The business closed and the borrowers defaulted on the loan in June 1998. The SBA loan was then discharged through bankruptcy in December 1998 and all collateral securing the SBA loan was transferred to the lender for liquidation.

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 requirements. The SBA and lender loan files were reviewed and district office and lender personnel were interviewed. The borrowers' financial and bankruptcy records were analyzed and the borrowers' sales agent and business supplier were interviewed. Audit fieldwork was accomplished between June and August 1999. The audit was conducted in accordance with Government Auditing Standards.

RESULTS OF AUDIT

FINDING The Borrowers' SBA Loan Application did not Disclose all Debts

The borrowers lacked sufficient cash to repay the SBA guaranteed loan. The lender was unaware of the lack of repayment ability because the borrowers did not disclose all debts during the loan approval process. To ensure the approval of a SBA guaranteed loan for the purchase of the business, the borrowers' real estate agent allegedly advised them to not report all debts. As a result, SBA's loss could be as much as $330,000 depending on whether the collateral can be sold and how much is received through a sale.

Unreadable Debts

The borrowers signed a SBA Form 1050 Settlement Sheet certifying that there were no liens or encumbrances against the real and personal property securing the loan. The escrow settlement sheet showed a business purchase price of $543,000. The borrowers, however, did not disclose additional business debts totaling $231,000. The exclusions included:

- *Deed of trust.* In January 1997, a deed of trust with an undisclosed balance of $81,000 was executed for the installation of [FOIA ex. 4]at the business site to satisfy a Federal requirement. The supplier of the[FOIA ex. 4]upgrade withheld recording the debt until after the SBA loan was disbursed.

- *Promissory note.* In March 1997, the borrowers executed a promissory note for $150,000 payable to the sellers. The note represented an additional cost of purchasing the business, but was not recorded as such by the seller or shown on the loan application by the buyer.

If these debts had been disclosed, the borrowers would not have qualified for a SBA guaranteed loan. The projected business cash flow for 1997, based on the financial history of the business, showed the borrowers had $63,000 per year to repay annual debts totaling $49,000. With the two undisclosed debts taken into account, the borrowers actually needed at least $102,000 per year to pay business debts.

Both the lender and SBA stated they would not have approved the loan if the additional debts had been disclosed. By certifying that no other debts existed, the borrowers obtained a SBA guaranteed loan that they were not eligible to receive.

Potential SBA Loss

A defaulted loan balance of $440,000 was transferred to liquidation in July 1998. The amount SBA will owe to the lender at purchase could be as much as $330,000 (based on a 75 percent guaranteed loan) depending on whether the collateral can be sold and what is received for it.

OTHER MATTERS

Finders Fee

The borrowers stated that they paid a $8,860 finder's fee to the real estate agent's brother. The fee was for locating a lender that would make the loan. Section 120.222, Title 13 Code of Federal Regulations prohibits the payment of such fees by a borrower.

INVESTIGATIVE REFERRAL

The matters discussed in this report have been referred to the Office of Inspector General's Investigative Division for possible action.