



U.S. Small Business Administration
Office of Inspector General

Memorandum

To: Eric R. Zarnikow
Associate Administrator, Office of Capital Access
/s/ Original Signed

Date: March 31, 2010

From: Debra S. Ritt
Assistant Inspector General for Auditing

Subject: Notice of Finding and Recommendation on Material Origination and Closing Deficiencies Identified in SBA and Lender-Approved Recovery Act Loans ROM-10-12

The OIG conducted an audit of 7(a) loans disbursed pursuant to the American Recovery and Reinvestment Act of 2009 (Recovery Act) to determine if loans made under the Act were originated and closed in compliance with SBA's policies and procedures and to identify any evidence of suspicious activity. This is the fourth and last in a series of finding notices related to our initial audit of 30 SBA-approved and 30 lender-approved loans. These reports provide the Agency with early notification of findings and recommendations related to material deficiencies in Recovery Act loans and with the loan approval process. The first Notice of Finding and Recommendation (NFR) identified four SBA-approved loans involving deficiencies in change of ownership transactions. The second NFR identified 14 lender-approved loans disbursed without the required borrower immigration certification. The third NFR identified three lender-approved loans that were not eligible for SBA guaranties. This NFR identifies miscellaneous material origination and closing deficiencies in three SBA-approved and one lender-approved Recovery Act loans.

We made four recommendations to the Associate Administrator for Capital Access to: (1) revise SOP 50 10 5(b) to require that SBA Form 912, *Statement of Personal History*, be completed by key employees of applicant businesses; (2) provide counseling and training to the SBA loan officers who approved loan numbers [FOIA ex. 2] and [FOIA ex. 2]; (3) implement the appropriate system controls to automatically identify the outstanding balances of all SBA loans made to a borrower to ensure SBA lending limits will not be exceeded upon the approval of a subsequent loan; and (4) require the lender to bring loan number [FOIA ex. 2]

into compliance with SBA requirements, or, if not possible, flag the loan as having an equity injection deficiency for consideration during the purchase review.

On February 3, 2010, we provided a draft of this NFR to SBA management for comment. On March 23, 2010, SBA submitted its formal comments, which are contained in their entirety in Appendix II. SBA agreed with recommendations 2 and 3, and disagreed with recommendations 1 and 4. A summary of management's comments and the OIG's response is provided below.

Recommendation 1

SBA disagreed that SBA Form 912 should be completed by key employees. SBA stated that the SOP in place at the time the referenced loan was made did not require Form 912s to be completed by managers. SBA also stated that requiring key employees to submit Form 912 is a significant policy change, and management is not inclined to make such a change based on one loan identified in an NFR.

We recognize that the SOP in place at the time the referenced loans was made did not require that SBA Form 912 be completed by key employees of applicant businesses. The 7(a) program, however, is governed by regulations outlined in Part 120 of Title 13 of the Code of Federal Regulations (CFR). This CFR provides the permanent program rules and supersedes SBA's SOP requirements, which are simply the Agency's practical guidance to understanding and enforcing the CFR. The program regulations that were in place when this loan was made, and remain in place, stipulate that a business with an associate (i.e. key employee) who is incarcerated, on probation, on parole, or has been indicted for a felony or a crime of moral turpitude is ineligible for an SBA loan. Therefore, our recommendation that key employees be required to submit Form 912 is an important control that needs to be implemented to ensure compliance with regulatory prohibitions against loans to individuals involved in a felony or crime. We plan to pursue a management decision on the recommendation through the audit resolution process.

Recommendation 2

SBA agreed to provide counseling to the appropriate loan officers on SBA's requirements governing business valuations, site visits and affiliation analysis.

SBA's proposed action to provide counseling to SBA loan officers about requirements governing business valuations, site visits and affiliation analysis was responsive to recommendation 2.

Recommendation 3

SBA agreed that one of the loans identified in our NFR exceeded SBA's combined program guaranty limit. SBA stated that this loan was processed early in the Recovery Act implementation period when system changes were being made and believes that the system has been corrected to identify these situations in the future. Nevertheless, SBA stated that it will determine if additional changes are needed and will flag the loans to ensure the guaranty amount paid does not exceed SBA's lending limits should the loan default.

SBA's proposed actions to determine if additional system changes are needed and to flag the loans to ensure guaranty limits are not exceeded were responsive to recommendation 3. It was not clear; however, why the Recovery Act would have impacted the system controls related to the maximum guaranty limit as this limit was already in effect and did not change under the Recovery Act.

Recommendation 4

SBA disagreed that the equity injection for loan number [FOIA ex. 2] did not comply with SBA's requirements. SBA stated that review of the lender's file identified three separate cash injections totaling \$49,591 and that the approximate \$3,000 shortfall was not considered material.

We continue to support our position that loan number [FOIA ex. 2] did not comply with SBA's equity injection requirements. While SBA claimed that the lender's file demonstrated a cash injection of \$49,591, documentation in the lender's file did not evidence an equity injection of this amount. It appears that SBA accepted buyer credits annotated on the escrow settlement statement for two deposits totaling \$45,615, a county tax payment of \$3,451 and a \$525 refund. Bank statements in the loan file showed, however, that \$20,000 of the \$49,591 was provided from the operating company's existing cash. As discussed in our NFR, this existing cash does not qualify as equity injection.

Further, although SOP 50 10 5(a) required the settlement statement to be accompanied by bank account statements showing the injection of funds into the business prior to disbursement, the required statements were not provided for the remaining \$29,591. Nevertheless, based on the descriptions provided on the escrow settlement statement, it appears the remaining \$29,591 was also derived from the operating company's existing cash. As noted in our NFR, the lender specifically documented that the business needed its existing cash, an additional cash injection of \$52,589, plus \$40,000 of working capital from loan proceeds in order to cover its operating needs. As a result, we continue to support our position

that the \$52,589 injection of cash was never made and intend to pursue a management decision on this issue through the audit resolution process.

We appreciate the courtesies and cooperation of the Office of Capital Access. If you have any questions concerning this NFR, please call me at 202-205-[FOIA ex. 2] or Debra Mayer, Director, Recovery Oversight Group, at 202-205-[FOIA ex. 2]

ACTIONS REQUIRED:

Please provide your management response for recommendations 1, 2 and 3 on the attached SBA Forms 1824, Recommendation Action Sheet, within 30 days from the date of this report. Please provide your management response for recommendation 4 on the attached SBA Form 1824, Recommendation Action Sheet, within 80 days from the date of this report. Your responses should identify the specific actions taken or planned to fully address each recommendation and the target dates for completion.

Attachment

U.S. Small Business Administration

Office of Inspector General

Notice of Finding and Recommendation

Audit Location/Division	Office of Capital Access
Date	March 31, 2010
Description of Issue	SBA and lender-approved Recovery Act loans were not originated and closed in compliance with SBA requirements

BACKGROUND:

The purpose of this Notice of Finding and Recommendation (NFR) is to inform you of issues that were identified during our initial audit of 7(a) loans disbursed under the American Recovery and Reinvestment Act of 2009 (Recovery Act). As part of this audit, we reviewed 30 SBA-approved loans and 30 lender-approved loans for compliance with SBA's loan origination and closing requirements.

CONDITION:

We identified three SBA-approved 7(a) Recovery Act loans that were not originated in compliance with SBA requirements. One of these loans may not have been eligible for an SBA guaranty because the key manager of the business had been convicted of a felony, and there was evidence that he was on probation at the time of loan application. Furthermore, SBA did not comply with its change of ownership requirements in approving this loan because it did not ensure the lender (1) obtained an independent business valuation for a change of ownership transaction in which a close relationship existed between the buyer and seller, and (2) conducted a site visit of the assets being purchased. Eligibility was also questionable for a second loan approved by SBA because it did not determine the effect that multiple affiliates of the borrower had on the business' size, repayment ability, and creditworthiness. Finally, a third loan approved by SBA was partially ineligible for an SBA guaranty because it resulted in the business exceeding by \$86,176 the \$1.5 million combined program guaranty limit.

We also identified a lender-approved loan that was disbursed without satisfying SBA's closing requirements. Specifically, the lender did not ensure \$52,589 of cash was injected into the business as equity capital prior to loan disbursement as required by the

loan authorization. Documentation in the lender's loan file demonstrated the business needed its current cash balance, an additional cash injection of \$52,589, and \$40,000 of working capital from loan proceeds in order to cover its operating needs. In its credit memorandum, the lender specifically documented that the borrower's required equity injection would be derived from the principals' personal cash assets, thereby preserving the operating company's cash resources needed for the business. However, the \$52,589 injection of cash was never made. Instead, the lender provided the operating company's bank statements for the 4 months prior to loan disbursement showing the business' existing cash as evidence of equity injection. The business' existing cash does not qualify as equity injection and no deposits were made into the business account from the principal's personal resources before loan disbursement. See Appendix I for a listing of the loans discussed in this NFR.

CRITERIA:

13 CFR 120.110 (n) states that a business with an associate who is incarcerated, on probation, on parole, or has been indicted for a felony or a crime of moral turpitude is ineligible for an SBA loan.

13 CFR 120.10 (2)(i) defines an associate of the small business as an officer, director, owner of more than 20 percent of the equity, or key employee of the small business.

13 CFR 121.103 states a "key employee" is an employee who, because of his/her position in the concern, has a critical influence in or substantive control over the operations or management of the concern.

SOP 50 10 5(a) lists the requirements for a change of ownership transaction. It specifies that if there is a close relationship between the buyer and seller, the lender must obtain an independent business valuation from a qualified source. Additionally, the SOP states that the lender must conduct a site visit of the assets being acquired and document in its loan file the date of the site visit as well as comments.

13 CFR §120.150 states that the applicant must be creditworthy. Loans must be so sound as to reasonably assure repayment, and SBA will consider the effect any affiliates may have on the ultimate repayment ability of the applicant.

SOP 50 10 5(a) states that the applicant business combined with its affiliates must not exceed the size standard designated for either the primary industry of the applicant alone or the primary industry of the applicant and its affiliates, whichever is higher.

SOP 50 10 5(a) states that the maximum SBA guaranty amount outstanding of all loans to any one business (including affiliates) cannot exceed \$1.5 million.

SOP 50 10 5(a) states that lenders must verify injections prior to disbursing loan proceeds and maintain evidence of such verification in their loan files. Additionally, it states that lenders are expected to use reasonable and prudent efforts to verify that equity is injected and used as intended, and failure to do so may warrant a repair or partial/full denial.

SOP 50 10 5(a) states that verifying a cash injection requires documentation, such as a copy of a check along with evidence that the check was processed (e.g., at least one bank account statement dated before, but close to, disbursement showing that the funds were available and deposited into the borrower's account), or a copy of an escrow settlement accompanied by a bank account statement showing the injection into the business prior to disbursement. A financial statement, alone, is generally not sufficient evidence of cash injection.

CAUSES:

In all 4 loans, SBA and lenders did not comply with SBA requirements for loan origination and closing, indicating a lack of due diligence and a lack of appropriate control procedures to really ensure compliance.

Concerning the first loan, SBA does not have procedures in place to enforce 13 CFR 120.110(n) by preventing an SBA loan from being made to a business with a key employee who is incarcerated, on probation, on parole, or has been indicted for a felony or a crime of moral turpitude. In order to enforce this regulation, SBA previously required key employees to complete SBA Form 912, *Statement of Personal History*, which requires disclosure of all indictments, arrests, and convictions. SBA, however, revised this procedure and no longer requires completion of this form by key employees. As a result, businesses with key employees that have committed crimes of moral turpitude may currently obtain SBA loans.

Concerning the third loan, the appropriate system controls do not appear to be in place to automatically identify the outstanding balances of all SBA loans made to a borrower to ensure SBA lending limits will not be exceeded upon the approval of a subsequent loan.

EFFECT:

Four Recovery Act loans valued at \$2.4 million were not originated or closed in accordance with SBA requirements. The inappropriate SBA-approved loans will (1) increase the risk of loss to SBA should these loans default, and (2) reduce the availability of SBA loans to other lenders and eligible borrowers. If the lender-approved loan is not brought into compliance with SBA requirements, the lender risks losing its SBA guaranty in the event of loan default.

RECOMMENDATIONS:

We recommend that the Associate Administrator for Capital Access:

1. Revise SOP 50 10 5(b) to require that SBA Form 912, *Statement of Personal History*, be completed by key employees of applicant businesses.

2. Provide counseling to the SBA loan officers who approved loan numbers [FOIA ex. 2] and [FOIA ex. 2] about their mistakes and train them adequately to:
(1) ensure lenders perform the appropriate business valuations and site visits for change of ownership transactions, and (2) evaluate the effect of affiliation of a borrower's size, repayment ability, and creditworthiness.
3. Implement the appropriate system controls to automatically identify the outstanding balances of all SBA loans made to a borrower to ensure SBA lending limits will not be exceeded upon the approval of a subsequent loan.
4. Require Wachovia SBA Lending, Inc. to bring loan number [FOIA ex. 2] into compliance with SBA requirements, or, if not possible, flag the loan as having an equity injection deficiency for consideration during the purchase review should the loan default and purchase be requested.

APPENDIX I. LOANS WITH ORIGINATION AND CLOSING DEFICIENCIES

Loan Number	Borrower	SBA or Lender Approved	Lender	Loan Amount	Deficiency
[FOIA ex. 2]	[FOIA ex. 4]	SBA	Coppermark Bank	\$200,000	A, B
[FOIA ex. 2]	[FOIA ex. 4]	SBA	Affinity FCU	\$150,000	C
[FOIA ex. 2]	[FOIA ex. 4]	SBA	Mountain West Bank	\$1,600,000	D
[FOIA ex. 2]	[FOIA ex. 4]	Lender	Wachovia SBA Lending, Inc.	\$445,000	E
Total				\$2,395,000	

Deficiency Type Legend:

- A. Associate convicted of a felony and on probation
- B. Noncompliance with change of ownership requirements
- C. No evaluation of affiliates
- D. Exceeded lending limits
- E. Unsupported equity injection



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

March 24, 2010

TO: Debra S. Ritt
Assistant Inspector General for Auditing

FROM: Eric R. Zarnikow
Associate Administrator
Office of Capital Access

SUBJECT: Management Response to Draft Notice of Finding and
Recommendation on Material Origination and Closing Deficiencies
Identified in SBA and Lender-Approved Recovery Act Loans,
Project No. 9512E

Thank you for the opportunity to respond to the Draft Notice of Finding and Recommendation (NFR) on Material Origination and Closing Deficiencies Identified in SBA and Lender-Approved Recovery Act Loans, Project No. 9512E, dated February 3, 2010. Please find our response to the proposed recommendations below.

1. *Revise SOP 50 10(b) to require that SBA Form 912, Statement of Personal History, be completed by key employees of an applicant business.*

SBA disagrees with this finding. The SOP in place at the time the loan was made did not require an SBA Form 912, for managers. The guidance at the time required that SBA Form 912 be completed by (a) the proprietor, if a sole proprietorship; (b) by each partner, if a partnership; and (c) by each officer, director, and additionally by each holder of 20% or more of the ownership stock, if a corporation, limited liability corporation, or a development company. Requiring key persons to submit SBA Form 912s is a significant policy decision. SBA is not inclined to make such a policy change based on one loan identified through an NFR.

2. *Provide counseling to the SBA loan officers who approved loan numbers [FOIA ex. 2] and [FOIA ex. 2] about their mistakes and train them adequately to: (1) ensure lenders perform the appropriate business valuations and site*

visits for change of ownership transactions, and (2) evaluate the effect of an affiliation of a borrower's size, repayment ability, and creditworthiness.

SBA will provide counseling to the SBA loan officers that made the referenced loans about requirement governing business valuations, site visits and affiliation analysis.

3. *Implement the appropriate system controls to automatically identify the outstanding balances of all SBA loans made to a borrower to ensure SBA lending limits will not be exceeded upon the approval of a subsequent loan.*

This loan was processed early in the Recovery Act implementation period when system changes were being made to implement the Recovery Act. SBA believes that the system has been corrected to identify these situations in the future and will further evaluate to determine if additional changes are needed. The loans will be flagged to ensure the guaranty amount paid does not exceed SBA's lending limits should the loan default.

4. *Require Wachovia SBA Lending, Inc. to bring loan number [FOIA ex. 2] into compliance with SBA requirements, or, if not possible, flag the loan as having an equity injection deficiency for consideration during the purchase review should the loan default and purchase be requested.*

SBA disagrees with this finding. Review of the lender's file identified three separate cash injections totaling \$49,591. The approximately \$3,000 shortfall is not considered material in relationship to the \$447,500 loan. The loan complies with SBA requirements.

We appreciate the opportunity to comment on the Draft Notice of Finding and Recommendation prepared by your office. Please let us know if you have any questions or need additional information.