



**U.S. SMALL BUSINESS ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL  
WASHINGTON, D.C. 20416**

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**Management Advisory  
Report No. 16-19**

**DATE:** August 16, 2016

**TO:** Maria Contreras-Sweet  
Administrator

Jihoon Kim  
Acting Director, Office of Financial Program Operations

**FROM:** Troy M. Meyer  
Assistant Inspector General for Audit

**SUBJECT:** SBA Loan Number 6439845000, Exemption 4 [REDACTED]

The attached management advisory relates to the Office of Inspector General (OIG) High Risk 7(a) Loan Review Program and is intended to provide the Small Business Administration (SBA) with early notification of issues identified as part of our review. The objectives for this program are to determine if (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with SBA's rules, regulations, policies, and procedures, and (2) material deficiencies exist that warrant recovering guaranteed payments made to lenders. (Appendix I describes our scope and methodology.)

This memorandum includes one recommendation that SBA agreed to implement. This recommendation can be closed upon SBA providing evidence that it has recovered the recommended amount from the lender. Please provide us within 90 days your progress in implementing the recommendation.

### **Background**

We selected high-dollar/early-defaulted (HD/ED) 7(a) loans using a scoring system developed by OIG to prioritize loans based on the risk of loss to SBA. We also considered other factors, such as the outstanding balance of the loan, the period to default, and whether SBA had completed all purchase review actions during the selection process.

As part of the Preferred Lenders Program (PLP), SBA authorized the lender (Newtek Small Business Finance, Inc.) to process, close, service, and liquidate SBA-guaranteed loans with limited review by SBA. On September 23, 2013, the lender approved an SBA loan for \$1,623,000 with a 75 percent SBA guaranty to the borrower (Exemption 4 [REDACTED] doing business as Exemption 4 [REDACTED]) to refinance existing debt, fund working capital, and pay closing costs. The borrowing business had two owners: a managing member (Exemption 4 [REDACTED]) who owned 60 percent, and a real estate investment company (Exemption 4 [REDACTED]) who owned 40 percent. The borrower's managing member also owned this real estate investment company.

The borrower defaulted on the SBA loan on September 1, 2014, after making 10 full loan payments. SBA purchased the loan on February 11, 2015 for \$1,205,359. SBA's share of the loan's outstanding balance was reduced to \$850,791 due to recoveries during liquidation.

## Results

We identified material lender non-compliance with SBA's loan origination and closing requirements. Specifically, the lender neither ensured SBA loan proceeds were used for an eligible purpose nor assessed the borrower's repayment ability and size in accordance with SBA's requirements.

### *Use of Proceeds*

The lender did not demonstrate that it approved the loan in accordance with SBA's origination and closing requirements. The majority of proceeds from the \$1.6 million SBA loan refinanced a \$1 million loan from Associated Mortgage Investors (AMI). The loan from AMI was disbursed on April 29, 2013, only 5 months prior to the SBA loan approval. However, the lender did not confirm that this debt was eligible for refinance, as required.

SBA procedures state that loan proceeds may not be used to refinance debt originally used for a loan purpose that would have been ineligible for SBA financing at the time it was incurred. Additionally, SBA requires the lender to prepare and maintain in the loan file a written analysis of why the debt was incurred along with supporting documentation.<sup>1</sup> Further, the SBA loan authorization states that the loan must be made for a sound business purpose and must benefit the small business.

We confirmed that the lender did not perform adequate due diligence to verify the original use of proceeds for the AMI loan. Consequently, the majority of the loan proceeds did not benefit the borrower. The lender's analysis stated that the AMI loan was used to purchase real estate. However, documentation in the lender's loan file supporting the debt to be refinanced only included a payoff statement from AMI and a copy of the original note. Neither of these documents supported that the original debt was used to purchase real estate. Further, we noted that the fixed assets on the borrower's May 31, 2013 balance sheet, which would indicate the purchase of any new real estate, had remained unchanged since December 31, 2012. In addition, we obtained documentation outside of the lender's file that showed the majority of the AMI loan proceeds did not benefit the borrower. Specifically, \$890,380 of the \$1 million AMI loan purchased certificates of deposit (CDs) and paid off delinquent property taxes for the owners of the borrower.<sup>2</sup> Additionally, only \$20,123 directly benefitted the borrower. (See Table 1.)

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<sup>1</sup> SOP 50 10 5(E), *Lender and Development Company Loan Programs* (June 1, 2012).

<sup>2</sup> Per Table 1: \$529,000 (60 percent owner) + \$361,380 (40 percent owner) = \$890,380.

**Table 1: Use of Proceeds for \$1 Million Loan from AMI and Beneficiaries**

Use of Proceeds	Borrower	60 Percent Owner	40 Percent Owner	Total
Delinquent Property Taxes	\$20,123	-	\$140,380	\$160,503
Certificate of Deposit	-	\$529,000	\$221,000	\$750,000
Miscellaneous*	-	-	-	\$89,497
<b>Total</b>	<b>\$20,123</b>	<b>\$529,000</b>	<b>\$361,380</b>	<b>\$1,000,000</b>

Source: Closing Statement

\* Miscellaneous expenses include origination fees, insurance, interest, and other miscellaneous closing costs that did not directly benefit any one party.

The payoff statement and note were not sufficient to verify that the AMI loan was used to purchase real estate. At a minimum, the lender should have requested the borrower’s closing statement for the \$1 million AMI loan to determine the payee of the loan proceeds. The lender’s non-compliance with SBA’s requirements resulted in a loan that did not materially benefit the small business and was not eligible for SBA financing.

#### *Repayment Ability and Size of the Borrower*

The lender also did not reasonably assure that the borrower had repayment ability and met SBA size standards. In accordance with SBA regulations, applicants must be creditworthy, and loans must have reasonable assurance of repayment considering past earnings, projected cash flow, future prospects, the ability to repay the loan with earnings from the business, and the effects of any affiliates.<sup>3</sup> As defined by SBA regulations, affiliation exists when either one individual or entity controls or has the power to control another or a third party or parties controls or has the power to control both. SBA considers factors such as ownership, management, previous relationships with or ties to another entity, and contractual relationships when determining whether affiliation exists.<sup>4</sup> SBA’s Standard Operating Procedures (SOP) require the applicant to disclose all affiliates and lenders to determine the effect they may have on meeting SBA’s size standards. The SOP also requires the lender to retain affiliate and subsidiary financial statements in its loan file.<sup>5</sup>

As previously noted, a managing member (Exemption 4 ) owned 60 percent of the borrowing entity, and a real estate investment company (Exemption 4 ) owned the remaining 40 percent. The borrower’s managing member disclosed on the SBA Form 4, *Application for Business Loan*, that the business or its owners owned or had a controlling interest in other businesses. However, there was no evidence in the lender’s loan file that the borrower provided a full list of affiliated businesses, their relationship with the borrower, and all financial data.

Instead, to identify business affiliates, the lender relied on a letter from the borrower’s certified public accountant (CPA) and the tax returns of the borrower’s owners. While the CPA’s letter and tax returns included seven affiliated limited liability companies (LLCs), we found evidence that suggested the managing member was affiliated with and may have had ownership interests in at least 18 other businesses. We confirmed his affiliation with at least seven other businesses not considered by the lender. Based on this evidence, the lender did not adequately assess the impact that the borrower’s other affiliated businesses would have had on the repayment ability and size of the borrower.

<sup>3</sup> Title 13 Code of Federal Regulations 120.150, Business Credit and Assistance.

<sup>4</sup> Title 13 Code of Federal Regulations 121.103, How does SBA determine affiliation?

<sup>5</sup> SOP 50 10 5(E), *Lender and Development Company Loan Programs* (June 1, 2012).

SBA requirements state that lenders must analyze each application in a commercially reasonable manner, consistent with prudent lending standards.<sup>6</sup> In addition, SBA will not purchase the guaranteed portion of a loan when a lender does not provide sufficient credible evidence to support it made the loan in accordance with SBA loan program requirements and prudent lending practices.<sup>7</sup> Further, SBA is released from liability on the guaranty (in whole or in part) if the lender failed to comply with any material SBA loan program requirement; failed to make, close, service, or liquidate a loan in a prudent manner; or the lender's improper action or inaction placed SBA at risk.<sup>8</sup> Consequently, the lender's material noncompliance with SBA requirements while making and closing the loan to the borrower resulted in a loan that was ineligible for the 7(a) Program and a potential loss to SBA of over \$850,000.<sup>9</sup>

## **Recommendation**

We recommended the Director of the Office of Financial Program Operations:

1. Require Newtek Small Business Finance, Inc. to bring the loan into compliance and, if not possible, seek recovery of \$850,791, plus interest, on the guaranty paid by SBA for the loan to **Exemption 4**.

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<sup>6</sup> SOP 50 10 5(E), *Lender and Development Company Loan Programs* (June 1, 2012).

<sup>7</sup> SOP 50 57, 7(a) *Loan Servicing and Liquidation* (March 1, 2013).

<sup>8</sup> Title 13 Code of Federal Regulations Part 120.524, *Business Credit and Assistance*.

<sup>9</sup> Proceeds from the liquidation process may further reduce this amount.

## Management's Response

Please indicate your response by checking the appropriate box below and providing the appropriate supporting documentation to OIG within 30 days from the date of this report.

- Management substantially concurs with the report and recommendation.
- Management does not concur with the report and recommendation. Please give reasons for management's non-concurrence.

### Explanation of proposed action and target date for final action:

After a thorough review, with no additional documentation submitted by the lender, OFPO concurs with the recommendation to recover the funds from the lender. The lender has been notified and the loan has been forwarded to HQ for the denial review process.

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Please contact us if you would like to discuss this report or any related issues.

cc: Nicolas Maduros, Chief of Staff  
Melvin F. Williams, Jr., General Counsel  
Martin Conrey, Attorney Advisor, Legislation and Appropriations  
Tami Perriello, Chief Financial Officer  
LaNae Twite, Director, Office of Internal Controls

## **Appendix: Objective, Scope and Methodology**

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This report presents the results of our review of SBA loan number 6439845000, **Exemption 4** [REDACTED], as part of our ongoing High Risk 7(a) Loan Review Program. Our objectives for this program are to determine if (1) high-dollar/early-defaulted 7(a) loans were originated and closed in accordance with SBA's rules, regulations, policies, and procedures and (2) material deficiencies exist that warrant recovering guaranteed payments made to lenders. To answer the objectives, we reviewed origination and closing actions as documented in SBA and lender loan files. We assessed these actions against all applicable SBA requirements. We also reviewed information in SBA's Mainframe Loan Accounting System.

We used an internally-developed and evolving OIG scoring system to prioritize loans for review based on known risk attributes. These risk attributes identify loans that have a higher potential for lender noncompliance and suspicious activity by loan participants. These attributes include, but are not limited to, the time lapse between loan approval and its transfer to liquidation, loan amount, equity injection, loan packager involvement, and the use of loan proceeds.

We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency's quality standards for inspection and evaluation. These standards require that we adequately plan inspections; present all factual data accurately, fairly, and objectively; and that we present findings, conclusions, and recommendations in a persuasive manner. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our evaluation objectives.

### **Use of Computer-Processed Data**

We relied on information from SBA's Mainframe Loan Accounting System to score loans using an internal scoring system developed by OIG. Previous OIG engagements have verified that the information maintained in this system is reasonably reliable. Further, data elements associated to reviewed loans were verified against source documentation maintained in SBA and lender loan files. As a result, we believe the information is reliable for the purposes of this program.