



Audit Report

Report Number: OIG-SBLF-14-005R

STATE SMALL BUSINESS CREDIT INITIATIVE: Illinois' Use of Federal Funds for Capital Access and Other Credit Support Programs

March 26, 2014

This Report was revised on July 9, 2015, to reflect changes made on pages 2, 12, 13, 17, and 18. The changes clarify that the Office of Inspector General tested a sample of administrative expenses in this audit. These changes do not affect the findings, conclusions, and recommendations as reported.

Office of
Inspector General
Department of the Treasury

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Abbreviations

CDC	Certified Development Company
CAP	Capital Access Program
DCEO	Illinois Department of Commerce and Economic Opportunity
OIG	Office of Inspector General
OMB	Office of Management and Budget
SSBCI	State Small Business Credit Initiative
The Act	Small Business Jobs Act of 2010

*The Department of the Treasury
Office of Inspector General*

March 26, 2014

Don Graves, Jr.
Deputy Assistant Secretary for Small Business, Housing, and
Community Development

This report presents the results of our audit of the state of Illinois' use of funds awarded under the State Small Business Credit Initiative (SSBCI), which was established by the Small Business Jobs Act of 2010 (the Act). Treasury awarded Illinois approximately \$78.4 million¹ in SSBCI funding, and as of March 31, 2013, the State received its first allocation of approximately \$25.9 million.² As of March 31, 2013, Illinois had expended or obligated approximately \$34.5 million.³ Of this amount, the State allocated approximately \$27.4 million⁴ to the Participation Loan Program, approximately \$5.6 million⁵ to the Invest Illinois Venture Fund Program, \$1.0 million to the Collateral Support Program, \$500,000 to the Conditional Direct Loan Program, and roughly \$15,870 to the Capital Access Program. The State also incurred approximately \$1.0 million⁶ in administrative costs.

The Act requires the U.S. Treasury Office of Inspector General (OIG) to conduct audits of the use of funds made available under SSBCI and to identify any instances of reckless or intentional misuse. Treasury has defined reckless misuse as a use of allocated funds that the participating state or administering entity should have known was

¹ Rounded up from \$78,365,264.

² Rounded up from \$25,860,537.

³ Rounded down from \$34,509,247. This number is in excess of the State's first allocation, as Treasury permits states to obligate funds in excess of individual allocations.

⁴ Rounded down from \$27,423,377.

⁵ Rounded up from \$5,570,000.

⁶ Rounded down from \$1,036,808.

unauthorized or prohibited, which is a highly unreasonable departure or willful disregard from the standards of ordinary care, and may be a single instance or a series of instances. Intentional misuse is defined as a use of allocated funds that the participating state or its administering entity knew was unauthorized or prohibited.

Our audit objective was to test participant compliance with program requirements and prohibitions to identify any reckless or intentional misuse of funds. To accomplish our objective, we reviewed a random sample of 48 loans and investments made as of March 31, 2013, to determine whether they complied with program requirements for use of proceeds, capital-at-risk, and other restrictions in the Act or in *SSBCI Policy Guidelines*. We also interviewed management and staff from the Illinois Department of Commerce and Economic Opportunity (DCEO) that administer, account for, and report on SSBCI funding. We reviewed a sample of the State's administrative costs charged against SSBCI funds to ensure they were allowable, reasonable, and allocable in accordance with *SSBCI Policy Guidelines*, and Office of Management and Budget (OMB) Circular A-87, *Cost Principles for State, Local, and Indian Tribal Government*.⁷

We performed our audit between July 2013 and February 2014 in accordance with *Government Auditing Standards*. Those standards require that we plan and perform the audit to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained to address our audit objective provides a reasonable basis for our findings and conclusions. A more detailed description of our audit objective, scope, and methodology is contained in Appendix 1 to this report.

Results In Brief

Illinois appropriately used most of the \$34.5 million in SSBCI funds it had expended as of March 31, 2013, but spent \$105,000 to

⁷ Office of Management and Budget Circular Number A-87, revised May 10, 2004.

participate in a loan that was used to purchase the stock of a company representing its entire ownership interest, which is prohibited by the *SSBCI Policy Guidelines*. The transaction constituted a reckless misuse of funds because Illinois officials should have known that such use was prohibited, and the State did not exercise ordinary care in ascertaining how the loan proceeds would be used despite contradictory evidence in the loan file, some of which indicated that the borrower intended to purchase the stock of a company. State officials also did not investigate representations made by the borrower and lender that contradicted loan documents.

The audit also identified 22 other transactions that did not fully comply with lender sex offender certification requirements. Additionally, when acting in the capacity of a direct lender or investor, Illinois neglected to execute lender certifications on the State's behalf as prescribed in the *National Standards*. Despite the inadequate assurances, Illinois certified for June 2012, September 2012, December 2012, and March 2013, that it was in compliance with all SSBCI requirements, which was materially inaccurate.

Finally, in its *2012 Annual Report*, Illinois unintentionally overstated by \$4.7 million the amount of private financing associated with one loan in which the State participated. This occurred because the financing structure of the transaction was changed without the State's knowledge.

We recommend that Treasury recoup the \$105,000 in recklessly misused funds, notify the State that it has incurred a specific event of default per its *Allocation Agreement* as a result of the reckless misuse, and require Illinois to modify its *Master Agreements* with lenders to include the required language mandating that lenders notify the State of any changes in the sex offender status of its principals. We also recommend that Treasury notify Illinois that it must provide lender certifications on its own behalf when acting as a direct lender or investor, and adjust its next *Annual Report* to correct for the \$4.7 million overstatement of a loan participation transaction. Finally, Treasury should determine whether Illinois is in general default of its *SSBCI Allocation Agreement* due to its failure to comply with lender

certification requirements, materially inaccurate compliance certifications, and inaccurate reporting of a loan participation transaction.

Treasury accepted all of the recommendations in the report and will recoup the \$105,000 of recklessly misused funds from Illinois. Treasury will also work with the state of Illinois to implement the corrective measures identified by the audit. Illinois disagreed with the finding of “reckless misuse” stating they acted in accordance with its legal counsel’s interpretation of the SSBCI guidance and that the prohibition was not clearly articulated. Illinois also disagreed that it did not fully comply with the lender sex offender certification requirement, stating that the language in the sex offender certification is identical to the suggested certification provided by Treasury. Finally, Illinois disagreed that it defaulted on its *Allocation Agreement* given that the deficiencies noted in the audit were rather minor. Formal written responses from Treasury and the state of Illinois are included in their entirety in Appendix 2.

Background

SSBCI is a \$1.5 billion Treasury program that provides participating states, territories, and eligible municipalities with funding to strengthen Capital Access Programs (CAPs) and other credit support programs that provide financial assistance to small businesses and manufacturers. CAPs provide portfolio insurance for business loans based on a separate loan loss reserve fund for each participating financial institution. Other credit support programs include collateral support, loan participation, loan guarantee, direct lending, and venture capital programs.

Each participating state is required to designate specific departments, agencies, or political subdivisions to implement the funding. The designated state entity distributes SSBCI funds to various public and private institutions, which may include a subdivision of another state, a for-profit entity supervised by the state, or a non-profit entity supervised by the state. These entities use funds to make loans or provide credit access to small businesses.

Primary oversight of the use of SSBCI funds is the responsibility of each participating state. To ensure that funds are properly controlled and expended, the Act requires that Treasury execute an *Allocation Agreement* with participants setting forth internal controls and compliance and reporting requirements before allocating SSBCI funds. SSBCI disbursements to participating states are made in three allocations: the first when the Secretary approves the state for participation, and the second and third after the participating state certifies that it has obligated, transferred, or spent at least 80 percent of the previous allocation. In addition, the participating state is required to certify that it has complied with all applicable program requirements.

Illinois' Participation in SSBCI

On July 12, 2011, Treasury approved the state of Illinois' application for the SSBCI program and awarded it approximately \$78.4 million. That same month, Treasury disbursed the State's first allocation of funds, totaling approximately \$25.9 million. As of March 31, 2013, Illinois had expended or obligated approximately \$35.5 million, of which approximately \$1.0 million was used for administrative costs.

The *Allocation Agreement* between Illinois and Treasury was signed on July 26, 2011, which designated the Illinois DCEO as the entity to implement the State's SSBCI programs. The *Allocation Agreement* authorized use of the SSBCI funds for five programs: the (1) Illinois Capital Access Program, (2) Illinois Participation Loan Program, (3) Collateral Support Program, (4) Conditional Direct Loan Program, and (5) Venture Capital Program.

Illinois Capital Access Program

The Illinois Capital Access Program assists businesses with achieving their capital financing needs. The design of the program encourages financial institutions to make loans to small businesses that would normally not qualify under conventional lending policies. Under the

program the bank and/or the borrower, along with DCEO, contribute a premium into a pooled reserve account. Each loan is then approved by the lender, which is supported by the reserve account. As of March 31, 2013, the State had expended or obligated \$15,870 in SSBCI funds for 7 CAP loan transactions.

Illinois Participation Loan Program

Under the Illinois Participation Loan Program, DCEO uses SSBCI funds to spur new bank lending to small businesses by purchasing portions of bank term loans and revolving lines of credit. DCEO applies below-market interest rates to its portion of the loans and subordinates its position to that of the lenders. As of March 31, 2013, the State had expended or obligated approximately \$27.4 million in SSBCI funds for 88 loan participation transactions.

Invest Illinois Venture Fund

The Invest Illinois Venture Fund is a new venture capital program that was established to support high-tech, bio-tech, and IT developments in Illinois. The Fund supports early-stage companies and start-ups that show a high potential for future growth, resulting in the creation of high-paying professional Illinois jobs. Companies that apply for funding must have lined up an outside lead investor to help shield the State from the risk it takes on as an investor in early-stage companies. As of March 31, 2013, the State had expended or obligated approximately \$5.6 million in SSBCI funds for 19 Illinois Venture Fund investments.

Illinois Collateral Support and Conditional Direct Loan Programs

The Collateral Support Program is a newly established program that provides added collateral, on a loan by loan basis, to the pool of collateral and guarantees backing potential borrowers. The added collateral increases the likelihood that lenders will provide financing to businesses that lack sufficient collateral, but are otherwise viable borrowers. As of March 31, 2013, the State had expended or

obligated \$1.0 million in SSBCI funds for 1 collateral support transaction.

The Conditional Direct Loan Program provides loans to help borrowers meet their needs for extra working capital when establishing major new facilities and financing major business projects. As of March 31, 2013, the State had expended or obligated \$500,000 in SSBCI funds for 1 direct loan.

Illinois Recklessly Misused \$105,000 to Support the Purchase of an Ownership Interest in a Business

Illinois recklessly misused \$105,000 in SSBCI funds to purchase a 50-percent participation in a \$210,000 term loan that was to be used to purchase the stock of a business representing its entire ownership interest. Although Illinois thought the transaction involved the purchase of assets, the acquisition was actually structured as a stock purchase transaction in an agreement executed between the buyer and seller in February 2012. The *SSBCI Policy Guidelines* and *SSBCI Frequently Asked Questions*, which were both in effect at the closing date of this transaction, expressly prohibit the use of SSBCI funds to purchase any portion of the ownership interest of any owner of a business.

An official at DCEO asserted that at the time the loan was enrolled in the SSBCI program he believed the proceeds were to be used to purchase business assets, such as accounts receivable, inventory, and equipment, which is an allowable use of funds. DCEO officials later stated they perceived the transaction to be a permissible use of SSBCI funds because it did not involve a business partner purchasing another partner's share of the company. Instead, a third party was purchasing the entire ownership interest and would be hiring new employees along with expanding the business. Furthermore, the officials stated that the meaning of the term "ownership interest" was unclear from Treasury's guidance that was in effect at the time. While DCEO officials believe the transaction was permissible, the *SSBCI Policy Guidelines* and *SSBCI Frequently Asked Questions* are clear in that both expressly prohibit the use of SSBCI funds to purchase any

portion of an ownership interest. Further although DCEO officials believed Treasury's guidance was unclear, the State never sought clarity on the meaning of "ownership interest" before enrolling the transaction.

Illinois did obtain, as required by the *SSBCI Policy Guidelines*, borrower and lender certifications attesting that the loan proceeds would not be used to purchase any portion of any ownership interest of any owner of the business. However, a review of the loan file identified documents with conflicting language that indicated the loan proceeds would be used to purchase stock, purchase assets, and obtain an ownership interest without mentioning the complete characteristics of the transaction. For example, the Applicant's project proposal described the project as, "purchasing the business assets...from the existing owner." However, in December 2011, the lender sent a loan request presentation to DCEO stating that, "the borrower will be the sole owner of the business once the purchase is made." Additionally, a January 2012 memorandum prepared by DCEO indicated that the proposed loan participation was intended to support the acquisition of assets of the business, but also stated that, "the borrower will own 100 percent of the stock issued for the [business]."

Due to inconsistent language in the loan documents, the OIG requested the *Stock Purchase Agreement*, which the State had not obtained, to ascertain the use of loan proceeds since the agreement is the definitive legal document governing the transaction. Upon reviewing the *Stock Purchase Agreement*, it was clear that the transaction included the purchase of stock, which conflicted with the borrower and lender certifications and the borrower's project proposal.

At the time this transaction was enrolled into the SSBCI program, it may not have been clear that a permissible use of funds would include the acquisition of a company via the purchase of a business's assets; however, it should have been readily apparent that the guidance prohibited the purchase of a business' stock. Therefore, it is our belief that if any documentation detailing a prospective transaction for enrollment indicated a potential stock purchase, further due diligence should have been performed to ensure the enrollment of only

compliant transactions. We submit that Illinois reviewed underwriting materials that should have prompted the request and review of additional documentation. By failing to procure the *Stock Purchase Agreement* before enrolling this transaction, Illinois deviated from acting in a manner consistent with the standards of ordinary care, and this deviation was highly unreasonable under the circumstances.

State officials stated their conduct was consistent with the standards of ordinary care because they acted in accordance with what they perceived to be a reasonable interpretation of the guidance communicated by their counsel and, as a result, they deemed the exact character of the transaction to be inconsequential as long as the purpose was in concert with their interpretation. The interpretation they relied upon, however, did not coincide with the plain meaning of the guidance that was in effect. We have consistently maintained that the exact structure of the transaction was of the utmost importance, and the State's failure to make this determination constituted a highly unreasonable departure from the standards of ordinary care.

We concluded the transaction constituted a "reckless misuse" of funds, as defined by Treasury, because the prohibition was clearly stated in *SSBCI Policy Guidelines*, and the noted inconsistencies in the loan file raised enough reasonable doubt to warrant further investigation by DCEO. Because DCEO reviews the loan file before electing to participate in a loan, it should have seen that the loan documents were inconclusive as to how the loan proceeds were to be used. Also as discussed above, the file contained language suggesting the borrower's intent to purchase the stock of the business, which contradicted the representations made by the borrower and lender. Yet, Illinois officials conceded that they did not review or obtain the *Stock Purchase Agreement* governing this transaction until after enrolling the loan.

Therefore, in our opinion, Illinois's failure to procure the *Stock Purchase Agreement*, in light of the guidance in place, constituted a highly unreasonable departure from the standards of ordinary care, qualifying the transaction as a "reckless misuse" of funds. As

required by the Act, Treasury must recoup the recklessly misused funds.

Illinois Did Not Fully Comply with Lender Sex Offender Assurance Requirements

Of the 33 CAP and loan participation transactions reviewed,⁸ 22 were not compliant with SSBCI lender sex offender certification requirements. Illinois obtained and executed *Master Agreements* with each lender attesting that no principal of the entity has been convicted of a sex offense against a minor; however, the agreements lacked all the requisite language.

The Act and *SSBCI Policy Guidelines* require lenders/investors to certify that their principals have not been convicted of a sex offense against a minor. Based on the *National Standards*, states may meet their obligation for such certifications by either (1) obtaining newly-executed sex offender certifications covering all principals of a lender/investor prior to enrolling each loan or investment in an SSBCI approved program, or (2) obtaining a set of sex offender certifications prior to enrolling any loans or investments and executing a written agreement with the lender/investor that creates a positive requirement to notify the state when an event occurs that renders the prior set of certifications obsolete.

Although Illinois had obtained a one-time sex offender certification from each lender for the transactions, its *Master Agreement* with each lender did not include language creating a positive requirement for the lenders to notify the State if and when an event occurs that would render the prior sex offender certifications obsolete.

⁸ Thirty-three expended transactions between the CAP and Participation Loan programs required both lender use-of-proceeds and sex offender certifications. However, 8 additional expended transactions (7 Venture Capital and 1 Direct Lending) required only lender use of proceeds certifications. In those 8 transactions, Illinois was acting in the capacity of a lender or investor and; therefore, the sex offender certifications were not required because the Act directs only “principals” of private entities to certify their sex offender status.

Because it is imperative that the State comply with all SSBCI program requirements, Treasury should require that Illinois modify its *Master Agreements* to include the required language mandating that lenders notify the State of changes in the sex offender status of their principals.

Illinois Did Not Complete Use-of-Proceeds Certifications for Direct Loans and State-Run Venture Capital Investments

Our review disclosed that for one direct loan and five venture capital transactions, the State had not completed the required lender/investor use-of-proceeds certifications. The *National Standards* require that “when a Participating State makes a direct loan or companion loan under an approved direct loan or loan participation program, three use-of-proceeds forms must be executed: one by the borrower, one by the participating state, and one by the lender making a companion loan.”

While Illinois collected a certification from the borrower for the direct loan transaction and from the investee and Venture Capital firm for the five investments, it did not complete the certifications required of the participating state in these transactions. Therefore, Treasury will need to notify Illinois that it must provide lender certifications on its own behalf when acting as a direct lender or investor.

Additionally, although Illinois was not in compliance with Treasury requirements for lender certifications for June 2012, September 2012, December 2012, and March 2013, the State certified that it was fully compliant with all program requirements. As a result, these certifications, which are required by Treasury’s *Allocation Agreement* with Illinois, were materially inaccurate.

Illinois Overstated the Private Financing Associated with One Loan Participation

In its *2012 Annual Report* to Treasury, Illinois inaccurately reported the total amount of a loan participation transaction. The amount reported to Treasury was approximately \$9.9 million although the

amount financed was \$5.2 million, resulting in an overstatement of approximately \$4.7 million.

The inaccuracy occurred because the private lender's contribution to the transaction was overstated. The lender with whom the State partnered with on the transaction, Northern Illinois Community Development Corporation, failed to notify the State that the project scope had materially changed after the SSBCI portion of the project had been funded. The borrower had also switched to a different lead lender, Alpine Bank. However, State officials also noted that no binding documentation existed requiring lenders to report on companion loans in which neither the State nor the lender had a direct interest. Additionally, Illinois officials stated that efforts to decrease the private companion loan financing was not material to Northern Illinois Community Development Corporation's decision, nor was it material to DCEO's participation in the loan.

Illinois has acknowledged the misreporting issue and maintains that it will report the correct amount in its next annual report. Additionally, to prevent similar occurrences in the future, the State is considering a modification to its borrower's certification form that will require borrowers to certify that the full project amount outlined in the project proposal reconciles with the actual total amount of financing received.

Although the \$100,000 in SSBCI funds used in this transaction was reported accurately, errors in reporting private financing can distort critical program performance indicators, such as the private leverage ratio. Therefore, Treasury should inform Illinois that it must adjust its next *Annual Report* to correct the \$4.7 million overstatement so that it has accurate data to evaluate the overall effectiveness of the SSBCI program.

Administrative Costs Charged to SSBCI Were Reasonable, Allowable, and Allocable

We tested a sample totaling \$589,882 of the \$1,036,808 of SSBCI funds expended by Illinois for administration of its SSBCI programs as of March 31, 2013. We found the sampled expenses were

reasonable, allowable, and allocable in accordance with *SSBCI Policy Guidelines* and Office of Management and Budget (OMB) Circular A-87. Section 4.2 of the Illinois *Allocation Agreement* states that the participating state shall only use the allocated funds for the purposes and activities specified in the agreement and for paying allowable costs of those purposes and activities in accordance with the cost principals set forth in OMB Circular A-87 (Cost Principles for State, Local, and Indian Tribal Governments) and codified in 2 C.F.R. Part 235.

Illinois provided supporting documents for all sampled administrative expenses charged to the SSBCI program, which showed that the expenses were allowable, reasonable, and allocable to the program.

Illinois is in Default of its Allocation Agreement

The audit identified several issues that could trigger a specific or general event of default of the *SSBCI Allocation Agreement* signed by Illinois. Pursuant to Section 6.3 of the Agreement, a finding of reckless misuse of allocated funds mandates Treasury to find the State to be in default. Under Section 6.1 of the Agreement, Treasury, in its sole discretion, may find the State to be in default of its *Allocation Agreement* if the State materially fails to comply with, meet, or perform any term, covenant, agreement, or other provision contained in the agreement. Additionally, Treasury may find the State to be in default of its *Allocation Agreement* if any representation or certification made to Treasury is found to be inaccurate, false, incomplete, or misleading in any material respect.

Because the State recklessly misused funds, Treasury shall find the State to be in a specific event of default of its *Allocation Agreement*. Additionally, the State's failure to comply with lender certification requirements, materially inaccurate compliance certifications, and inaccurate reporting of private financing may individually or collectively trigger a general event of default. Therefore, Treasury will need to consider whether a general event of default has occurred. If Treasury finds Illinois to be in default, it may (a) withhold disbursements pending correction of the default; or (b) wholly or partly

reduce suspend, or terminate the commitment of Treasury to make disbursements to the State.

Recommendations

We recommend that the Deputy Assistant Secretary for Small Business, Housing and Community Development:

1. Recoup the \$105,000 in recklessly misused funds and notify the State that it has incurred a specific event of default per its Allocation Agreement.
2. Require that the State modify its Master Agreements to include the required language that mandates lenders to notify the State of changes in the sex offender status of their principals.
3. Notify the State that it must provide lender certifications on its own behalf when acting as a direct lender or investor.
4. Inform Illinois that it must adjust its next Annual Report to correct for the \$4.7 million overstatement of a loan participation transaction identified by the audit.
5. Determine whether an event of general default has occurred resulting from the State's failure to comply with lender certification requirements, materially inaccurate compliance certifications, and inaccurate reporting of private financing, and if so, consider whether future funding to the State should be reduced, suspended, or terminated.

Management Comments and OIG Response

We provided a draft of the report to Treasury on February 21, 2014, and received their formal written comments on March 21, 2014, which also included prepared formal responses from Illinois dated March 17, 2014. Treasury accepted all of the report recommendations, stating that it will recoup \$105,000 from Illinois. Treasury will also require Illinois to modify any Master Agreements with lenders that are noncompliant and require Illinois to provide lender certifications when it is acting as a direct lender under the SSBCI program. Finally, Treasury will work with Illinois to adjust the \$4.7

million overstatement in the *2012 Annual Report* and determine whether a general default has occurred as a result of the OIG findings.

Illinois disagreed with the finding of “reckless misuse” stating that the State acted in accordance with its legal counsel’s interpretation of the SSBCI guidance and that the prohibition was not clearly articulated. Illinois also disagreed that it did not fully comply with the lender sex offender certification requirement, stating that the language in the sex offender certifications is identical to the suggested certification provided by Treasury. Finally, Illinois disagreed that it defaulted on its *Allocation Agreement* given that the deficiencies noted in the audit were rather minor.

As noted previously, SSBCI guidance at the time of the stock purchase expressly “prohibited the use of funds to purchase any portion of the ownership interest of any owner of a business.” Therefore, we believe Treasury’s guidance clearly articulated the prohibition. Also, while the State had obtained annual lender sex offender certifications using the language prescribed by Treasury, the certifications were incomplete as they omitted language that held each lender accountable for notifying the State should an event occur that rendered the certification obsolete, as required by Treasury. Finally, according to Illinois’ SSBCI *Allocation Agreement*, Treasury shall find the State to be in default of its agreement if the OIG has determined that the state recklessly misused SSBCI funds. Therefore, the State is in default of its *Allocation Agreement*. Treasury may also declare other general events of default if any representations, certifications, reports or other statements by the State is found to be inaccurate, false, incomplete or misleading in any material respect. Treasury has sole discretion to make such a declaration based on the audit findings.

We believe that Treasury’s planned actions are fully responsive to all of the audit recommendations. Formal written responses from Treasury and the state of Illinois are included in their entirety in Appendix 2.

* * * * *

We appreciate the courtesies and cooperation provided to our staff during the evaluation. If you wish to discuss the report, you may contact me at (202) 622-1090, or Lisa DeAngelis, Audit Director, at (202) 927-5621.

Debra Ritt
Special Deputy Inspector General for
Office of Small Business Lending Fund Program Oversight

Appendix 1: Objective, Scope, and Methodology

The objective of our audit was to test participant compliance with program requirements and prohibitions to identify any reckless or intentional misuse of funds. As of March 31, 2013, the state of Illinois had received its first disbursement totaling approximately \$25.9 million¹ and had obligated or spent roughly \$34.5² million. Of the \$34.5 million, approximately \$27.4³ million supported 88 transactions enrolled in the Illinois Participation Loan Program, approximately \$5.6⁴ million supported 19 enrolled investments in the Invest Illinois Venture Fund, \$1.0 million was used for 1 collateral support transaction, \$500,000 was used for 1 direct conditional loan transaction, and \$15,870 supported 7 transactions enrolled in the Capital Access Program. Furthermore, approximately \$1.0⁵ million was expended for the administration of the program.

To test compliance with SSBCI program requirements, we reviewed a random sample of 48 loans/investments (35 from the Illinois Participation Loan Program, 8 from the Invest Illinois Venture Fund, 3 from the Illinois Capital Access Program, 1 from the Collateral Support Program, and 1 from the Conditional Direct Loan Program) that were enrolled as of March 31, 2013, and performed testing to ensure all of the loans complied with the requirements and prohibitions of the Act and associated Treasury guidelines. During July 2013, we conducted an on-site review of loan files at the Illinois Department of Commerce and Economic Opportunity and compared the documentation to specific requirements and prohibitions of the Act and associated Treasury guidelines. We also reviewed a sample of the State's administrative expenses charged against SSBCI funds to ensure they were reasonable, allowable, and allocable in accordance with the *SSBCI Policy Guidelines*, and Office of Management and Budget Circular No. A-87, *Cost Principles for State, Local, and Indian Tribal*

¹ Rounded up from \$25,860,537.

² Rounded down from \$34,509,247.

³ Rounded down from \$27,423,377.

⁴ Rounded up from \$5,570,000.

⁵ Rounded down from \$1,036,808.

Government. Our sample included all indirect costs and select direct administrative expenses. We also interviewed Treasury SSBCI program staff to determine whether any additional guidance had been provided to the State on allowable uses of the SSBCI funds.

We interviewed management and staff designated by the state of Illinois that were responsible for administering, managing, accounting for, and reporting on the Illinois Capital Access Program, Illinois Participation Loan Program, Invest Illinois Venture Fund, Collateral Support Program, and Conditional Direct Loan Program. We reviewed policies, procedures, and other written guidance provided by DCEO. We conducted our audit between July 2013 and February 2014, in accordance with *Government Auditing Standards*. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained to address our audit objectives provides a reasonable basis for our findings and conclusions.

Appendix 2: Management Response



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 21, 2014

Debra Ritt
Special Deputy Inspector General for
Office of Small Business Lending Fund Program Oversight
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Ms. Ritt:

Thank you for the opportunity to review the Office of the Inspector General's (OIG) draft report entitled *State Small Business Credit Initiative: Illinois' Use of Federal Funds for Capital Access and Other Credit Support Programs* (the Report). This letter provides the official response of the Department of the Treasury (Treasury).

We appreciate the Report's finding that Illinois generally used State Small Business Credit Initiative (SSBCI) funds appropriately and that a majority of the sampled transactions complied with SSBCI program requirements. However, the Report also identified some instances of non-compliance. In response, with your consent, Treasury transmitted a copy of the Report to Illinois program officials on March 5, 2014. Treasury asked Illinois to provide a narrative response describing the measures it has taken or plans to take to address the deficiencies noted in the Report.

In its reply, enclosed, Illinois states that the State appreciates many of the Report's findings, but that the State disagrees with the conclusion that it "recklessly misused" any SSBCI funds. Illinois also disagrees with second recommendation that Illinois did not fully comply with the lender sex offender certification requirement. Illinois accepts recommendations 3 and 4. With respect to recommendation 3, Illinois has implemented a policy to complete self-certifications required on its own behalf when acting as a direct lender or investor. With respect to recommendation 4, Illinois is in the process of requesting to amend its 2012 Annual Report to properly reflect the private financing associated with the loan.

Treasury accepts all of the recommendations in the Report. Specifically, Treasury will recoup \$105,000 from Illinois. In addition, Treasury will require Illinois to modify any Master Agreements with lenders that are noncompliant, and Treasury will require Illinois to provide lender certifications when it is acting as a direct lender under an SSBCI program. Treasury will work with Illinois to adjust the \$4.7 million overstatement in the 2012 Annual Report. Finally, Treasury will determine whether a general default occurred as a result of the issues OIG identified in the last recommendation.

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Thank you once again for the opportunity to review the Report. Treasury appreciates our work together throughout the course of the SSBCI program.

Sincerely,

A handwritten signature in black ink, appearing to read "Cliff Kellogg", enclosed in a rectangular box.

Cliff Kellogg
Director of the State Small Business Credit
Initiative

Enclosure



**Illinois
Department of Commerce
& Economic Opportunity**

Pat Quinn, Governor

March 17, 2014

Mr. Don J. Graves, Jr.
Deputy Assistant Secretary for Small Business,
Community Development and Housing Policy
Department of the Treasury
Washington, DC 20220

VIA ELECTRONIC MAIL

Dear Mr. Graves:

Thank you for the opportunity to respond to the Office of the Inspector General's (OIG) draft report titled *STATE SMALL BUSINESS CREDIT INITIATIVE: Illinois' Use of Federal Funds for Capital Access and Other Credit Support Programs*, report number OIG-SBLF-14-0XX dated February XX, 2014. This letter serves as the State of Illinois' official response to the United States Department of the Treasury (Treasury).

Following submission of a strong application centered on a history of administrating similar programs in the past, Illinois was awarded the 4th largest allocation of any state in the country. To date, Illinois has successfully deployed \$56,658,813 in SSBCI funds which is second most in the country behind Michigan. The SSBCI funds deployed by Illinois are supporting 173 businesses and leading to the creation of 2,429 jobs and the retention of an additional 1,646 jobs. Illinois has run a highly successful program that has increased critical access to capital for small businesses across Illinois. Illinois' SSBCI program, branded *Advantage Illinois*, has developed into one of, if not the most, important economic development tools at the state's disposal.

Section Addressing Recommendation #1: Illinois Recklessly Misused \$105,000 to Support the Purchase of an Ownership Interest in a Business.

Illinois vigorously disagrees with the OIG's conclusion of "reckless" misuse or that this particular activity "constituted a highly unreasonable departure from the standards of ordinary care." Illinois' conduct was carefully conducted in accordance with its legal counsel's interpretation of

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the changing provisions of the multiple Guidelines issued by Treasury and accordingly, any characterization of that conduct as “reckless” is inappropriate and inaccurate.

The initial guidance that Treasury provided Illinois stated that “the proceeds of loans financed through an OCSP [which includes the loan in question] shall not be used for the following prohibited purposes . . . [e]ffecting a *partial* change of business ownership or a *change that will not benefit the business*. . .” (emphasis added). Illinois’ counsel interpreted this prohibition to apply to situations where the financing was used to allow one owner of a business to buy-out the other owners of a business, or other situations where the funds were to be used merely to recalculate the capital tables/ownership of a company – and resulting in no benefit to the business (such as hiring additional employees, expanding the business, purchasing equipment, etc.). This interpretation was reasonable based on the plain meaning of the words used, as well as the additional examples of prohibited uses provided by Treasury that related to situations where the financing provided no real benefit to the business (but rather a benefit to the owner or lender).

It was clear to Illinois that the loan in question would result in the creation of 10 new jobs and the expansion of the business - which are obvious benefits to the business. It was also clear that there was a complete and total change in ownership of the business (it was not merely one owner buying out his partner).

It is now apparent that Illinois’ counsel’s interpretation was not consistent with Treasury’s intent. However, that does not render Illinois’ conduct reckless nor does it lead to a conclusion that the transaction constituted a reckless misuse of funds.

Despite what the OIG states in its report, the prohibition was not clearly articulated in the numerous publications that Treasury provided. As stated above, the initial guidance provided by Treasury prohibited financing of “a *partial* change of business ownership or a *change that will not benefit the business*. . .” (emphasis added). Subsequently Treasury issued other publications containing guidance, where the language was modified to read “purchase any portion of the ownership interest of any owner of the business”. Given that the immediately preceding prohibitions were all in the vein of prohibiting the use of funds to merely benefit an owner and not the business (e.g. “loan proceeds will not be used to . . . reimburse funds owed to any owner, including any equity injection or injection of capital for the business’ continuance . . .”), Illinois’ counsel interpreted the prohibition to continue to apply to circumstances where there was no benefit to the business. The language “any equity interest” can mean the same as “partial change of business ownership”, thus the interpretation had a reasonable basis and was made in good faith.

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The OIG also incorrectly concludes that “the noted inconsistencies in the loan file raised enough reasonable doubt to warrant further investigation from [Illinois].” Based on the above-referenced interpretation of counsel, it was not material whether the transaction was structured as an asset purchase or a stock purchase because the result was the same – a small business that needed capital to (1) grow and (2) create jobs, was receiving capital that it otherwise would not. Thus, there was no need to further investigate. Following the advice of its counsel, Illinois did, in fact, act within the standards of ordinary care. Accordingly such conduct was not reckless.

Section Addressing Recommendation #2: Illinois Did Not Fully Comply with Lender Sex Offender Assurance Requirements.

Illinois disagrees with the recommendation. As stated by the OIG in its draft report, Illinois did obtain sex offender certifications from each lender enrolled in the program. The OIG claims that the certifications did not “include language creating a positive requirement for the lenders to notify the State if and when an event occurs that would render the prior sex offender certifications obsolete.” However nowhere in the National Standards is such language required. Treasury provided an example of an acceptable Sex Offender Certification, and nowhere in that example is there language creating the requirement suggested by the OIG. (See Appendix B to the National Standards, a true and correct copy attached hereto as Exhibit “A”).

The actual requirement is that such a certification is made for each loan in which Illinois participates. Illinois meets this requirement where the Lender certifies that

“[a]s to each Loan in which [Illinois] purchases a Participation, the Lender agrees that it will have determined that all of the following are true and correct: . . .

As required by Section 3011(c)(2) of the Small Business Jobs Act of 2010, no Principal of the Lender has been convicted of a sex offense against a minor (as such terms are defined in Section 111 of the Sex Offender Registration and Notification Act (42 U.S.C. § 16911)). For the purposes of this certification, “principal” means the following: if a sole proprietorship, the proprietor; if a partnership, each managing partner and each partner who is a natural person and holds a 20% or more ownership interest in the partnership; and if a corporation, limited liability company, association or a development company, each director, each of the five most highly compensated executives or officers of the Lender, and each natural person who is a direct or indirect holder of 20% or more of the ownership stock or stock equivalent of the Lender; . . .” (see Section 3 and 3(F) to the Master Agreement).

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It should be noted that the above certification language is verbatim to the language in Treasury's Sample Certification that it attached to its National Standards. Pursuant to this language, the Lender is certifying to Illinois each time it submits a loan to Illinois that it is compliant with the sex-offender certification. Accordingly, Illinois fully complied with Lender Sex Offender Assurance Requirements and disagrees with the recommendation of the OIG.

Section Addressing Recommendation #3: [Illinois Did Not Complete Use-of-Proceeds Certifications for Direct Loan and State-Run Venture Capital Investments.](#)

Illinois accepts this recommendation and will provide self-certifications for all direct loans and direct investments, and has already implemented this policy.

Section Addressing Recommendation #4: [Illinois Overstated the Private Financing Associated with One Loan Participation.](#)

Illinois accepts this recommendation and is in the process of amending its 2012 Annual Report to properly reflect the private financing associated with this loan. Additionally, the appropriate change has already been reflected in Illinois' Fourth Quarter 2013 Quarterly Report.

In this case, Illinois was asked to participate 50% in a \$200,000 Term Loan that was the key Working Capital component of a project totaling \$9.9 million. The remaining \$9.7 million portion was to be composed of two loans provided by Local Bank A plus new Borrower Cash Equity. The SSBCI-funded Term Loan in which Illinois participated was analyzed, approved, closed and disbursed by Illinois in its normal manner, in conformity with SSBCI Guidelines.

Unfortunately, without notice to Illinois, the Borrower decided to change from Bank A to Bank B in connection with the remaining \$9.7 million investment in the overall Project. Negotiations between Bank B and the Borrower resulted in Bank B agreeing to lend only \$5.0 million under an SBA-7A guaranteed facility at that particular time, thus delaying the real estate investment portion of the Project until a later date. Illinois' Lending Partner was belatedly advised of this change and, believing that the matter was of no concern to Illinois since our shared loan wasn't impacted, chose not to inform Illinois of this turn of events.

Illinois requires its Lending Partners to advise it of adverse changes in the status of joint loans or in the financial condition of Borrowers. When our Lending Partners are concurrently involved in "companion loans" within the same overall Project that do not require Illinois' participation, we nevertheless require and review copies of the "companion loan" Closing Documentation prior to disbursing Illinois' participation funds. The OIG's Recommendation has

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prompted Illinois to modify our practices going forward to include a formal review of the Closing Documentation of all companion loans, including those from third party Lenders.

Section Addressing Recommendation #5: Illinois is in Default of its Allocation Agreement.

When one takes into account how highly successful Illinois' SSBCI program has been (2nd most active in the entire country) and compares that to the rather minor findings contained in the draft report, it should not lead to a conclusion that Illinois is in default of its *Allocation Agreement*. As mentioned above, Illinois has administered one of the best performing SSBCI programs in the country deploying nearly \$57 million in SSBCI funding to support 173 small businesses in the state.

Given the high level of activity of Illinois' program, the nature of the results contained in the Draft Report are rather minor. One of those conclusions is incorrect, as it claims that Illinois failed to include language in its sex offender certification that is simply not required. One recommendation is purely administrative in nature (including an incorrect number in a quarterly report), that was caused by a third-party bank changing their financing without notifying Illinois, and has already been corrected. Another issue involved an improper participation in a loan totaling \$105,000. It should be noted that \$105,000 constitutes 0.18% of the total amount of SSBCI funds deployed by Illinois. It is not alleged that Illinois intentionally misused any funds, but rather misinterpreted changing, and arguably confusing, regulations. For Illinois to be held in default of its *Allocation Agreement* based on this negligible basis would do a great disservice to Illinois' SSBCI program.

Illinois looks forward to working with Treasury to fully deploy the third and final allocation of Illinois' SSBCI funding and stands ready to provide any additional information required in response to this audit.

Sincerely,



Adam Pollet
Director

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Exhibit A

Appendix B – Sample Sex Offender Certification

Treasury has created this sample self-certification that a participating state, territory or municipality may use in order to obtain certification from lenders, investors, and small business borrowers or investees. This certification is not intended to replace or supersede any internal controls the participating state, territory, or municipality has in place. Rather, this certification is provided for illustrative purposes and is available for use by the participating state, territory, or municipality according to their discretion. These sample certifications are also attached as Annexes to the SSBCI Frequently Asked Questions Document available at www.treasury.gov/ssbcj.

Example Sex Offender Certification (May be Used for Both Borrowers/Investees and Lenders/Investors)

This certification is required by Section 3011(c)(2) of the Small Business Jobs Act of 2010 from any private entity that receives a loan, a loan guarantee, or other financial assistance using funds received by a participating State under the State Small Business Credit Initiative.

Legal name of entity:

As required by Section 3011(c)(2) of the Small Business Jobs Act of 2010, the private entity hereby certifies to the participating State that the Principals of the private entity have not been convicted of a sex offense against a minor (as such terms are defined in section 111 of the Sex Offender Registration and Notification Act (42 U.S.C. 16911)). For the purposes of this Certification, Principal means the following: if a sole proprietorship, the proprietor; if a partnership, each managing partner and each partner who is a natural person and holds a 20% or more ownership interest in the partnership; and if a corporation, limited liability company, association or a development company, each director, each of the five most highly compensated executives or officers of the entity, and each natural person who is a direct or indirect holder of 20% or more of the ownership stock or stock equivalent of the entity.

Legal Name:

By: _____

Authorized Signatory

Name: _____

Title: _____

Date: _____

Appendix 3: Major Contributors

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The Office of Inspector General also acknowledges the contributions of the following individuals who worked on the revisions to the report: Susan Barron, Theresa Cameron, Regina Morrison, Nicolas Harrison, and Shaneasha Edwards.

Appendix 4: Distribution List

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