

Management Advisory Report

PLP Processing Restrictions for Paying off Existing SBA Debt in a Change of Ownership Transaction

**Report Number 5-27
September 28, 2005**

Washington, D.C.

The finding in this report is the conclusions of the Office of Inspector General's Auditing Division based on testing of SBA operations. The finding and recommendations are subject to review, management decision, and corrective action in accordance with existing Agency procedures for follow-up and resolution. This report may contain proprietary information subject to the provisions of 18 USC 1905 and must not be released to the public or another agency without permission of the Office of Inspector General.



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

MANAGEMENT ADVISORY REPORT
Issue Date: September 28, 2005
Report Number: 5-27

To: James Rivera, Associate Administrator,
Office of Financial Assistance

/s/ Original

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

Subject: PLP Processing Restrictions for Paying off Existing SBA Debt
in Change of Ownership Transactions

Attached is a copy of the subject advisory report. The report contains one finding and two recommendations. You concurred with both recommendations.

The finding in the report is the conclusion of the Office of Inspector General's Auditing Division. The finding and recommendations are subject to your review and corrective action in accordance with existing Agency procedures for audit follow-up and resolution.

Please provide your management response and actions to address the recommendations within 30 days from the date of this report on the attached SBA Forms 1824, Recommendation Action Sheet.

Any questions you may have regarding this report should be directed to Garry Duncan, Director, Credit Programs Group, at (202) 205-[FOIA Ex. 2].

Attachments

Management Advisory Report
PLP Processing Restrictions for Paying off
Existing SBA Debt in a Change-of-Ownership Transaction

Summary

The purpose of this management advisory report is to inform you of an issue identified during a review of certain loans originated by the Business Loan Center, LLC (lender). We reviewed selected paid-in-full (PIF) loans to determine whether they were processed in accordance with Small Business Administration (SBA) policies regarding preferred lender program (PLP) processing restrictions for paying off existing SBA debt in a change-of-ownership transaction.

Our review disclosed that the lender did not comply with SBA's PLP processing restrictions for paying off existing SBA debt in seven separate change-of-ownership transactions. Two transactions involved guaranty purchases for two defaulted loans totaling almost \$1.5 million. The lender has repaid the guaranty purchase amount on one of the loans. We believe recovery of the guaranty purchase amount paid for the second defaulted loan (number 4105574007) would be appropriate. The other five transactions involved same institution debt, whereby the lender paid off its existing SBA loans. Although the loans were current as of August 31, 2005, we believe flagging the current loans would be appropriate. In the event of default, guaranty purchase decisions should take into account the restrictions that made these loans ineligible for PLP processing.

SBA guidance on lender refinancing of an existing SBA loan

Prior to December 1, 2000, SBA had no clear policies precluding lenders from using their PLP authority to pay off existing SBA loans in a change-of-ownership transaction. Standard Operating Procedure (SOP) 50 10 (4), titled "Loan Processing", dated December 1, 1997, restricted a PLP lender from refinancing an existing loan on which it held a SBA guaranty. However, the SOP did not consider a loan for the purchase of a business to be refinancing, even if the proceeds were used to pay off the seller's existing SBA loan. Also, the lender prepared PLP checklist furnished to SBA when applying for a loan guaranty did not require disclosure of a seller's existing SBA loan. It only required disclosure of the purchaser's existing SBA loans.

On November 30, 2000, SBA published Revision "E" to SOP 50 10 (4). Revision "E" became effective on December 1, 2000, and covered major policy changes and clarifications, including loans to purchase businesses with outstanding SBA loans. Under Revision "E", a new subparagraph (e) was added to Subpart A, Chapter 2, Paragraph 12, titled "Paying off Seller Debt is not Refinancing to Effect a Change of Ownership". While the new policy re-stated SBA's position that paying off seller debt was not refinancing, it also required that if the debts of the business being sold included existing SBA debt, the loan could not be processed under any of the Agency's expedited loan processing programs. In such cases, the application must be processed by SBA under standard procedures. Revision "E", however, did not make a distinction between SBA debt at the same lending institution and SBA debt at a different lending institution.

On November 19, 2001, SBA issued Procedural Notice No. 5000-761, titled “Loan Processing Restrictions on Paying off Existing SBA Debt and Servicing Procedure for Loan Assumptions”. The notice became effective on November 19, 2001, and amended the second paragraph to SOP 50 10 (4) (E), Subpart A, Chapter 2, Paragraph 12, Subparagraph (e). This policy notice expired on November 1, 2002. SBA policy in existence prior to December 1, 2000, did not clearly restrict a PLP lender from paying off existing loans on which it held SBA guaranties except in the case of a refinancing. Under the existing procedures, lenders were restricted from using their PLP authority to pay off an existing SBA loan in a change-of-ownership situation. Under the new procedure, lenders with PLP authority could process change-of-ownership transactions as long as the SBA guaranteed loan being paid off was NOT with the same lending institution.

PLP processing restrictions

We obtained the lender’s paid in full (PIF) database from the Accounting Systems Branch of SBA’s Office of the Chief Information Officer. The database consisted of 1,246 PIF loans that were sorted by borrower street addresses. The Branch also provided a database of all other lender loans, excluding those that had been cancelled. The database consisted of 5,105 loans and included those in regular servicing, liquidation, charged-off, and sold status. This database was also sorted by the borrower’s street address. As such, we identified change-of-ownership transactions by comparing street addresses in both databases. Our review showed that 14 relationships involved change-of-ownership transactions. Details of these relationships are discussed in the following paragraphs.

Change-of-ownership transactions between December 1, 2000, and November 18, 2001

Three change-of-ownership loan transactions were originated during this period (see Exhibit 1 for loan transaction details). Pursuant to Revision “E” of SOP 50 10 (4), the lender was prohibited from using its PLP authority to pay off existing SBA loans.

The loan to Hamilton Motel (PLP-4245654009) was approved in January 2001. On the PLP checklist, the lender did not identify that the loan paid off existing SBA debt. There was no mention of its existing SBA loan to the seller (PLP-1805124009). As of August 31, 2005, the loan was current.

On December 4, 2000, the lender submitted an application for a 62.5 percent guaranty on a \$1.2 million PLP loan to Yousafi, LLC d/b/a Villager Lodge (PLP-4105534006). According to the PLP checklist, the purpose of the loan was to purchase real estate and personal property. The lender did not identify the loan as paying off existing SBA debt. Again there was no mention of its existing SBA loan to the seller, Home Vacation, Inc. (formerly Cook and Host, Inc) d/b/a Village Lodge (PLP-2877904000). Six months after funding, the lender granted a three month deferment resulting in no principal reductions to the loan between June 2001 and November 2002. In April 2004, the loan went into default and on July 7, 2004, the SBA purchased the guaranty from the secondary market in the amount of \$736,874.

On December 4, 2000, the lender also submitted an application for a 56.20 percent guaranty on a \$1.3 million PLP loan to Yogi Hospitality, LLC d/b/a Ramada Inn

(PLP-4105574007). According to the PLP checklist, the purpose of the loan was to purchase real estate and personal property. Again the lender did not identify the loan as a change-of-ownership transaction and there was no mention of its existing SBA loan to the seller, Host and Cook, Inc. d/b/a Ramada Inn (PLP-2877894010). Six months after funding, the lender granted a three month deferment resulting in no principal reductions to the loan between June 2001, and July 2002. In April 2004, the loan went into default and on July 6, 2004, the SBA purchased the guaranty from the secondary market in the amount of \$737,190.

On November 4, 2004, we provided the lender with a list of all the PIF loans under review and asked how the loans were paid off. As a result of our inquiry, the lender on November 15, 2004, contacted SBA's National Guaranty Purchase and Liquidation Center (Center) offering to repay the guaranties on the loans to Villager Lodge (PLP-4105534006) and Ramada Inn (PLP-4105574007). The lender stated that although it had approved the loans prior to December 1, 2000, delays in processing and closing made the loans technically ineligible for PLP processing. As such, the lender wished to honor its obligations and requested pay-off figures for both loans. On December 3, 2004, the lender repaid the guaranty on the loan to Villager Lodge in the amount of \$736,994.

In an e-mail dated November 15, 2004, the SBA Loan Programs Division advised the Center that since both loans were approved on December 4, 2000, they were subject to Revision "E" of SOP 50 10 (4) that became effective on December 1, 2000. Under Revision "E", lenders were prohibited from using their PLP authority to pay off existing SBA loans in a change-of-ownership situation. Nevertheless, while SBA "...appreciated the lender's offer to repay the guaranties..." it thought that the lender was imposing too harsh a penalty on itself and recommended a repair. The following day, the Center forwarded the e-mail to the lender.

Based on comments made in the above referenced e-mail, the lender did not repay the guaranty on the loan to Ramada Inn. Instead, in a December 9, 2004, letter to the Center, the lender stated that principal and interest payments on the Ramada Inn loan had been made in a timely manner for 3½ years; however, when the borrower ran into financial difficulties in March 2004, a deferment was granted to alleviate cash flow problems. The lender's November 15, 2004, letter to the Center also stated that it was in the process of liquidating the loan.

The lender's status reports to SBA, however, showed that SBA's analysis was incorrect as there were no principal reductions on the loan between June 2001 and July 2002. The status reports showed other periods where there were no principal reductions. The lender also neglected to mention that at the time of origination, the SBA loan was secured by a second mortgage on the commercial real estate, subject to a \$1.6 million first mortgage in favor of F&M Bank-Richmond. At the time of origination, the commercial real estate and personal property appraised at \$3.6 million. The business, however, is now closed and the current appraisal as of August 2004, valued the real estate and personal property at \$940,000. Pursuant to the lender's liquidation plan, the first lien holder was foreclosing and negative equity under SBA's second position totaled over \$700,000. There was no additional collateral. On February 7, 2005, the lender acknowledged by e-mail that it expects no recovery.

Change-of-ownership transactions after November 19, 2001

Four change-of-ownership transactions were originated during this period (see Exhibit 2 for loan transaction details). All loans were current as August 31, 2005. Pursuant to SBA Procedural Notice 5000-761 that amended Revision "E" of SOP 50 10 (4) as of November 19, 2001, lenders were prohibited from using their PLP authority to pay off existing

SBA loans at their own institutions. Specific details of the transactions follow.

- Under this transaction, the seller's existing SBA loan (PLP-3068574002) had been approved by the lender in July 1999. In January 2003, the lender approved another loan for the purchase of the motel (Econolodge Bedford). The PLP checklist, however, did not identify the new loan (PLP-6004854008) as paying of existing SBA debt. Its stated purpose was to acquire real estate and personal property. The loan was funded in April 2003. In a letter dated December 3, 2004, lender's counsel stated that SBA had approved the loan prior to funding. An e-mail dated December 9, 2004, from the Little Rock Loan Servicing Center, however, stated that there were no SBA approvals of any kind in the loan file. The lender has also not provided any supporting documentation and since June 2004, there have been no principal reductions on the loan.
- Loans to A Bar Z Motel (PLP-9233263009) and Rodeway Inn (PLP-1753504002) were approved by Emergent Business Capital and later acquired by Transamerica. In September 2002, the lender acquired both loans from Transamerica. As such, when the lender paid off the loan to A Bar Z Motel in May 2003, it already owned the seller's existing SBA loan. The PLP checklist for the new loan to Traveler Inn (PLP-6274224007), however, did not identify the loan as paying off existing SBA debt. Similarly, when the lender paid off the loan to Rodeway Inn in October 2003, it already owned the seller's existing SBA loan. The PLP checklist for the new loan to Rodeway Inn (PLP-6744624004) also did not identify the seller's loan as same institution
- A loan to Noah's Ark Academy (PLP-4053314007) was approved by Amresco Independent Funding, and then purchased by the lender in January 2003. As such, when the lender paid off the Noah's Ark Academy SBA loan in June 2004, it already owned the seller's existing SBA loan. The PLP checklist for the new loan to Noah's Ark Academy (PLP-7553164010) did not identify the seller's loan as same institution debt.

Recommendations

We recommend that the Associate Administrator, Office of Financial Assistance take the following actions.

- A.1 Recover from the lender the guaranty paid on loan number PLP-4105574007 in the amount of \$737,190.
- A.2 In accordance with SBA Policy Notice 5000-761, flag the following current loans.
 - PLP-4245654009
 - PLP-6004854008
 - PLP-6274224007
 - PLP-6744624004
 - PLP-7553164010

If a loan defaults, the guaranty purchase decision should take into consideration that it was ineligible because the lender was prohibited from using its PLP authority to pay off the existing SBA loan.

Management Comments

In response to recommendation A.1, SBA agreed to pursue full recovery of the guaranty paid on the loan in question. See Attachment A for the management comment.

In response to recommendation A.2, the Office of Financial Assistance agreed to flag the five loans. It will be noted through the Guaranty Repair Tracking System procedures that these are PLP loans with change of ownership eligibility issues and that these issues should be carefully considered during the purchase review process.

OIG Evaluation of Management Comments

Management comments are responsive to the recommendations.

Change of Ownership Transactions December 1, 2000, to November 18, 2001

PLP Loan No.	Borrower Trade Name Address	Originating Lender Location	Approval Date	Loan Amount	Date Funded	Gty %	PIF Date	Balance at PIF	Current Status	Balance at 12/31/04
2877904000 Transaction 1	Home Vacation, Inc. f/k/a Cook and Host, Inc.	Business Loan Center	04/07/99	\$1,000,000	07/31/99	75	12/31/00	\$992,376	PIF	N/A
	Villager Lodge 17-41 N. Little Church Petersburg, VA	Richmond, VA								
4105534006 Transaction 2	Yousafi, LLC	Business Loan Center	12/04/00	\$1,200,000	12/31/00	62	12/03/04	\$ (1)	PIF	N/A
	Villager Lodge 14-41 N. Little Church Petersburg, VA	Richmond, VA								

(1) On 7/7/04, SBA purchased the guarantee from the secondary market in the amount of \$736,874. On 12/03/04, the lender repaid the guarantee in the amount of \$736,994.

PLP Loan No.	Borrower Trade Name Address	Originating Lender Location	Approval Date	Loan Amount	Date Funded	Gty %	PIF Date	Balance at PIF	Current Status	Balance at 12/31/04
2877894010 Transaction 1	Host and Cook, Inc.	Business Loan Center	04/07/99	\$1,000,000	07/31/99	75	12/31/00	\$ 993,029	PIF	N/A
	Ramada Inn 501 E. Washington St. Petersburg, VA	Richmond, VA								
4105574007 Transaction 2	Yogi Hospitality, LLC	Business Loan Center	12/04/00	\$1,333,000	01/31/01	56	N/A	N/A	[FOIA Ex 4] PIF	\$ 737,190 (2)
	Ramada Inn 501 E. Washington St. Petersburg, VA	Richmond, VA								

(2) On 7/6/04, SBA purchased the guarantee from the secondary market in the amount of \$737,190.

Change of Ownership Transactions After November 18, 2001

PLP Loan No.	Borrower Trade Name Address	Originating Lender Location	Approval Date	Loan Amount	Date Funded	Gty %	PIF Date	Balance at PIF	Current Status	Balance at 12/31/04
3068574002 Transaction 1	Savitri Corporation, Inc.	Business Loan Center	07/15/99	\$ 673,000	09/30/99	75	04/30/03	\$ 645,880	PIF	N/A
	Bedford Econolodge	Richmond, VA								
	RD #2 Box 28									
	Bedford, PA									
6004854008 Transaction 2	Econolodge Bedford	Business Loan Center	01/09/03	\$ 675,000	04/30/03	75	N/A	N/A	Current (3)	\$ 643,156
	Econolodge Bedford	Richmond, VA								
	141 Hillcrest Drive									
	Bedford, PA									

(3) No principal reductions have been made on the loan since June 2004.

PLP Loan No.	Borrower Trade Name Address	Originating Lender Location	Approval Date	Loan Amount	Date Funded	Gty %	PIF Date	Balance at PIF	Current Status	Balance at 12/31/04
9233263009 Transaction 1	[FOIA Ex. 6] A Bar Z Motel 2690 W. Highway 40 Craig, CO	Emergent Business Capital (4) Greenville, SC	04/29/96	\$ 880,000	04/30/96	75	05/31/03	\$ 803,986	PIF	N/A
6274224007 Transaction 2	[FOIA Ex. 6] Traveler Inn 2690 W. Highway 40 Craig, CO	Business Loan Center New York, NY	04/25/03	\$ 619,000	05/31/03	75	N/A	N/A	Current	\$ 606,652

(4) Lender acquired loan in September 2002 from Transamerica (successor to Emergent Business Capital).

Change of Ownership Transactions After November 18, 2001

PLP Loan No.	Borrower Trade Name Address	Originating Lender Location	Approval Date	Loan Amount	Date Funded	Gty %	PIF Date	Balance at PIF	Current Status	Balance At 12/31/04
1753504002 Transaction 1	Prabhavi, LLC Rodeway Inn 1919 Highway 16 South Graham, TX	Emergent Business Capital (5) Greenville, SC	12/19/97	\$ 757,000	01/31/98	75	10/31/03	\$ 694,413	PIF	N/A
6744624004 Transaction 2	[FOIA Ex. 6] Rodeway Inn 1919 Highway 16 South Graham, TX	Business Loan Center New York, NY	09/30/03	\$ 910,000	10/31/03	75	N/A	N/A	Current	\$ 894,189

(5) Lender acquired loan in September 2002 from Transamerica (successor to Emergent Business Capital).

PLP Loan No.	Borrower Trade Name Address	Originating Lender Location	Approval Date	Loan Amount	Date Funded	Gty %	PIF Date	Balance at PIF	Current Status	Balance at 12/31/04
4053314007 Transaction 1	Children's First Noah's Ark Academy 14563 Okeechobee Loxahatchee, FL	Amresco Independent Funding (6) Dallas, TX	11/08/00	\$ 960,000	11/30/00	75	06/30/04	\$ 879,278	PIF	N/A
7553164010 Transaction 2	Preschool Management II, Inc. Noah's Ark Academy 14563 Okeechobee Loxahatchee, FL	Business Loan Center New York, NY	06/24/04	\$1,345,000	06/30/04	75	N/A	N/A	Current	\$1,337,011

(6) Lender acquired loan in January 2003 from Amresco Independent Funding.



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

Attachment A

DATE: September 27, 2005
TO: Robert G. Seabrooks
Assistant Inspector General for Auditing
FROM: James E. Rivera, AA/FA
SUBJECT: Management Advisory Report

This is in further response to the above referenced management advisory report. We recently received a copy of a letter dated November 15, 2004 from Leonard Rudolph to SBA in which Business Loan Center, LLC offered to repay the amounts disbursed by the Agency to the secondary market holders of SBA guaranteed loans to Yogi Hospitality LLC (410-557-4007) and Yousafli, LLC (410-553-4006). The lender has repaid loan 410-553-4006 in full, and has repaid \$350,000 of loan 410-557-4007 pursuant to a "repair" action structured by the National Guaranty Purchase Center.

In view of the lender's offer to repay both loans, we concur with the recommendation in the management advisory report with respect to recovery of the amount disbursed by SBA to purchase loan 410-557-4007, less the payment of \$350,000 already made by the lender. We will request the lender to remit such payment.