REDACTED FOR FOIA

AUDIT OF AN EARLY DEFAULTED 7(a) LOAN TO

NADI MANUFACTURING, INC.

AUDIT REPORT NO. 0-11

March 28, 2000

The finding in this report is the conclusion of the OIG's Auditing Division based on testing of the auditee's operations. The finding 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

AUDIT REPORT
ISSUE DATE: MARCH 28, 2000
REPORT NUMBER: 0-11

To: John M. Quinn, District Director
San Francisco District Office

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

Subject: Audit of an Early Defaulted Loan to NADI Manufacturing, Inc.

Attached is a copy of the subject audit report. The report contains one finding and two recommendations addressed to your office. Your comments and the comments of the lender have been synopsized and included in the report. Your comments indicate that you agree with the audit results and recommendations. The lender stated it was willing to work out a satisfactory resolution of the issues.

The recommendations are subject to review and implementation of corrective action by your office in accordance with the existing Agency procedures for follow-up. Please provide your management response to the recommendations using the attached SBA Forms 1824, Recommendation and Action Sheet.

Any questions or discussions of the issues contained in the report should be directed to Garry Duncan at 202-205-7732.

Attachments

AUDIT OF AN
EARLY DEFAULTED LOAN TO
NADI MANUFACTURING, INC.

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BACKGROUND

The Small Business Administration (SBA) is authorized under section 7(a) of the Small Business Act to provide financial assistance to small businesses in the form of government guaranteed loans. SBA guaranteed loans are made by participating lenders under an agreement (SBA Form 750) to originate, service and liquidate loans in accordance with Administration rules and regulations.

In [ex. 4] Heller First Capital Corporation (lender) approved loan number [ex. 4] to NADI Manufacturing, Inc. (borrower) under Preferred Lender Program procedures. The $350,000 loan was made to restructure an existing debt with a 75 percent SBA guarantee. In July 1997, the lender requested that the loan be placed in liquidation after the borrower made one payment. In July 1997, the borrower filed for bankruptcy and, in October 1998, SBA purchased the loan guarantee.

AUDIT SCOPE AND OBJECTIVE

This report provides the conclusions of an audit of a SBA guaranteed loan. The loan was judgmentally selected for review as part of the Office of Inspector General's ongoing program to audit SBA guaranteed loans charged off or transferred to liquidation within 36 months of origination (early default).

The audit objective was to determine if the early loan default was caused by lender or borrower noncompliance with SBA's requirements. The SBA and lender loan files were reviewed and district office and lender personnel were interviewed. The borrower's financial records were analyzed and business associates interviewed. The audit was conducted between June and August 1999 in accordance with Government Auditing Standards.

RESULTS OF AUDIT

Finding   The Lender did not Follow SBA Loan Origination Requirements

The default occurred because the borrower lacked the ability to repay the loan, was not creditworthy at the time of loan origination, and lacked the financial assets to survive. The lender's actions allowed the loan proceeds to be indirectly used for an ineligible purpose. As a result, SBA inappropriately paid the lender $266,311 to purchase the guarantee.

Overstated repayment ability

The lender's cash flow calculation used to determine the borrower's repayment ability excluded debts totaling $194,116. Because the debts were excluded, the lender erroneously calculated net cash flow to be $89,846 instead of negative $102,470 (see Appendix A). Section 120.150, Title 13 of the Code of Federal Regulations (CFR) requires borrowers to have the ability to repay loans from their business earnings.

FOIA ex. 4

Poor credit history

The lender overlooked evidence regarding the borrower's creditworthiness by rationalizing that the deficiencies were typical for a growing business. The borrower's credit reports and financial statements showed a history of late payments, unpaid Federal taxes, past due rents, overdrawn checking accounts, and an inability to absorb additional debt. Section 120.150 of the CFR requires lenders to assess the borrower's creditworthiness and credit history prior to approving a SBA guaranteed loan.

Overstated net worth

The lender overstated the borrower's net worth by $433,394. This occurred when the lender omitted tax liabilities and a second line of credit from the financial analysis. As shown in Appendix B, the borrower's actual net worth before obtaining the SBA loan was negative $625,989 not a negative $192,595 as computed by the lender.

The borrower's negative net worth and increasing debts showed financial instability that should have indicated that the business could not survive. Section 120.150 of the CFR and SOP 50-10 require the lender to ensure that the borrower's business has a sufficient chance for success and that the SBA loan can be repaid.

Inappropriate use of loan proceeds

The borrower used SBA loan proceeds to indirectly pay delinquent Federal withholding taxes and penalties totaling $276,562. Prior to approving the loan, the lender required the borrower to pay off its Federal tax liens. The borrower reported it lacked the funds to pay the taxes. So the lender issued a letter to the holder of the first loan, [ex. 4] confirming that the SBA loan proceeds would be released after a line of credit was extended that allowed the borrower to pay off the tax liens. [ex. 4] then provided a $260,000 second line of credit that the borrower used to pay the delinquent Federal taxes. After the tax liens were removed, the lender released the loan proceeds of $350,000. Appendix B shows that the borrower's total debts to [ex. 4] declined from $450,229 to $360,229 and the Federal tax liens shrank from $276,562 to $0. Sections 120.160 (d) of the CFR and SOP 50-10 prohibit using SBA loan proceeds to pay past-due taxes.

Impact on the SBA guarantee

The lender's violations as described above resulted in the approval and disbursement of a SBA guaranteed loan to a borrower that was not creditworthy and lacked the ability to repay the loan. Section 120.524, Title 13 of the Code of Federal Regulations states that SBA is released from the payment of a loan guarantee if the lender has failed to comply materially with any of the obligations of the regulations or the Loan Guarantee Agreement.

FOIA ex. 4

Recommendations

We recommend that the San Francisco District Office take the following actions:

1a. Repair the loan guarantee by recovering $266,311 from the lender for loan number [ex 4]

1b. Remind the lender of its obligation to comply with SBA regulations, policies and procedures for originating and disbursing loans, particularly in the areas of determining repayment ability, creditworthiness, net worth, and use of loan proceeds.

District Office comments

The San Francisco District Office agreed with the finding and recommendations. On March 15, 2000, the district office issued a letter to the lender requesting that the lender repay SBA for the amount of the guarantee percentage. This amount was calculated at $266,311 (see Appendix C).

The district office verbally stated that they met twice in 1999 with lender officials from the Chicago Office to discuss loan deficiencies and lender obligations.

Evaluation of District Office comments

The district office comments and actions are responsive to the recommendations.

Lender comments

The lender concurred with the audit finding and stated it would not have approved or closed this loan under its current underwriting and closing procedures. The lender agreed certain liabilities were omitted and stated that it did not intend to circumvent the SBA prohibition on paying past due taxes and the use of loan proceeds. The lender stated that it is willing to work out a satisfactory resolution if the district office requires a repair or guarantee adjustment (see Apendix D).

Evaluation of lender comments

The lender comments are responsive to our recommendations.

FOIA EX. 4

Appendix A

Calculation of Cash Flow and Repayment Ability at Loan Application

NADI Manufacturing, Inc.

	Heller Calculations 1996 (Actual)	Audit Calculations 1996 (Actual)
Cash Available		
Net Income	$15,164	$15,164
Interest	8,663	8,663
Depreciation	10,032	10,032
Finance Fees	109,852	109,852
Officers Salaries	165,651	165,651
Owner's Draw	-83,400	-83,400
Gross Cash Flow	**$225,962**	**$225,962**
Debts		
[Ex.4] ($450,000 pre-loan)	$42,000	
[Ex.4] ($260,000 post-loan)		$ 42,000
Credit Card	9,600	20,400
Other	12,600	
Note Payable-[Ex.4]($17,200)		10,356
Loan Payable-Line of Credit ($44, 876)		26,928
1995 Federal Tax Liabilities		156,832
Debt Service Subtotal	**$64,200**	**$256,516**
Net Cash Flow Prior to the SBA Loan	**$161,762**	**($30,554)**
Heller/SBA Loan ($350,000)	71,916	71,916
Total Required Debt to Service	**$136,116**	**$328,432**
Net Cash Flow After SBA Loan	**$89,846**	**($102,470)**

Fo:A Ex.4

Appendix B

Financial Position Before and After Loan Approval

NADI Manufacturing, Inc.

	Before the Loan		After the Loan	
	Heller	Actual	Heller	Actual
Cash				
Accounts Receivable	$566,466	$566,466	$566,466	$566,466
Inventory	146,414	146,414	146,414	146,414
Prepaid	6,976	6,976	6,976	6,976
Total Current Assets	719,856	719,856	719,856	719,856
Fixed Assets	10,856	10,856	10,856	10,856
Other Assets	9,180	9,180	9,180	9,180
Total Assets	**$739,892**	**$739,892**	**$739,892**	**$739,892**
Account Payable	$137,816	$137,816	$137,816	$137,816
Accrued Expenses	256,033	256,033	256,033	256,033
1991-94 Tax Liabilities (Liens)		**276,562**		0
Advances from [ex 4]				**260,000**
1995 Tax Liabilities		**156,832**		**156,832**
Advance from [ex. 4]	450,229	450,229	100,229	100,229
Cash Overdraft	25,483	25,483	25,483	25,483
Heller/SBA Loan			35,151	35,151
Total Current Liabilities	869,561	1,302,955	554,712	971,544
Notes Payable	62,926	17,200	62,926	17,200
Loan Payable		44,876		44,876
Loan to Shareholders		850		850
Heller/SBA Loan			314,849	314,849
Total Liabilities	**$932,487**	**$1,365,881**	**$932,487**	**$1,349,319**
Net Worth	**-$192,595**	**-$625,989**	**-$192,595**	**-$609,427**

[1] Second line-of-credit used to pay Federal tax liens.

FOIA Ex. 4

Appendix C

U.S. SMALL BUSINESS ADMINISTRATION
SAN FRANCISCO DISTRICT OFFICE
455 MARKET STREET, 6TH FLOOR
SAN FRANCISCO, CA 94105-2445

March 15, 2000

[ex. 6]
Deputy General Counsel
Heller Financial
900 Circle 75 Parkway, Suite 900
Atlanta, GA 30339

Subject: Nadi Manufacturing
SBA # [ex. 4]

Dear [ex. 6]

Last week we met with the Inspector General (I.G.) Auditors that reviewed the subject file. Pursuant to that meeting, this office re-evaluated the additional loan documentation submitted related to the PLP approval of the subject loan.

The following major deficiencies were noted in the approval and disbursement of this loan:

The lender's credit memo was dated November 21, 1996, and stated that NADI owed the IRS approximately $100,000. The credit memo outlined that the past due taxes were to be repaid by a line of credit issued by [ex. 4] (in the amount of $100,000 and not to exceed an amount of $200,000) before the SBA loan was disbursed. However, it appears Heller had evidence in the loan file from IRS dated October 23, 1996, that the amount of the unpaid withholding taxes was in excess of $275,000, not $100,000 as noted in the credit memo. The cash flow analysis in the credit memo did not take into consideration the repayment for this amount of additional debt (and it also appeared to omit other liabilities and did not appear to accurately reflect the actual cash position of the business).

On February 17, 1997 [ex. 4] sent a letter to Heller to confirm that they had issued a credit line of $260,000, and included a copy of the cashier's check in the amount of $270,426.54 payable to IRS. Since this amount represented a substantial discrepancy from the original credit terms, this should have been considered an "adverse change" and triggered a review of the credit to determine if the company had sufficient cash flow and repayment ability to cover this additional debt. Apparently that was not done and Heller disbursed the loan on February 19, 1997, according to the Settlement Sheet of that date.

It is the opinion of our office that the above deficiencies in analyzing this loan request do not reflect prudent lending practices and were in violation of SOP 50 10 subpart "D," Chapter 3, Paragraph 8.b and 13 CFR §120.150. The business failed after making only two payments on this loan, which may further support the contention that the business did not have the repayment ability to handle this additional debt, along with its other liabilities. It appears these deficiencies are significant enough to suggest a "denial of liability" under the Guaranty Agreement. While only the SBA Administrator has the authority to deny liability, a lender may voluntarily repay SBA for a loss attributable to a loan.

Due to the facts as stated above, SBA has determined that its loss attributable to this loan is the full principal balance. Therefore, SBA respectfully requests that Heller Financial reimburse

FOIA EX. 4, 6

REDACTED IN FULL

Redaction Number: 1

FOIA Exemption #: 4, 5, 6

PA Exemption #:

# of Withheld Pages: 2

Description: APPENDIX C : MODIFICATION AND ADMINISTRATION ACTION

SBA for the amount of the guarantee percentage minus any amounts already repaid since the guaranty was purchased. Our calculations indicate that this amount is $266,310.59. The guaranteed portion of 75 percent would be $199,732.94.

If Heller Financial does not feel this amount is justified, please provide any missing or additional documentation, corrections or comments regarding these deficiencies at your earliest convenience. Please feel free to contact me at [EX. 6] should you have any questions.

Sincerely,

Spencer Stratton
Assistant District Director for Financial Assistance

Cc: [EX. 6] Office of Inspector General, Audit Manager

[FOIA EX. 6]

Heller Financial, Inc.
900 Circle 75 Parkway, Suite 900
Atlanta, Georgia 30339
Telephone: (770) 980-6016
Facsimile: (770) 980-6215

Heller Financial

[Ex. 6]
Deputy General Counsel

VIA FEDERAL EXPRESS
AND U.S. MAIL

January 31 , 2000

[Ex. 6]
Small Business Administration
Office of Inspector General
330 North Brand Boulevard, Suite 650
Glendale, CA 91203-2304

Re: **Audit of Early Defaulted Loan to NADI Manufacturing, Inc.**

Dear [Ex. 6]

This letter is in response to the audit of the early defaulted loan, NADI Manufacturing, Inc. As we explained to the auditors in California, and again when those auditors were visiting our Chicago office, this loan, closed in 1997, would not be approved or closed under our current underwriting and closing procedures. That being said, we tried to explain that the growth this company was undergoing had made them cash poor and we had thought a restructure of short term debt would allow a growing company to survive. Unfortunately, this did not occur.

It is also true that we requested the borrower to pay its Federal taxes and we were certain our loan proceeds would not be used to pay past due taxes. The audit implies we sought to circumvent that and we did not. Our loan proceeds became part of the working capital of the company and to some extent you can say our proceeds (at least some of them) went to pay a lender who, as working capital lender, did pay back taxes (as well as other obligations).

That being said, and with the information we had when we did the loan, we honestly thought this growing company could use this restructure, long term and succeed. We do recognize that we may have omitted certain of borrower's liabilities.

FOIA Ex. 6

Heller Financial

As we have stated on numerous occasions, we value our relationship with the SBA and each district we do business. We will not let one loan or a disagreement on the underwriting or approval of one loan jeopardize that relationship. If the district contacts require a repair or guarantee adjustment, we will work out a satisfactory resolution of the issue.

Cordially,
HELLER FINANCIAL, INC.

[EX. 6]

Deputy General Counsel

[EX. 6]

FOIA EX. 6

Appendix E

AUDIT REPORT DISTRIBUTION

Recipient	**Number of Copies**
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General Accounting Office	1