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## SBA Office of Inspector General Scrutinizes Small Business Lenders: Lenders at Risk for Denial of SBA Loan Guarantees

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On September 8, 2008, the Small Business Administration's Office of Inspector General issued its third report this year criticizing SBA oversight of lenders and calling for tighter controls on lenders' activities. These reports come as the OIG is aggressively working with US Attorneys to pursue civil and criminal cases against lenders, their employees, and their brokers. SBA OIG referrals resulted in 96 indictments, 71 convictions, and \$25 million in recoveries and fines in the last reported period.

In its most recent report, the OIG identified deficiencies "so egregious" that it called for a full denial of the SBA loan guarantee on six loans originated by six different lenders. The "material lender noncompliance" alleged by the OIG included inadequate evidence of equity injection, inadequate evidence of IRS tax verifications, inadequate appraisals, and failure to disclose environmentally contaminated property. Because of these errors, the OIG called on the SBA to seek recovery of the full guarantee amount plus interest, despite the fact that the SBA conducted two comprehensive reviews of these loans before charging off their outstanding balances. The SBA is seeking responses from the cited lenders, but has noted that three of the repurchases occurred over six years ago, meaning that the statute of limitations may bar SBA recovery.

The September 8 report follows two other audits this year criticizing SBA oversight of five other lenders:

- On May 9, 2008, the OIG issued an audit titled *Oversight of SBA Supervised Lenders*. The audit reviewed the lending practices of four lenders considered "high-risk" because they had loan purchase rates higher than other large lenders; were cited for recurring compliance issues during onsite examinations; and failed to meet SBA performance benchmarks. The report concluded that the SBA had failed to take sufficient enforcement actions to mitigate the risk, leading to \$329 million in losses to the agency. To limit these risks, the OIG recommended more prompt, thorough guarantee repurchase reviews; more probing onsite audits; and progressively stricter enforcement actions.
- On March 21, 2008, the OIG issued an audit titled *UPS Capital Business Credit's (UPSC) Compliance with Selected 7(a) Lending Requirements*. The audit claimed that 44 percent

of the reviewed loans did not have adequate documentation to show how borrowers used loan proceeds. The OIG recommended that the SBA require the lender to provide appropriate documentation; that the SBA demand a repair on one loan; and that the SBA establish a corrective action plan for the lender.

In other recent audits, the OIG has claimed that the SBA failed to address performance and compliance issues or protect government funds once deficiencies were identified, and called on the SBA to develop guidelines under which it will suspend or revoke a lender's status in the Preferred Lender Program. The OIG also argued that the SBA has made tens of millions of dollars in erroneous payments to lenders that did not provide the information necessary to prove that they had originated and serviced loans in compliance with SBA regulations.

### **Legal Developments: Potential Adverse Consequences for Failure to Identify and Correct Risks Common to SBA Lending**

In this climate of enhanced oversight, there is a wide variety of administrative, civil and criminal tools available to the government for pursuing claims against lenders, their employees and their brokers for allegedly improper lending practices:

- **Administrative Actions.** The SBA may seek to repair or deny a loan guarantee; suspend or revoke a lender's PLP authority; or debar a lender from government-guaranteed lending programs.
- **Civil Claims.** The SBA may seek to recover losses on defaulted loans through contract claims, the False Claims Act (31 U.S.C. § 3729), the Program Fraud Civil Remedies Act (31 U.S.C. §§ 3801-3802), or under FIRREA (12 U.S.C. § 1833a).
- **Criminal Actions.** The government may seek to prosecute lenders, their employees, or their brokers for conduct related to their lending practices, including under 18 U.S.C. § 1001 (general false statements statute), 15 U.S.C. § 645(a) (false statements to the SBA), 18 U.S.C. § 1014 (false statement to influence SBA or Farm Credit Administration), 18 U.S.C. § 371 (conspiracy to defraud the United States), and 18 U.S.C. § 287 (criminal false claims).

These legal risks are particularly profound for lenders participating in the SBA's Preferred Lenders Program, under which the SBA delegates loan decisions regarding eligibility to the lender. The vast majority of credit determinations are left to PLP lenders, and the SBA conducts only a cursory review of a limited set of documents before approving the loan guarantee. After its payment of a guarantee on a defaulted loan, the SBA then conducts a full-fledged review of the lender's loan documents to determine whether deficiencies in underwriting, closing, or servicing contributed to the failure of loan.

### **Internal Controls: Prudent Steps to Limit Common Risks**

Lenders can limit the legal risks common to SBA lending by fortifying internal controls designed to prevent, detect, and correct regulatory deficiencies and fraud.

Some of these controls address specific issues that frequently recur in government audits. For instance, lenders can limit the risk of inadequate documentation of equity injection through closing officer verification of bank statements; employee training to identify tax transcript-bank statement discrepancies; gift donor certifications for sources of gift funds; and the requirement of personal guarantees from donors providing more than 50% of the equity injection.

Other controls provide systematic tools for anticipating and correcting deficiencies before a government inquiry. The establishment of an internal audit group with principals from the closing, servicing, and auditing functions is often a useful means of identifying areas of potential concern. That group can be tasked with comprehensively reviewing and addressing problems associated with high-risk portfolio concentrations, post-closing audit summaries, early-default loans, and findings from external auditors. Through these reviews, as well as the implementation of a confidential fraud hotline, the lender can more readily meet its regulatory obligations of identifying and alerting the SBA of borrower fraud.

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## *Authors*



**Ronald C. Machen**

**PARTNER**

Chair, Litigation/Controversy  
Department

✉ [ronald.machen@wilmerhale.com](mailto:ronald.machen@wilmerhale.com)

☎ +1 202 663 6881

**Thomas F. Connell**

**RETIRED PARTNER**

☎ +1 202 663 6000



**Matt Jones**

**PARTNER**

✉ [matthew.jones@wilmerhale.com](mailto:matthew.jones@wilmerhale.com)

☎ +1 202 663 6018