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Report to the Chair and Ranking Minority Member, Committee on Small Business, House of Representatives

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SMALL BUSINESS ADMINISTRATION

SBA Monitoring Problems Identified in Case Studies of 12 SBICs and SSBICs

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The Honorable Jan Meyers, Chair
The Honorable John J. LaFalce
Ranking Minority Member
Committee on Small Business
House of Representatives

In response to Committee requests, we have expanded on previous work that identified abuses and problems with the Small Business Administration's (SBA) Small Business Investment Company (SBIC) and Specialized Small Business Investment Company (SSBIC) programs.[1] Our March 1994 report responded to a request from the Committee's then Chairman that we investigate the operations of Capital Management Services, Inc., an SSBIC.[2] We found that during its 14 years of operation, Capital Management had repeatedly entered into prohibited transactions, including loans to ineligible businesses, loans to associates, and loans for real estate purchases. We also reported that SBA's oversight of Capital Management was clearly inadequate in that it failed to correct repeated violations found in its audits over the years, resulting in an estimated $2.9-million loss to SBA.

Subsequently, you asked us to determine whether other SBICs and SSBICs engaged in practices similar to those we had identified at Capital Management. To aid us in that determination, SBA identified 111 SBICs and SSBICs with serious regulatory violations—about 24 percent of the 466 companies that were either active or in liquidation as of September 1995. Of the 111 companies, we selected 11 for review. We also selected a company that had come to our attention during our review of several firms that participated in SBA's 8(a) business development program. After selecting the companies, we interviewed SBA program officials; the SBA Office of Inspector General (OIG); and, where appropriate, U.S. Attorney's offices.

To report our findings, we used a case study methodology that describes the details and nature of improper management practices by 12 program participants as identified by SBA and SBA's monitoring of the participants. (See app. I.)

[1]According to SBA, over the past 35 years, the SBIC and SSBIC programs have provided approximately $12 billion in financings to 75,000 small businesses. As of September 1995, there were 187 active SBICs and 90 active SSBICs providing funding to small businesses. There were also 189 SBICs and SSBICs in liquidation, owing $501 million to SBA. SBA expects to ultimately lose $239 million.

[2]Small Business Administration: Inadequate Oversight of Capital Management Services, Inc.—an SSBIC (GAO/OSI-94-23, Mar. 21, 1994).

As stated in our September 28, 1995,[3] testimony before the Committee concerning these 12 SBICs and SSBICs, we determined that improper management practices, including regulatory violations and some suspected criminal misconduct, were similar to those identified at Capital Management. We also found that SBA's response to these improper practices was often inadequate, a factor that may have contributed to estimated losses to the government. (See app. IV through app. XII.)

Reviews in recent years by GAO and SBA's OIG[4] have raised concerns about the adequacy of SBA's oversight and management of this program. Our previous reports have discussed concerns about eligibility issues and other regulatory violations. In addition, according to an SBA OIG 1993 report, delays in placing financially troubled SBICs and SSBICs in liquidation—an action that serious regulatory violations, such as those described in this report, should immediately trigger—have reduced the potential recovery of government funds.

Results in Brief

The SBICs and SSBICs we reviewed engaged in such improper management practices as loans to associates, including officers and directors of the licensees; loans for prohibited real estate purchases; or loans to ineligible individuals. In addition, the SBICs and SSBICs seldom took timely action to correct the violations after being notified by SBA, nor did SBA ensure that the violations that it had identified during examinations were corrected in a timely manner. Therefore, the same or similar violations were identified during subsequent examinations. Such mismanagement or misconduct may have contributed to the liquidation or bankruptcy of some of the SBICs and SSBICs, with resultant losses to the government. Estimated losses for three of the five companies that have gone into liquidation or bankruptcy have exceeded $4 million.

SBA has increased the frequency of its examination of SBICs' and SSBICs' performance, expanded the comprehensiveness of those examinations, and recently revised its licensing procedures so that new SBICs are more experienced and better capitalized. While we acknowledge these

[3] Small Business Administration: Prohibited Practices and Inadequate Oversight in SBIC and SSBIC Programs (GAO/T-OSI-95-16, Sept. 28, 1995).

[4] (GAO/OSI-94-23, Mar. 21, 1994); Small Business Administration: Inadequate Documentation of Eligibility of Businesses Receiving SSBIC Financing (GAO/RCED-94-182, Apr. 26, 1994); Small Business: Information of SBA's Small Business Investment Company Programs (GAO/RCED-95-146FS, May 12, 1995); (GAO/T-OSI-95-16, Sept. 28, 1995); Small Business Administration: Better Oversight of SBIC Program Could Reduce Federal Losses (GAO/T-RCED-95-285, Sept. 28, 1995); and Audit Report on The Small Business Investment Company (SBIC) Liquidation Function (U.S. Small Business Administration, Office of Inspector General, 3-2-E-004,031, Mar. 31, 1993).

improvements, our work shows that SBA did not respond to serious regulatory violations identified during examinations in a timely manner.

Improper Management Practices

SBICs and SSBICs we reviewed were located in seven states and engaged in improper management practices similar to those found in our investigation of Capital Management. The improper practices included such regulatory violations as loans to associates in New York, Michigan, California, and Louisiana; prohibited real estate transactions in Oklahoma, Rhode Island, and New York; and loans to ineligible individuals in Alabama and Michigan.

Loans to Associates

SBA regulations prohibit an SBIC or SSBIC from providing financing to any of its associates, which include any officer of the SBIC or SSBIC and any close relative of an officer. Loans to associates take several forms, such as a loan to a business in which an officer or director has an interest or one with a condition that a reciprocal loan from the loan recipient be made to the licensee officer or director. The following are examples of loans to associates that SBA identified during its examinations of SBICs or SSBICs.

- A New York SBIC made four loans totaling $240,000 to a realty corporation between 1982 and 1989. During that period, a director of this SBIC served as the president and secretary of the realty corporation. These four violations were not discovered until after a 1994 examination.
- Between 1988 and 1991, a Michigan SSBIC made various loans totaling over $220,000 to a health care facility for which certain of its officers had personally guaranteed loans. As a result of these loans, the officers—the chairman of the board, his wife, and the president—were released from their personal loan guarantees.
- Between 1986 and 1990, a California SSBIC made 15 loans to relatives, partners, and other associates totaling $692,000.

Prohibited Real Estate Purchases

SBA regulations prohibit an SBIC or SSBIC from providing funds to a small concern to purchase real estate, or to release it from a real estate obligation, unless the funds will be used to acquire realty for the business's activity or for sale to others after prompt and substantial improvement. The following examples are representative of violations that SBA found.

- A New York SBIC made a $150,000 equity investment in 1982 for the purpose of constructing a hotel. Rather than develop a commercial hotel, the SBIC used the loan proceeds to acquire and manage low-income housing, a prohibited real estate practice. This violation was not discovered until the March 1994 examination.

- Four related SBICs located in Providence, Rhode Island, were associated with a Rhode Island accountant. SBA believes that one 1989 transaction involving all four SBICs was designed so that the accountant realized a $900,000 profit from the sale of a property in downtown Providence. According to SBA, during the course of this transaction, the accountant engaged in a scheme to misapply SBIC funds to pay off his (the accountant's) personal financial obligations.

Loans by SSBICs to Ineligible Individuals

SSBICs invest solely in small businesses that are at least 50 percent owned, controlled, and managed by socially or economically disadvantaged individuals. Neither the Small Business Investment Act of 1958 nor the 1972 amendment to the act has precisely defined "socially or economically disadvantaged." However, SBA policy provides criteria and procedures for determining social or economic disadvantage. (See app. III.) This policy has also designated certain minority groups as disadvantaged. SBA requires SSBICs to prepare profiles of small business concerns to document their eligibility to receive financing. Eligibility criteria include designated minority status, low income, unfavorable location of business, area of high unemployment, limited education, physical or other handicap, past or prevailing marketplace restrictions, and Vietnam-era service in the armed forces. Following are examples of loans made to ineligible owners, according to SBA examinations.

- An Alabama SSBIC made loans in 1993 to a clothing manufacturer in Alabama who was not a member of a designated group and had a personal net worth of over $12 million.
- Between 1990 and 1993, two Michigan SSBICs provided funds to small businesses whose owners were wealthy individuals with homes and businesses in financially stable or affluent areas. Most of the recipients were Chaldeans (Christian Arabs), or of other Arabic ancestry, who are not an SBA-designated minority group. The eligibility profiles for these individuals were boilerplate checklists that demonstrated no social or economic disadvantage. The treasurer/chief financial officer of one of these SSBICs justified the individuals' economic disadvantage by saying that the entire country was in a recession; therefore, almost any area in the country would qualify as one with high unemployment.
- A New York SSBIC made loans between 1981 and 1986 to companies controlled by the SSBIC president. Although 51 percent of the stock of these

companies purportedly was held by a minority, SBA determined that the SSBIC's president actually controlled—i.e., had the power to direct the management of—these companies, which violated SBA regulations.

Untimely SBA Actions

SBA did not effectively monitor the 12 SBICs and SSBICs that we reviewed. While SBIC and SSBIC management officials make investment decisions independent of SBA, SBA monitors these actions as part of its oversight activities to ensure that program participants comply with applicable regulations that prohibit specific types of investment. The infrequency of SBA examinations, the primary monitoring tool, contributed to a late discovery of violations and resulted in placing SBA's funds at risk. These periodic examinations identified violations that often went uncorrected from one examination cycle to the next. Furthermore, SBA also failed to take appropriate action once it identified serious regulatory violations, such as excessive capital impairment[5] and potential criminal misconduct.

In many of the companies that we reviewed, lengthy periods of time passed between examinations. For example, many of the troublesome loans made by four Providence, Rhode Island, SBICs occurred during a period of infrequent SBA examinations. Eleven of 15 improper loans made by a California SSBIC occurred during the 4-year period (1989-1993) over which SBA conducted no examinations of this SSBIC.

In a number of the investment companies that we reviewed, examiners would find and report violations, only to find and report the same or similar violations in a subsequent examination. For example, SBA examinations of one Michigan SSBIC in 1990, 1993, and again in 1994 identified loans to businesses that were operated by business associates or that benefitted associates of the SSBIC. In another case, SBA's 1991 examination report cited a Louisiana SSBIC for making loans to associates, the same violation for which the SSBIC was previously cited in 1982 and 1983.

SBA's Office of Operations failed to take appropriate action in one instance by engaging in lengthy negotiations with an SSBIC concerning corrective actions on capital impairment. The investment company went into bankruptcy in spite of negotiation efforts, resulting in a loss to SBA. In 1992, SBA had reported an increase in a Louisiana SSBIC's capital

[5]SBA defines capital impairment as the ratio of the cumulative actual losses (from operations and investment transactions) and unrealized losses (from decreases in the value of securities) to the private capital invested in the SBIC and SSBIC. Capital impairment exists for SSBICs when accumulated losses exceed 75 percent of private capital.

impairment from 47 percent to 70 percent, in part because the SSBIC had overvalued 11 delinquent loans by over 200 percent. SBA transferred the company into liquidation in June 1992. In March 1993, this SSBIC signed a settlement agreement in which SBA gave it 6 months to reduce its impairment. However, at the end of the 6 months, although the SSBIC's capital impairment increased to 84 percent, SBA gave it another 6 months to reduce the impairment. SBA justified granting this extension because the SSBIC had demonstrated a "good faith effort" to comply with reporting requirements contained in the initial settlement agreement. The SSBIC failed to reduce its capital impairment and filed for bankruptcy in 1994. SBA estimates a $1.6-million loss.

Because SBA failed to take effective and timely action, criminal violations may have gone unprosecuted. In one instance, SBA's failure to make a determination to take administrative action against an SSBIC caused the U.S. Attorney's Office to decline prosecution.

Agency Comments and Our Evaluation

We met with SBA's Associate Administrator for Investment and other Investment Division officials on February 12, 1996, and discussed the contents of this report. They generally agreed with our findings, but emphasized that (1) SBA has made improvements to the SBIC and SSBIC programs; (2) SBA has sought to balance competing roles in managing the programs; and (3) some of the active SBICs and SSBICs that we reviewed are currently in regulatory compliance.

Since 1994, SBA has made improvements to the examination process. For example, SBA has decreased the period of time between examinations from 22 months to every 14 months, on average, and has expanded the comprehensiveness of examinations. Furthermore, it has required examiners to visit sites of selected portfolio investments and assess portfolio eligibility requirements. In addition, because of recently revised licensing procedures, new SBICs are more experienced and better capitalized.

SBA officials explained that delays in taking corrective actions, such as placing an SBIC and SSBIC in liquidation, may be due to SBA's competing roles in managing the program. They told us that the roles—(1) ensuring that the program benefits eligible small businesses, (2) monitoring regulatory compliance, and (3) protecting itself against loss on leverage assistance—often conflict. These roles conflict when weighing the appropriate action to be taken on serious regulatory violations found during examinations against the impact the action may have on a participant's ability to continue in business.

SBA provided us with current data about the financial health and regulatory compliance of specific SBICs and SSBICs. We have incorporated this updated information in our report where appropriate.

In our September 1995 testimony, we acknowledged the improvements that SBA had made; however, we continued to find weaknesses with oversight, including the ability to respond to examination findings in a timely manner. We made recommendations regarding these oversight weaknesses.[6]

SBA may have competing roles that cause delays in resolving serious regulatory violations; however, for the 12 SBICs and SSBICs we reviewed, the agency did not act decisively to ensure that the companies had taken the required corrective actions. The recurrence of a number of serious regulatory violations for some SBICs and SSBICs should have been red flags, or indicators, that more serious problems of possible criminal misconduct—such as false statements, mail fraud, or wire fraud—might exist. Without effective correction of regulatory violations by the companies and aggressive oversight of the companies by SBA, improper management practices will continue and significant government investment will be at risk. Only with timely and effective follow-up on findings of serious regulatory violations can SBA hold troubled companies accountable and reduce the likelihood of further financial losses to the government.

We are sending copies of this report to interested congressional committees and the Administrator of SBA. We will also make copies available to others upon request. If you have any questions concerning this

[6]Small Business Administration: Better Oversight of SBIC Program Could Reduce Federal Losses (GAO/T-RCED-95-285, Sept. 28, 1995). We recommended, in part, that SBA (1) develop an oversight strategy to better target SBICs and SSBICs with repeated or egregious violations; (2) give its Office of Examinations responsibility for tracking actions that SBICs and SSBICs take to correct problems that SBA finds during examinations; and (3) expedite the design and implementation of a system to routinely analyze SBIC and SSBIC asset valuations to detect problems of potential asset overvaluation.

report, please contact me or Assistant Director Donald G. Fulwider of my staff at (202) 512-6722. Major contributors to this report are listed in appendix XIII.

Donald J. Wheeler
Acting Director

Contents

Abbreviations

GAO	General Accounting Office
OIG	Office of Inspector General
OSI	Office of Special Investigations
RCED	Resources, Community, and Economic Development Division
SBA	Small Business Administration
SBIC	Small Business Investment Company
SCDF	Southern Cooperative Development Fund, Inc.
SCDFIC	SCDF Investment Corporation
SSBIC	Specialized Small Business Investment Company

Methodology

To identify problematic SBICs and SSBICs, we asked officials in SBA's Office of Examinations to provide us with names of SBICs and SSBICs that had engaged in serious regulatory violations. SBA identified 111 SBICs and SSBICs with serious regulatory violations—about 24 percent of the 466 companies that were either active or in liquidation as of September 1995. Focusing on those companies that had been transferred to the Office of Liquidation, placed on SBA's "watch list"[7] because they were in danger of being capitally impaired, or referred to SBA's OIG because of suspected criminal activities, we selected 11 for review. In addition, we focused on examination findings that could be categorized as egregious. In making our selections, we reviewed examination reports on a majority of these 111 companies.

We also selected an additional SSBIC—owned by a corporation that was previously a participant in SBA's 8(a) business development program[8] —that came to our attention during our investigation of several unrelated firms that participated in SBA's 8(a) program.[9]

In selecting these 12 companies—7 SSBICs and 5 SBICs—we considered their geographic locations to ensure that our review covered all regions of the country. As a result, we chose companies located in New York, Rhode Island, Michigan, California, Louisiana, Oklahoma, and Alabama, which are covered by three of the four SBA examination regions. Seven of the 12 companies examined are active (not in liquidation).

To report our findings, we used a case study methodology that describes the details and nature of improper management practices by 12 program participants as identified by SBA and SBA's monitoring of the participants.

We conducted our review between October 1994 and October 1995. After selecting the 12 companies for review, we conducted further interviews of SBA officials in the Investment Division, which is responsible for managing the SBIC and SSBIC programs. These interviews included individuals in the Investment Division's Operations, Examinations, and Liquidation offices. We also spoke with SBA OIG officials. When there were indications that a

[7]In September 1991, SBA established a watch list of SBICs and SSBICs experiencing financial difficulty as part of its efforts to closely monitor their activities and assist in timely transfers to the Office of Liquidation when warranted.

[8]Section 8(a) of the Small Business Act, as amended, established the Minority Small Business and Capital Ownership Development Program, or 8(a) program, to develop and promote businesses that are owned and controlled by "socially and economically disadvantaged" individuals.

[9]Small Business Administration: 8(a) is Vulnerable to Program and Contractor Abuse (GAO/OSI-95-15, Sept. 7, 1995).

company was the subject of an investigation or a prosecution, we contacted the appropriate U.S. Attorney's Office.

GAO requested comments on a draft of this product from the Associate Administrator for Investment of SBA's Investment Division. On February 12, 1996, he and his staff provided us with comments on the draft. Our report incorporates SBA's comments, including updated information on several of the companies that we discuss, where appropriate.

Background

The Small Business Investment Act of 1958 created a program to help small businesses obtain financing for starting, maintaining, and expanding operations. Under the program, SBICs provide funding to small businesses through equity investments (purchasing their stock) and debt (issuing them loans). In 1972, the Congress amended the act to establish specialized SBICs, called SSBICs, to fund small businesses that are owned by persons who are socially or economically disadvantaged. In supporting small businesses, SBICs and SSBICs use their own private funds and funds obtained by borrowing at favorable rates (also called leverage) guaranteed by SBA or by selling preferred stock to SBA.

Within the SBIC and SSBIC programs, SBA does not directly or indirectly approve or disapprove financing decisions made by SBICs and SSBICs. Investment decisions are made independently by the SBIC management and general partners or board of directors. However, SBA monitors the investment companies to ensure their compliance with applicable regulations.

These regulations have two primary purposes: (1) to help ensure that SBICs and SSBICs are benefitting small businesses and are not making loans and investments that can be detrimental to small concerns, and (2) to reduce the risk to SBA on the leverage assistance that is provided.

Management and oversight of SBA's SBIC and SSBIC programs are provided by its Investment Division's Offices of Operations, Examinations, and Liquidation.

- The Office of Operations monitors, regulates, and provides operational assistance to licensees. Its analysts are responsible for identifying regulatory or financial violations and overseeing corrective actions. The analysts consider (1) the licensee's annual audited financial statement, (2) financing reports that identify the characteristics of investments made by each licensee, and (3) the results of periodic on-site examinations of licensees conducted by the Office of Examinations.

  Analysts also initiate actions to move failing firms into liquidation when (1) their losses, in comparison to their private capital, exceed an acceptable level (capital impairment); (2) they default on their agreement to repay funds owed to SBA; or (3) they commit regulatory violations, such as making ineligible investments.

The Office of Licensing, a subfunction of the Office of Operations, reviews applications for new SBICs and SSBICs (licensees) and recommends approval or denial.

- The Office of Examinations was created in 1992, when the Congress transferred responsibility for periodic examinations of SBICs and SSBICs from the OIG to the Investment Division. The Office of Examinations assists SBA management in ensuring that licensed companies are adhering to statutory and regulatory requirements. SBIC and SSBIC examinations include financial and performance audit objectives designed to assess the licensee's compliance with SBA regulations and established policies governing the SBIC and SSBIC programs.
- The Office of Liquidation oversees the liquidation of failed SBICs and SSBICs and the resulting disposal of assets. This office also handles the process for companies that voluntarily exit the program.

"SBA Policy and Procedural Release #2017"

SBA POLICY AND PROCEDURAL RELEASE #2017

Subject: Determination of "Disadvantaged Small Business Concern."

The purpose of this memorandum is to provide guidance to Section 301(d) and other licensees in their determination that a small business concern is socially or economically disadvantaged, and to outline minimum information needed for such determination.

I. STATEMENT OF POLICY

A disadvantaged small business is a small business concern which is at least 50 percent owned, and controlled and managed by socially or economically disadvantaged individuals. No assistance may be provided by Section 301(d) licensees to small business concerns unless such concerns are socially or economically disadvantaged.

II. LEGISLATION RELATING TO 301(d) LICENSEES

Section 301(d) of the Small Business Investment Act of 1958 was added in 1972 to give legislative authority to a program of providing assistance to present or potential business persons whose participation in the free enterprise system is hampered because of social or economic disadvantages. Prior to the 1972 amendment to the Act, the Small Business Administration had licensed a special class of small business investment companies (MESBICs). These MESBICs were licensed solely for the purpose of rendering financial and management assistance to members of minority races and to those persons who are socially or economically disadvantaged.

Section 301(d) of the Act provides for the licensing by SBA of a small business investment company, "the investment policy of which is that its investments will be made solely in small business concerns which will contribute to a well-balanced national economy by facilitating ownership in such concerns by persons whose participation in the free enterprise system is hampered because of social or economic disadvantages . . ."

III. REGULATIONS

Pursuant to this authority, SBA has defined a Section 301(d) license in Section 107.3 of the Regulations as "a licensee organized under a State business or nonprofit corporation statute, and licensed pursuant to Section 301(d) of the Act" and having an investment policy limited to "making investments solely in Small Concerns which will contribute to a well-balanced national economy by facilitating ownership of such concerns by persons whose participation in the free enterprise system is hampered because of social or economic disadvantages." "Disadvantaged Concern" is defined in terms of the statutory language as one "owned by a person or persons whose participation in the free enterprise system is hampered because of social or economic disadvantages." The regulations also make special provisions for investments in disadvantaged concerns by Licensees other than Section 301(d) Licensees. See, for example § 107.301(a).

Revised May 1, 1980

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IV. MEANING OF SOCIALLY OR ECONOMICALLY DISADVANTAGED

Except to recommend the elimination of any suggestion that only members of minority groups are eligible for assistance under this program and to specify that the program is to aid all who are hampered in achieving full citizenship in our economic system by virtue of their social or economic disadvantages, Congress has not fully defined the words "socially or economically disadvantaged." This lack of precise legislative definition suggests that a precise definition is inappropriate, and that flexibility is warranted.

V. PROCEDURES RELATING TO ELIGIBILITY DETERMINATIONS OF DISADVANTAGED BUSINESSES

In determining whether small business concerns are socially or economically disadvantaged, reliance should not be placed upon a single factor, but on a composite of such factors as the social or economic background of the principal owners, controlling individuals and managers of the concern, along with the general pattern of their life, opportunities and education which have prevented them from obtaining financial or other assistance available to the average entrepreneur in the economic mainstream. Such persons may often include, but are not limited to Negroes, Indians, Eskimos, Aleuts, and persons of Mexican, Puerto Rican, Cuban, Filipino, or Oriental extraction. In determining whether the owners of small business concerns are "disadvantaged," consideration may be given to the following factors:

(a) low income;

(b) unfavorable location such as urban ghettos or depressed rural areas and areas of high unemployment or under-employment;

(c) limited education;

(d) physical or other special handicap;

(e) inability to compete effectively in the marketplace because of prevailing or past restrictive practices; and

(f) Vietnam era service in the Armed Forces, (August 5, 1964 to May 7, 1975),

or such other factors as contribute to a disadvantaged condition in the ordinary (dictionary) meaning of that word: lacking in basic resources or conditions necessary to an equal position in society.

VI. DOCUMENTATION

The composite of the foregoing factors and other pertinent information will establish a profile to be used as the basis for determining eligibility. A separate profile should be completed by the licensee with respect to each small business concern assisted, and maintained for SBA's inspection.

Revised May 1, 1980

Metro-Detroit Investment Company

Background

SBA licensed Metro-Detroit Investment Company of Farmington Hills, Michigan, as an SSBIC on June 1, 1978. As of February 28, 1994, Metro-Detroit had private capital of $2 million and SBA leverage of $6 million. Metro-Detroit is an active SSBIC.

The U.S. Secret Service and SBA's OIG, in coordination with the U.S. Attorney, investigated Metro-Detroit officers for suspected criminal activity in 1991. SBA placed Metro-Detroit on its watch list on May 1, 1992, because of the investigation of the SSBIC's activities. That investigation is still ongoing.

SBA Examinations

According to SBA's March 1990, February 1993, and September 1994 examination reports, Metro-Detroit made loans to businesses that were operated by Metro-Detroit associates or that benefitted Metro-Detroit associates. This SSBIC also made loans to 21 nondisadvantaged small concerns and engaged in prohibited loans for real estate. For example, a party store operator, the husband of a Metro-Detroit employee, received various loans totaling $228,000. Metro-Detroit also made loans totaling over $220,000 to a health care facility. Prior to these loans, Metro-Detroit's chairman of the board, president, and the chairman's wife had personally guaranteed other loans to the same health care facility. The Metro-Detroit loans released the officers from their personal loan guarantees to the facility, and SBA concluded that this was a conflict of interest.

Metro-Detroit primarily financed small businesses engaged in the retail sale of groceries. SBA's 1993 and 1994 examination reports noted that most were owned and operated by Middle Eastern individuals and Chaldean families (Christian Arabs from Iraq). Metro-Detroit has contended that these Arabic people have been strongly discriminated against and thus qualify as an eligible minority group. However, SBA has not categorized Chaldeans and other Arabic persons as members of a designated group presumed to be socially disadvantaged. Table IV.1 provides examples of the 21 loans that Metro-Detroit made to those that SBA considers not to be socially or economically disadvantaged.

Table IV.1: Selected Metro-Detroit Loans to Ineligible Recipients

Recipient	Recipient's net worth (dollars in millions)	Residence valuation (dollars in thousands)	Amount of financing (dollars in thousands)
1[a]	$24.6	$1,200	$250
2[b]	1.5 (approximate)	260	225
3	2.8	360	313
4	2.0	230	225
5	>5.0[c]	Various[d]	200
6	2.7	800	120
7	2.9 and 1.1	475 and 200	300

[a]Operator's asset valuation was $64.4 million.

[b]Individual is the first cousin of Metro-Detroit's chairman of the board.

[c]Each of five brothers had a net worth greater than $1 million.

[d]Suburban residences ranged in value up to $800,000.

Following the 1993 examination report, SBA requested specific evidence about the social disadvantage of Chaldeans and others of Arabic ancestry who had received loans from Metro-Detroit. Despite its not receiving the requested information, SBA raised no objections to the loans, citing previous confusion regarding the eligibility issue. However, SBA directed Metro-Detroit to ensure that future Chaldean applicants demonstrate their disadvantaged state before being granted loans.

Currently, according to SBA officials, Metro-Detroit has no regulatory violations; no capital impairment exists; and the company is healthy. The U.S. Attorney's Office has not brought any charges against the company thus far; however, the investigation is ongoing.

Mutual Investment Company, Inc.

Background

SBA licensed Mutual Investment Company, Inc. of Southfield, Michigan, as an SSBIC on April 21, 1980. As of November 11, 1992, Mutual had $7,491,630 in SBA leverage and $3,259,120 in private capital. SBA transferred Mutual to liquidation on November 18, 1993; and the U.S. District Court placed it in receivership on January 25, 1994. As of July 31, 1995, SBA's outstanding leverage was about $6 million. SBA estimates the loss to the government at over $1.5 million.

In January 1991, the local police made a gambling raid at a private residence of an associate of Jack Najor, Mutual's owner. While conducting asset forfeiture proceedings on the raided residence, local police discovered a mortgage lien for Mutual.

Local authorities then contacted the U.S. Secret Service, which jointly with the SBA OIG investigated Mutual. The investigation disclosed four loans made by Mutual to individuals who used the proceeds to pay off loans from Metro-Detroit, another SBA SSBIC. (See app. IV.) In addition, the investigation determined that Mr. Najor had bought homes and paid off credit cards with the SSBIC's funds that were supposed to be used for financing eligible business concerns. Mr. Najor admitted he had solicited and received cash payments from prospective borrowers in exchange for approving them for SBA loans.

In connection with criminal violations involving Mutual, Mr. Najor was sentenced to a 1-day incarceration because of his advanced age and poor health. He also received a 3-year release probation with a payment of $180 per month (the cost of supervision) and was fined $50,000. A total of $2.3 million has been recovered to date by the SBA receivership. In addition, Mutual's treasurer/financial officer admitted that he had committed bank fraud and signed a pretrial diversion agreement for his cooperation in the investigation.

SBA Examinations

During its last examination[10] of Mutual—for the 32-month period ending September 30, 1992—SBA determined that Mutual had made 26 loans to 23 small concerns, totaling more than $6.6 million. SBA identified numerous regulatory violations, which included loans to businesses that were not disadvantaged.

[10]Examinations dated March 25, 1987, for the 12-month period ending January 31, 1987; May 18, 1988, for the 12-month period ending January 31, 1988; and April 6, 1990, for the 24-month period ending January 31, 1990, disclosed no violations of SBA regulations.

Mutual used boilerplate checklists to justify each loan recipient's eligibility as socially or economically disadvantaged. However, the checklist, along with the loan file, had virtually no details on individual borrowers' circumstances concerning program eligibility and was not signed by the borrowers. Mutual's treasurer/chief financial officer justified the economic disadvantage of the individuals by saying that almost any area would qualify as one with high unemployment because the entire country was in a recession.

When SBA examiners visited 11 businesses in California and Michigan to which Mutual had extended loans, they determined that none of the owners were socially or economically disadvantaged. Table V.1 illustrates the information that SBA gathered on 4 of the 11 businesses.

Table V.1: Mutual Loans to Ineligible Businesses

Loan recipient	Recipient's net worth	Amount of loan	SSBIC rationale for loan	SBA observations on business or loan recipient
Liquor store (California)	$642,565	$260,000	Unfavorable location	Liquor store was located on the main street of Oceanside, CA, a beachfront community. Owner used at least $58,323 as a down payment on a $250,000 residence.
Restaurant (California)	[a]	465,000	Competition due to restrictive practices	Owner could provide no documentation as to how he used loan proceeds. He said that he had invested $400,000 in stock options for a company that operated a chain of convenience stores and lost the entire amount. He used $63,770 to pay off a loan.
Market (California)	$1.9 million	100,000	Unfavorable location (high unemploy-ment area)	Market was on a main street in San Diego. Owner denied that market was in a high unemployment area.
Market (California)	Over $3.6 million	200,000	Unfavorable location	Market located in downtown San Diego in heart of financial and commercial district among high-rise hotels and offices.

[a]SBA was unable to determine net worth because the recipient's assets were not in his name.

Four Rhode Island SBICs

Background

Three Providence, Rhode Island, SBICs—Moneta Capital Corporation, Fairway Capital Corporation, and Wallace Capital Corporation—received $16.25 million in SBA loans between 1986 and 1992. A fourth Rhode Island SBIC—Richmond Square Capital Corporation[11]—received no SBA loans. These four SBICs are strongly interrelated through (1) individuals involved in their operations, (2) financings in which the firms participated, and (3) similarity of regulatory violations discovered through SBA examinations and other federal investigations. Through his various roles and associations, Mr. Arnold Kilberg has been the central connection between the four SBICs. Mr. Kilberg served as president of Moneta; investment adviser and manager of Richmond Square and Fairway; and an independent accountant to Wallace. Wallace's president and owner was a former Moneta employee.

Moneta was licensed as an SBIC on May 4, 1984. As of January 1995, it had $6 million in SBA leverage and $2 million in private capital. Moneta is currently active and, according to SBA, as of May 1995, was 55 percent capitally impaired. Because of regulatory violations concerning Fairway and Moneta, SBA forced Mr. Kilberg and his wife to resign as officers and directors of Moneta in January 1994. Moneta is wholly owned by a profit-sharing trust whose principal beneficiary is Mr. Kilberg.

Fairway was licensed as an SBIC on January 31, 1990. As of November 30, 1992, it had $7.5 million in SBA leverage and $2.52 million in private capital. On April 22, 1994, Fairway was transferred to the Office of Liquidation for the purposes of liquidating Fairway's assets to repay its debt to the SBA and, ultimately, of revoking its license. As of February 1996, Fairway had repaid $5 million, and SBA anticipates that the balance will be repaid. Fairway is partially owned by Mr. Kilberg's children.

Wallace was licensed as an SBIC on December 22, 1986. As of December 31, 1994, it had $2.75 million in SBA leverage and $2.02 million in private capital. Wallace is on SBA's watch list, following heavy losses in its loan portfolio.

SBA Examinations

According to SBA examination reports, the four SBICs violated SBA regulations by misapplying loan proceeds, using SBIC funds to pay personal

[11]Richmond Square was licensed as an SBIC on January 31, 1990. As of September 30, 1994, an application for the sale of $2 million in guaranteed debentures was pending, but on the basis of its four prior examination findings, SBA did not approve the application. Richmond Square had $3.03 million in private capital.

debts, engaging in prohibited real estate loans, providing short-term financing, and exceeding lending limits.

For example, SBA found that one of the prohibited real estate transactions, which occurred in 1989 and involved all four SBICs, was designed so that Mr. Kilberg realized a $900,000 profit from the sale of the Shepard Building in downtown Providence, Rhode Island. To do so, he submitted required forms to SBA that falsely stated that the loan proceeds were going to an auto repair business; instead, he used the funds to pay off a personal debt. SBA determined that Mr. Kilberg and others misapplied at least $1.1 million, made false statements, and engaged in a prohibited real estate transaction. This transaction became the subject of an investigation by the SBA OIG and the Federal Bureau of Investigation in 1991. The U.S. Attorney's Office for Rhode Island declined to prosecute.

SBA's examination reports on Wallace and Moneta[12] issued on March 9, 1993, and March 30, 1993, respectively, first reported a prohibited real estate transaction: a 1989 $400,000 loan (Wallace $150,000 and Moneta $250,000) to Corliss Landing Associates, a limited partnership that owned and leased commercial real estate. The stated purpose of the loan was to refinance the existing debt and pay for remodeling. SBA concluded that $316,000 was disbursed to the companies' limited partners as "distribution of surplus proceeds from financing." The 1995 examination reports for both Wallace and Moneta still reported these prohibited real estate transactions as violations.

Moneta's 1993 examination also reported a second prohibited real estate transaction: a 1989 Moneta loan for $250,000 to Providence Land Company, Inc., a real estate broker. SBA examiners were unable to confirm the use of the proceeds and to locate and interview the president of the land company. However, SBA instructed Moneta to divest itself of the loan because it was a prohibited real estate financing. Moneta has recovered some of the amount loaned to this land company.

[12]Examination reports on Wallace were released on March 9, 1993, for the 43-month period ending May 31, 1992; February 3, 1994, for the 16-month period ending September 30, 1993; and March 16, 1995, for the 15-month period ending December 31, 1994. Examination reports for Moneta were issued March 30, 1993, for the 49-month period ending November 30, 1992; March 1, 1994, for the 13-month period ending December 31, 1993; and May 1, 1995, for the 13-month period ending January 31, 1995. Examination reports were also issued on Fairway on December 5, 1990, for the 13-month period ending June 30, 1990, and March 30, 1993, for the 29-month period ending November 30, 1992. Richmond Square's reports were issued on April 13, 1992, for the 26-month period ending June 30, 1991; September 23, 1993, for the 24-month period ending June 30, 1993; and December 8, 1994, for the 15-month period ending September 30, 1994.

A March 1989 examination of Moneta for the 25-month period ending October 31, 1988, reported that Moneta participated in a short-term financing to 82 Corporation. SBA regulations state that all financings shall be for a minimum period of 5 years. The purpose of the loan was to construct residential units in Lincoln, Rhode Island. The examination disclosed that this short-term financing violated regulations, and Moneta was instructed to divest of the loan. The loan was repaid in full 1 year later.

According to SBA officials, as of February 1996, Moneta had no major regulatory violations and it was no longer capitally impaired; Wallace had no major regulatory violations; and Richmond voluntarily surrendered its license in January 1996.

SCDF Investment Corporation

Background

SBA licensed SCDF Investment Corporation (SCDFIC) of Lafayette, Louisiana, as an SSBIC on April 26, 1973. It is a wholly owned subsidiary of Southern Cooperative Development Fund, Inc. (SCDF). SCDF also owns a majority interest in two other businesses—Southern Hotel Corporation and SCDF Land and Equipment Leasing Corporation.

Because of regulatory violations and capital impairment, SBA transferred SCDFIC to liquidation status on June 9, 1992. As of September 1994, SCDFIC had $3.1 million in SBA leverage and, as of October 1993, $2.7 million in private capital. SCDFIC filed for bankruptcy protection in 1994, and SBA projects the government's financial loss will be $1.6 million.

SBA Examinations

SBA's January 1991 report[13] cited SCDFIC for making loans to associates, the same violation for which SCDFIC was previously cited in 1982 and 1983. SBA's May 1992 examination report found that SCDFIC advanced $50,000 to its associate, SCDF Land and Equipment Leasing Corporation, a violation prohibited by the regulations. In addition, the May 1992 report noted that during 1991 SCDFIC had outstanding accounts receivable balances with its parent, SCDF. SCDFIC allowed the advances to go uncollected even though SBA's Office of Operations told the company to collect the advances.

SBA's May 1992 examination report[14] stated that SCDFIC had purchased a $100,000 participation in a loan—prohibited by SBA regulations—made by a bank to SCDFIC's parent holding company, SCDF. SBA maintained that SCDFIC was aware of the violation but chose to ignore the regulations. The report also noted that SCDFIC had not prepared eligibility profiles for 3 loans and had overvalued 11 delinquent loans by more than 200 percent, resulting in an increase in SCDFIC's capital impairment from 47 to 70 percent. SBA transferred SCDFIC into liquidation in June 1992. In the settlement agreement signed in March 1993—9 months after SCDFIC entered liquidation—SBA gave SCDFIC 6 months to reduce its capital impairment. However, at the end of the 6 months, SCDFIC's capital impairment had increased to 84 percent, but SBA gave the SSBIC another 6 months to reduce its impairment. SBA justified granting this extension because SCDFIC had demonstrated a "good faith effort" to comply with reporting requirements contained in the initial settlement agreement. Unable to meet the terms of the agreement, SCDFIC subsequently filed for bankruptcy in 1994.

[13]Issued January 16, 1991, for the 24-month period ending December 31, 1989.

[14]Issued May 8, 1992, for the 24-month period ending December 31, 1991.

Square Deal Venture Capital Corporation

Background

On September 28, 1979, SBA licensed Square Deal Venture Capital Corporation of New Square, New York, as an SBIC. Square Deal received $1 million in leveraged financing and had private capital of $546,000 as of December 31, 1993. Victor Ostreicher was president and director of Square Deal, and Chaim Berger was a director. In late 1994, SBA referred Square Deal to SBA's OIG, which is conducting a criminal investigation of the company. In March 1995, SBA placed the corporation into liquidation and is in the process of estimating its loss.

SBA Examinations

During the 15 years Square Deal was active, SBA examined it 10 times and repeatedly found noncompliance with regulations, including, since 1980, those prohibiting conflicts of interest. SBA examinations in March 1993—the first conducted in 48 months—and March 1994 revealed serious regulatory deficiencies.

For example, SBA reported in its March 1993 examination report that Square Deal had been involved in at least four ineligible loans between 1982 and 1989. That report also found that the accountant who audited Square Deal's 1988-1992 audited financial statements had certified that he was an independent accountant; in fact, he was a Square Deal employee. The lack of independence is a serious regulatory violation because SBA uses financial statements to monitor financial condition.

Both the 1993 and 1994 examination reports concluded that because Square Deal's internal controls over portfolio valuations did not ensure that realistic values were assigned to its portfolio securities, the values may have been materially overstated.[15] Examples follow.

- In its annual reports to SBA for 1992 and 1993, Square Deal reported that it held a 40-percent stock interest, valued at $150,000, in the New Square Hotel, Inc., a defunct corporation that Square Deal had disposed of in 1991. SBA's 1994 examination report concluded that the investment should have been written off in 1991.
- In its 1994 report, SBA reviewed six of Square Deal's portfolios, including New Square Hotel, Inc., and found them to be inappropriate, inadequately documented, or both. SBA also concluded that Square Deal's annual reports were misleading and valuations were excessive. The examination determined that Square Deal was 81.4 percent capitally impaired.

[15]Square Deal's valuation methods had been questioned in previous examinations.

In the March 1994 report, SBA found, based on a site visit and other information, that New Square Hotel, Inc., financed by Square Deal, was an ineligible operator of residential dwellings, which constitutes a prohibited use of funds for real estate. SBA examiners found that the purpose of Square Deal's investment—purportedly to develop a commercial hotel operation—was actually to acquire and manage low-income housing, which is a prohibited use of funds.

Subsequent to the 1994 report, reviews by SBA and others, including GAO, disclosed additional violations by Square Deal. For example, when Square Deal purchased its interest in New Square Hotel, Inc., Victor Ostreicher, president and director of Square Deal, was also president of New Square Hotel, Inc. This purchase constituted a conflict of interest. In addition, Square Deal made at least four loans totaling $240,000 to a corporation for which one of Square Deal's directors, Chaim Berger, was listed as president and secretary. These constituted prohibited loans to associates.

Alliance Business Investment Company

Background

SBA licensed Alliance Business Investment Company of Tulsa, Oklahoma, as an SBIC on August 12, 1959. As of August 1994, it had $1.85 million in SBA leverage and $3.48 million in private capital. Alliance is an active SBIC.

SBA Examinations

The most recent SBA examination reports were issued in August 1990, June 1993, and November 1994. All three reports disclosed that Alliance was holding and operating substantial real estate and oil and gas properties in violation of the regulations. SBA approved Alliance's March 1994 plan to divest of the prohibited properties in September 1994. In August 1995, approximately 5 years after the examinations first reported the regulatory violation, Alliance informed SBA that it had disposed of the ineligible oil properties. In September 1995, SBA informed us that Alliance no longer owned the real estate properties.

According to SBA officials, Alliance has now complied with its divestiture plan.

First American Capital Funding, Inc.

Background

SBA licensed First American Capital Funding, Inc. of Fountain Valley, California, as an SSBIC on May 2, 1984. As of December 1994, it had $1.65 million in SBA leverage and $823,000 in private capital. First American is an active SSBIC.

SBA Examinations

We reviewed three SBA examination reports.[16] Beginning with the May 1993 examination report, SBA noted numerous regulatory violations, including conflicts of interest, loans to associates, and misrepresentation to SBA about the use of funds.

Between 1986 and 1990, First American's president made loans totaling $692,000 to relatives and business partners. The president also made a $100,000 loan in 1990 to a small business that, in turn, "loaned" the president $40,000 from its loan proceeds. SBA's 1993 examination disclosed that the president—who resigned in 1991 as a result of his improprieties—had arranged the financing for his own benefit and that First American had misrepresented to SBA the use of the $100,000 financing.

SBA was unaware of the conflict of interest before it started its May 1993 examination. However, First American had notified SBA in writing—in May 1992, August 1992, and January 1993—about 12 other loans to associates made by its former president to small concerns. First American filed a lawsuit against the former president; and as part of the settlement, the former president returned 45,000 shares of First American stock. The former president's wife still owns 25,000 shares.

The 1994 examination noted that First American had not corrected previously noted regulatory violations. As of April 1995, First American had notified SBA of other loans to associates, bringing the total number to 15. These 15 loans, totaling $692,000, were made between 1986 and 1990.

Currently, according to SBA officials, all First American assets have been paid off or charged off (treated as a loss or expense on SBA's books).

[16] The SBA examination reports that we reviewed were issued May 21, 1993, for the 51-month period ending January 31, 1993; March 24, 1994, for the 11-month period ending December 31, 1993; and April 4, 1995, for the 12-month period ending December 31, 1994.

CVC Capital Corporation

Background

SBA licensed CVC Capital Corporation of New York City as an SSBIC in March 1978. CVC's sole officer, director, and shareholder was Joerg G. Klebe. SBA transferred CVC to its Office of Liquidation on September 18, 1992, with SBA leverage of $4,350,000 and private capital of $3,635,000. In a November 12, 1992, letter to Mr. Klebe, SBA's Acting Director, Office of Liquidation, stated that the reasons for liquidation included, but were not limited to, conflict-of-interest transactions, impermissible investments, improper use of funds, and payment of excessive management fees. SBA had collected $350,000 from CVC and on July 31, 1995, projected an ultimate loss to the government of $1 million.

SBA Examinations

An SBA OIG report of investigation dated May 28, 1987, reported eight allegations involving Mr. Klebe and CVC. The results of the investigation stated that Mr. Klebe had devised a scheme to unlawfully obtain and maintain loans from the program. Mr. Klebe's scheme involved the creation of corporations purported to be under the control of a minority individual (who routinely held 51 percent of the corporation's stock); in fact, the actual control of the corporations remained with Mr. Klebe. A related SBA OIG report of investigation dated January 17, 1990, stated that the Office of the U.S. Attorney for the Southern District of New York declined to proceed either criminally or civilly because SBA would not take administrative action against CVC.

The August 18, 1992, report for the 64-month period ending June 30, 1991, reported 19 violations, which included such serious regulatory violations as inaccurate valuation of portfolio assets, which concealed that CVC was approaching capital impairment, and disregard for SBA regulations. The 1992 examination report also stated that on August 14, 1990, CVC made a $190,000 loan to a firm, a transaction that SBA determined constituted a gift because it was not at arm's length. As a result of the 1992 examination report findings, SBA transferred CVC to the Office of Liquidation[17] and demanded payment of the leverage owed to it.

[17]CVC was transferred to the Office of Liquidation on August 21, 1990, for failure to pay interest and was returned to the Office of Operations on November 28, 1990, because the delinquent interest was paid. One condition of transferring CVC back to active status called for an SBA examination to ascertain that CVC was in compliance with SBA regulations. This examination was completed in August 1992, resulting in CVC's being transferred back to the Office of Liquidation. Some of the findings of the 1992 report supported concerns that the Office of Operations had expressed when CVC was transferred to active status in November 1990.

FJC Growth Capital Corporation

Background

SBA licensed FJC Growth Capital Corporation of Huntsville, Alabama, as an SSBIC on March 7, 1991. FJC is a wholly owned subsidiary of a defense contracting firm that formerly participated in the SBA 8(a) program. As of January 31, 1995, FJC had $2 million in SBA leverage and private capital of approximately $2.5 million. FJC is an active SSBIC.

SBA Examinations

SBA has conducted three examinations of FJC—in 1992, 1994, and 1995.[18] The 1992 report identified no regulatory violations. The 1994 report concluded that FJC had made a $450,000 loan to an Alabama clothing manufacturer to finance equipment purchases and plant modernization. The owner was not a member of a designated disadvantaged group, nor was he otherwise disadvantaged. As of February 1993, he had a net worth in excess of $12 million, including a $575,000 residence. On February 4, 1995, the Office of Operations informed FJC that it agreed with the report findings and requested that FJC comment further on the eligibility of the owner.

The 1995 report concurred with the 1994 examination and concluded that FJC had financed three ineligible small concerns, including the one discussed in the 1994 examination. FJC had also made a $350,000 loan to a limited partnership whose owner belonged to a designated disadvantaged group but controlled a smaller share—35.7 percent—than the required minimum of 50 percent. FJC also loaned $250,000 to a holding company in Georgia that is wholly owned by an Asian American—a member of a designated disadvantaged group. However, SBA noted that the holding company may not be managed by a disadvantaged person, as required by SBA regulations. SBA was informed by the Asian American who owned the holding company that he did not actually manage the company.

[18]The August 7, 1992, report covered the 15-month period ending May 31, 1992. The August 4, 1994, report covered the 19-month period ending December 31, 1993. The May 26, 1995, report covered the 13-month period ending January 31, 1995.

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