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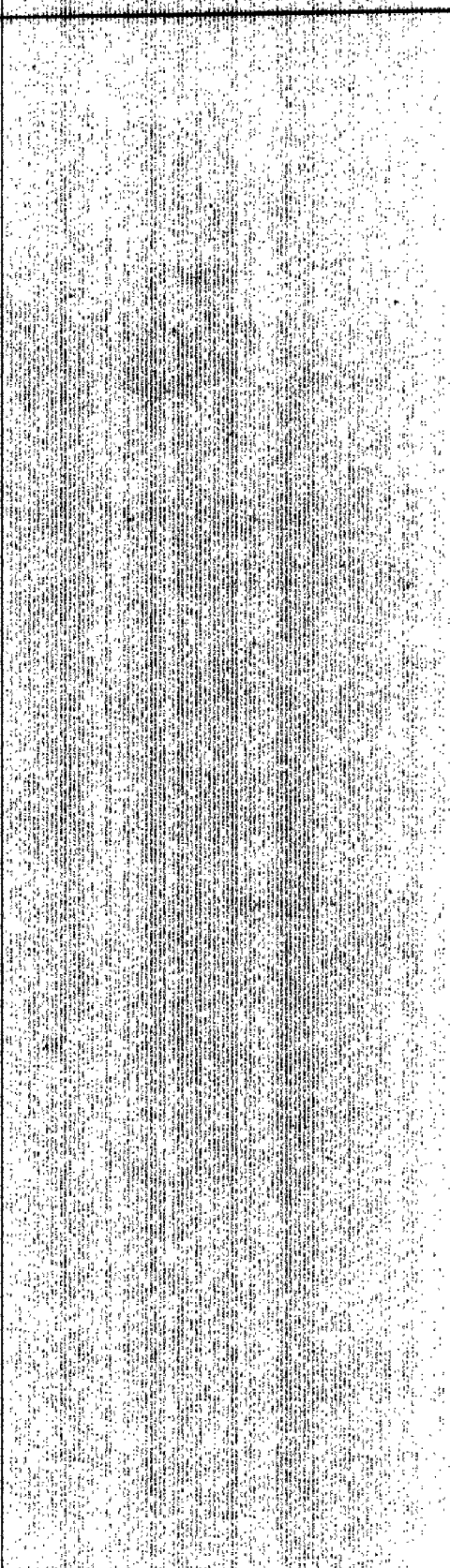
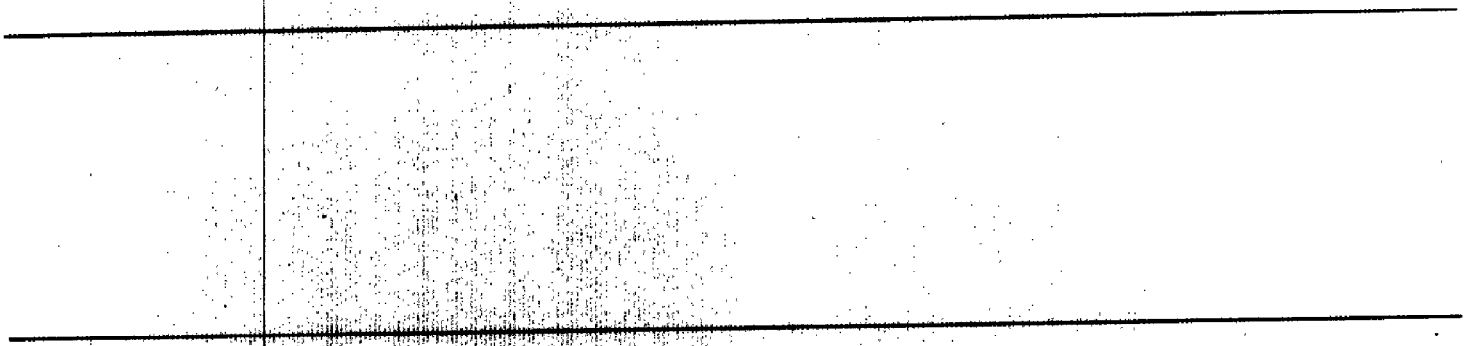
Report to the Chairman, Committee on  
Small Business, House of  
Representatives

March 1994

SMALL BUSINESS  
ADMINISTRATION

Inadequate Oversight  
of Capital Management  
Services, Inc.—an  
SSBIC







United States  
General Accounting Office  
Washington, D.C. 20548

151066

Office of Special Investigations

B-256662

March 21, 1994

The Honorable John J. LaFalce  
Chairman, Committee on Small  
Business  
House of Representatives

Dear Mr. Chairman:

This report responds to your request dated November 19, 1993, that we review the operations of Capital Management Services, Inc., a Little Rock, Arkansas, Specialized Small Business Investment Company (SSBIC)<sup>1</sup> licensed by the Small Business Administration (SBA). You requested that we (1) determine if SBA properly regulated and oversaw the operations of Capital Management; (2) determine whether Capital Management adhered to SBA regulations in determining the eligibility of firms it financed and whether it operated in a businesslike manner in providing financing; and (3) analyze the financing that Capital Management provided to (a) Susan McDougal (through her business Master Marketing), (b) Castle Sewer and Water Corporation, and (c) Castle's wholly owned subsidiary, Southloop Construction Corporation.

We interviewed SBA officials and former directors as well as loan recipients of Capital Management. We reviewed business records of Capital Management now in SBA's possession and obtained relevant documents from other sources. However, some documents and participants were unavailable because of an ongoing criminal investigation: first by the Department of Justice, then by the Office of the Independent Counsel.<sup>2</sup> We briefed the Office of the Independent Counsel on our investigation and will provide any investigative materials that the office requests. In a separate report that will be issued later to you, we will assess SSBICs' compliance with SBA requirements for determining the eligibility of businesses that SSBICs finance.

<sup>1</sup>In 1972, the Congress amended the Small Business Investment Act of 1958 and created a program to assist small concerns owned by socially or economically disadvantaged persons. SBA refers to this as the Specialized Small Business Investment Companies Program.

<sup>2</sup>When we initiated our investigation, the Department of Justice was investigating Capital Management. On Jan. 31, 1994, the Attorney General of the United States appointed an Independent Counsel "to investigate possible violations of law relating to President William Jefferson Clinton's or Mrs. Hillary Rodham Clinton's relationship with the Madison Guaranty Savings and Loan Association; Whitewater Development Corporation; or Capital Management Services, Inc."

## Background

### Specialized Small Business Investment Companies

SSBICS are small business investment companies that SBA licenses to invest solely in disadvantaged small businesses. A disadvantaged small business is at least 50 percent owned, controlled, and managed by socially or economically disadvantaged individuals. SBA—under the terms of the Small Business Investment Act of 1958—has not precisely defined “socially or economically disadvantaged,”<sup>3</sup> (emphasis provided) preferring to allow flexibility in eligibility determinations. (See app. I.)

SSBICS provide financing to these small business concerns through equity investments (purchasing the companies’ stock) and loans. Their resources come primarily from two sources: (1) private (nongovernmental) investment capital and (2) SBA-guaranteed loans and SBA-purchased preferred stock.

### Capital Management Services, Inc.

Capital Management was incorporated under Arkansas state law on September 14, 1978. SBA licensed it as an SSBIC on March 14, 1979. David L. Hale<sup>4</sup> was an initial founder of Capital Management. By 1980, David Hale, then a municipal court judge, and two family members were majority shareholders and controlled Capital Management. From 1982 until 1993, these individuals owned all of Capital Management. Mr. Hale was president and a director of Capital Management, making all decisions relating to its operations until September 15, 1993, when SBA placed Capital Management into receivership because of capital impairment. (“Capital impairment” exists when an SSBIC’s accumulated losses exceed 75 percent of its private capital. According to a 1993 SBA complaint filed against Capital Management, the company’s accumulated losses exceeded its private capital by 171 percent.)

Capital Management’s books and records indicate that Mr. Hale and the two family members provided private capitalization to the company

<sup>3</sup>This requirement is different in other SBA programs. For example, section 8(a) of the Small Business Act, as amended, established the Minority Small Business and Capital Ownership Development Program or 8(a) Program. The 8(a) Program is intended exclusively for business development purposes to help small businesses owned and controlled by “socially and economically disadvantaged” individuals. (Emphasis provided.)

<sup>4</sup>David Hale was a prosecuting attorney for the Sixth Judicial District of Ark. in 1967-71; National President of the U.S. Jaycees in 1974-75; member of the U.S. Bicentennial Commission in 1975-76; member of the U.S. Council on Inflation in 1975-76; and municipal court judge for Pulaski County, Ark., in 1979-93.

totaling approximately \$1.4 million. SBA provided funding to Capital Management totaling \$3.4 million on the basis of this private capitalization. Between 1980 and 1993, Capital Management reported 79 financings to SBA, totaling approximately \$9.8 million, to 57 small concerns.

## Results in Brief

SBA's oversight of Capital Management was clearly inadequate. SBA examiners failed to recognize strong indicators, or "red flags," that Capital Management was improperly managed. While SBA did finally take action against Capital Management in 1993, its inadequate oversight through the years resulted in a \$3.4-million loss to SBA. GAO reviews in recent years have been critical of SBA oversight of several programs.<sup>5</sup>

Mr. Hale operated Capital Management in an improper manner by entering into prohibited transactions. Such prohibited transactions included loans to business associates and loans for real estate purchases, both of which violated SBA regulations.<sup>6</sup> He also took advantage of the opening provided by the flexibility in SBA guidelines—for determining socially or economically disadvantaged individuals—to provide loans to individuals with questionable claims to program eligibility.

We were unable to fully analyze the transactions with Susan McDougal, Castle Sewer and Water, and Southloop Construction because key participants were unavailable for interview and Capital Management records were incomplete. Nevertheless, the Susan McDougal loan is an example of loans that Mr. Hale made to persons with questionable eligibility. Capital Management documents showed that Mrs. McDougal had represented the combined net worth of her and her husband to be \$2.2 million and that Mr. Hale had failed to follow SBA guidelines in documenting her eligibility. The sole justification for all three recipients' eligibility, according to Capital Management records, was a 2-paragraph "boilerplate" document developed by Mr. Hale that we found in numerous other loan files.

<sup>5</sup>Small Business: Problems in Restructuring SBA's Minority Business Development Program (GAO/RCED-92-68, Jan. 31, 1992); Small Business: Improving SBA Loan Collateral Liquidations Would Increase Recoveries (GAO/RCED-92-5, Dec. 19, 1991); Credit Management: Widespread Loan Origination Problems Reported (GAO/AFMD-91-7, Nov. 9, 1990).

<sup>6</sup>In addition, Mr. Hale has been indicted by a Little Rock, Ark., federal grand jury for allegedly falsifying a \$400,000 capital investment in Capital Management and allegedly falsifying the status of certain loans on the company's books.

## Inadequate SBA Oversight

Past GAO reviews have commented on SBA's lack of program oversight. Our investigation established that SBA oversight of Capital Management was seriously inadequate. SBA failed to recognize serious indicators, or "red flags," such as Mr. Hale's reporting 15 delinquent loans as satisfied in full immediately after SBA examiners had questioned the loans' value.

## SBA's Examinations of Capital Management

During Capital Management's 14 years of operation, SBA conducted 11 examinations of the company—10 by SBA's Office of Inspector General (OIG) and 1 by SBA's Office of Small Business Investment Companies. The examinations' results went directly to SBA's Investment Division, which is responsible for SSIC oversight. Six of the 11 reports of examination noted various concerns, including Capital Management's financing of businesses that were not socially or economically disadvantaged and of businesses that were controlled by associates. The remaining five examinations disclosed no regulatory violations.

On May 5, 1993, SBA's Investment Division referred issues raised by the March 11, 1993, report of examination to the OIG for investigation. The examination concluded that Capital Management had reported new investments in companies, when in fact the corporation had provided no direct financial assistance. On May 20, 1993, the OIG referred the matter to the Federal Bureau of Investigation (FBI), which initiated an investigation of Capital Management and Mr. Hale. On July 21, 1993, the FBI executed a search warrant on Capital Management, seizing certain files.

On August 16, 1993, SBA officials determined that Capital Management should be liquidated and placed in receivership. SBA was appointed Receiver on September 15, 1993, and obtained Capital Management books and records from Mr. Hale 6 days later. On September 23, 1993, a Little Rock, Arkansas, federal grand jury issued an indictment of David Hale, which was superseded by a February 17, 1994, indictment. Mr. Hale is scheduled for trial on March 28, 1994.

## Previous Failures to Recognize and Act Promptly on Indicators of Improper Management

SBA's reports of examination, and supporting workpapers, for Capital Management indicated that, for the most part, SBA conducted only cursory examinations of the company during its 14-year operation. Generally, the examiners looked at the documents provided by Mr. Hale and relied on his representations as to the circumstances surrounding the various financings undertaken by Capital Management. In those instances when SBA examiners raised serious issues with Mr. Hale, he was often able to

convince them that he had corrected or eliminated the problem. The examiners should have followed up to determine the substance of the corrective action.

A key example of SBA examiners' undue reliance on Mr. Hale's representations occurred during the examination for the period ending November 30, 1990. The 1991 report of examination questioned why Capital Management had maintained its loans and equity interest at face value, when 86 percent of the outstanding loans were past due. Further, it questioned whether Capital Management should have depreciated or written down part of the value of the loans or equity interests because of the unlikelihood of full repayment.

After SBA provided the draft report to Mr. Hale, Capital Management sold 15 of its loans and 2 of its stock investments. Mr. Hale told the SBA examiners that he had sold the financings at no loss to Capital Management.

Examiners should have noted that Mr. Hale's purported sale of financings involved a significant portion of Capital Management's portfolio and that he provided SBA no documentation about the sales. In fact, some of these loans had been exchanged for worthless paper.

Other incidents should have heightened SBA's concerns, including the fact that nine companies receiving financing from Capital Management used Capital Management's address—1910 N. Grant Street—as their business address. In addition, Mr. Hale controlled all aspects of Capital Management. These red flags should have resulted in SBA's going to third parties to verify the accuracy of information provided by Mr. Hale.

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## Hale's Improper Management Practices

As president of Capital Management, Mr. Hale authorized transactions that violated a number of regulations, thereby failing to fulfill his responsibilities to Capital Management and SBA. These improper transactions included loans to business associates and loans for real estate purchases. Further, in his operation of Capital Management, Mr. Hale took advantage of SBA's flexible eligibility guidelines in providing financing to individuals that he determined were socially or economically disadvantaged.

## Loans to Associates

Mr. Hale, as president and director, used Capital Management to provide financing both for companies he secretly owned, contrary to what Capital Management reported to SBA, and a company whose president and majority stockholder was closely related to a Capital Management officer. On the basis of its analysis after Capital Management was placed in receivership, SBA believes that Mr. Hale secretly controlled 13 of 57 small concerns that Capital Management had financed. Two of the 13 companies were Retail Liquidators, Inc., and Little Rock Clothiers, both of Little Rock, Arkansas. Other companies are involved in the criminal charges currently filed against Mr. Hale. Robert Boyce, the purported owner and president of Retail Liquidators, told us that Mr. Hale secretly owned that company and others, using them to obtain loans from Capital Management. Weaver-Bailey Contractors, Inc., was a Little Rock company whose president was the brother of Capital Management's secretary/treasurer.

Regulations prohibit an SSBIC from providing financing to any of its associates, which include any officer of the SSBIC and any close relative of an officer. (13 C.F.R. §§ 107.903(b)(1), 107.3(a)(1) (1993).

## Retail Liquidators, Inc.

During 1987 and 1988 Capital Management provided \$350,000 in three loans to Retail Liquidators, Inc., a Little Rock, Arkansas, corporation designed to liquidate failing businesses. Capital Management records indicate that Retail Liquidators was a valid small concern whose sole owner and president—Robert Boyce—was a socially or economically disadvantaged individual. However, Mr. Boyce told us that Mr. Hale owned and operated Retail Liquidators and used him as a front to borrow money from Capital Management.

Mr. Boyce stated that he had met Mr. Hale through the Jaycees and in 1987 had rented office space from him. At that time, his business consisted of selling computer forms and preprinted paper stock. Later in 1987, Retail Liquidators was incorporated under Arkansas state law and began operating at 1910 N. Grant Street—Capital Management's address.

According to Mr. Boyce, Mr. Hale also owned a clothing store called Little Rock Clothiers.<sup>7</sup> Mr. Boyce stated that Retail Liquidators paid him \$1,000

<sup>7</sup>During 1986 and 1989, Capital Management loaned Little Rock Clothiers, in which Mr. Hale had a hidden interest, a total of \$350,000. On July 15, 1991, Capital Management exchanged these loans for stock in Incredible Closeout Corporation; no money was involved. However, Capital Management reported to SBA that (1) the Little Rock Clothiers loan had been paid in full and (2) a separate financing had been made to Incredible Closeout. Incredible Closeout valued the loans on its books at \$1,000. According to the company's owner, Mr. Hale had told him that future money, as SBA loans, would be available to the company. After Capital Management went into receivership, SBA determined that the exchange's purpose was to remove improper loans from Capital Management's books.



per month, which was later increased to \$1,500 per month. His duties were to maintain the books of Retail Liquidators, Little Rock Clothiers, and a third company owned by Mr. Hale, Retail Factors.

Mr. Boyce stated that Mr. Hale arranged to borrow money for Retail Liquidators from Capital Management and asked him to sign the loan documents. Mr. Hale explained to him that since the loan was to the corporation he, Mr. Boyce, had no personal liability. Mr. Boyce agreed to do so because of Mr. Hale's reputation in the community and because he needed the income. Retail Liquidators operated for about 2.5 years, made no money, and had Little Rock Clothiers as its principal client. Mr. Boyce recalled that Mr. Hale had advised him that an SBA examiner would be calling and had told him how to answer any questions. When the examiner did call, he responded as Mr. Hale had instructed him. Mr. Boyce concluded that while on paper it appears that he owned Retail Liquidators, in fact, Mr. Hale owned the company and made all the decisions for it as he had for Little Rock Clothiers and Retail Factors.

SBA's March 14, 1991, draft report of examination, which was provided to Mr. Hale, raised concerns that Capital Management had not adequately documented the valuation of its loan and equity portfolio, including that of Retail Liquidators.<sup>8</sup> The draft report stated that the last loan payment was on February 28, 1989. On April 18, 1991, Mr. Hale told SBA examiners that the simplest way to determine a questioned portfolio's value was to sell it; if the sale did not result in a loss, the valuation was proper. He further stated that in answer to the concerns raised by the examination report, he had sold 17 questioned portfolio accounts, which included Retail Liquidators, at no loss to Capital Management. SBA's May 31, 1991, final report concluded, without further investigation, that they were satisfied with Capital Management's valuation of its loan and equity portfolio.

On April 15, 1991, 3 days before responding to the draft report of examination, Capital Management sold four financings, including its entire interest in Retail Liquidators and three other accounts, and purportedly received an equity interest in Capital Placement. In January 1994, we interviewed Capital Placement's owner and concluded that the transaction had never been completed. SBA concluded that this was an attempt by Mr. Hale to remove overvalued loans and equity interest from the books of Capital Management.

<sup>8</sup>An improper determination of the market value of an SSBIC's loan and equity portfolio could lead to unrealized losses, which may indicate that capital impairment exists.

**Weaver-Bailey Contractors, Inc.**

On January 20, 1987, Mr. Hale advised SBA that Capital Management had made a 10-percent equity investment at a cost of \$150,000 in Weaver-Bailey Contractors, Inc., a Little Rock, Arkansas, corporation. Capital Management records indicated that the company had a fiscal 1986 gross income of \$5.7 million and a net worth of \$591,000 and that Charles Weaver was the company's president and majority stockholder. SBA learned that Charles Weaver was the brother of Fred Weaver, the secretary/ treasurer and a director of Capital Management.

SBA advised Mr. Hale that this transaction violated the "transactions with associates" prohibition regulation. Mr. Hale responded that Fred Weaver had divested himself of his ownership interest in Weaver-Bailey 6 months before the transaction and that, according to an attorney, this sale would correct any problem with the financing. Mr. Hale stated that he would do whatever SBA required to correct the situation and agreed to divest Capital Management of the equity interest. In January 1988, Weaver-Bailey paid Capital Management \$150,000 in exchange for the Weaver-Bailey stock.

In an interview with us, Fred Weaver stated that Capital Management was to loan Weaver-Bailey \$150,000, provided that Weaver-Bailey would immediately loan Mr. Hale \$100,000 for a few months. As Weaver-Bailey needed the \$50,000 for operating capital at that time, it agreed to Mr. Hale's terms. About 1 year later, Mr. Hale repaid the \$100,000 to Weaver-Bailey, using a cashier's check. Weaver-Bailey used this money and its own funds to repay the \$150,000 to Capital Management.

**Loans for Real Estate Purchases**

Mr. Hale provided SBA funds to small concerns to purchase, or pay the mortgage of, real estate. Two such instances include Capital Management loans to two Arkansas concerns—Pulaski Heights Development Corporation and the Communication Company, a research and consulting firm. Regulations prohibit an SSBIC from providing funds to a small concern to purchase real estate, or to release 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. (13 C.F.R. § 107.901)

**Pulaski Heights Development Corporation**

According to SBA's April 18, 1983, report of examination, Capital Management, although prohibited by regulation, loaned \$145,000 to Pulaski Heights Development Corporation on July 15, 1982, to purchase real estate. The examiner concluded this after a February 23, 1983, field visit to the property showed that no work had been done.

Mr. Hale disagreed with the examination's conclusions, stating that the loan was for the purchase and development of real estate and that no violation existed. However, the examination report recommended that Capital Management divest itself of the financing, and Mr. Hale agreed to comply. Capital Management records showed this loan as repaid on July 13, 1983.

### The Communication Company

Capital Management records indicated that the Communication Company, the sole proprietorship of Stephen A. Smith, began in June 1983 to conduct public affairs research and communication consulting. On February 21, 1986, Capital Management loaned Mr. Smith \$65,000<sup>9</sup> for the stated purpose of providing working capital, including employment of a full-time account executive and marketing representative, for the Communication Company. However, according to correspondence in Capital Management's file, the loan was actually used to pay off a real estate mortgage of Kings River Land Company for which Mr. Smith had one-third interest. Thus, the Capital Management loan to Mr. Smith would have been prohibited under the regulations.

On September 21, 1990, Capital Management filed a complaint in the Circuit Court of Washington County, Arkansas, against Mr. Smith for making no payment since July 20, 1989, and demanded payment. Mr. Smith subsequently filed bankruptcy. The Capital Management debt was discharged in the bankruptcy in 1992.

### Flexible SBA Eligibility Guidelines

The May 1980 "SBA Policy and Procedural Release #2017" noted that the Congress, in specifying that the SSBIC program aid anyone hampered by the economic system, did not fully define "socially or economically disadvantaged." The release stated that flexibility when determining applicants' eligibility was warranted. It further noted that such factors as a low income, limited education, or participation in the Armed Forces during the Vietnam era (Aug. 5, 1964-May 7, 1975) may be considered in determining if an applicant was disadvantaged. The release stipulated that the SSBIC was to prepare and maintain an eligibility "profile" for each loan recipient, based on a composite of the information leading to the eligibility determination. (See app. I.)

However, Capital Management prepared and maintained few eligibility profiles, counter to direction in release #2017. Instead, from 1979 through

<sup>9</sup>The loan was a 12.5-percent promissory note, dated Feb. 21, 1986, payable in 48 equal monthly installments. Mr. Smith's financial statement indicated his net worth as \$152,000.

1990, Mr. Hale maintained a boilerplate document titled, "Determination of Disadvantaged Small Business Concern," as the justification in the loan files verifying the borrower's eligibility as a socially or economically disadvantaged person. The text of the document in its entirety follows:

"The owner of the herein SBC [small business concern] because of his economic background and the social and economic system [in] which he works has prevented him from obtaining financial and other assistance available to the average entrepreneur in the economic mainstream.

"A composite of the hereinabove factors and other pertinent information established a profile used as the basis for eligibility within the guidelines of SBA policy and procedure release No. 2217 [2017]."

Some SBA reports of examination noted problems with Capital Management's eligibility determinations. The April 18, 1983, report concluded that Pulaski Heights was owned by an individual who was not socially or economically disadvantaged. Pulaski Heights' owner was a Caucasian, had a master's degree in engineering, and was not known to be a Vietnam veteran. The report further noted that all of the 10 financings undertaken during 1982 were to Caucasians, many with college degrees, some earning in excess of \$40,000. In response, Mr. Hale stated that when he evaluated an individual's qualifications, he asked himself, "Will the person, without our help, be able to continue in, or enter, the free enterprise system? If the person can't compete, or survive, without the financing, he/she qualifies."

SBA's May 15, 1991, report of examination stated that Capital Management failed to properly prepare eligibility profiles. Mr. Hale responded at that time that he had used his 2-paragraph determination document since March 1979 and SBA had approved it in the past.

The May 1991 report of examination also questioned Capital Management's financing a small concern that did not meet the definition of a disadvantaged small business. The concern's owner was not a Vietnam era veteran nor a member of a minority group; and the owner had a net worth of \$2.4 million.

In response, Mr. Hale stated, "Arkansas is the poorest state in the United States with almost one-half of its area included in the Delta Development Region created by the United States Congress. This area has been determined by the Congress . . . to be Economic[ally] depressed in

comparison with that of the Third World Countries." Thus, he reasoned that any resident of Arkansas qualified for an SBA loan. However, since SBA had questioned the loan, he stated that it would be sold and agreed to follow SBA's guidelines in the future.

## Additional Capital Management Transactions

You requested that we analyze three specific Capital Management transactions to Susan McDougal (through her business Master Marketing); Castle Sewer and Water Corporation; and Castle's wholly owned subsidiary, Southloop Construction Corporation. We were unable to fully analyze these transactions because Capital Management's records were incomplete and key participants were unavailable for interview.

Nevertheless, the Susan McDougal loan is an example of loans that Mr. Hale made to persons with questionable eligibility. Capital Management's loan file showed that Mrs. McDougal had represented the combined net worth of her and her husband to be \$2.2 million and that Mr. Hale had failed to properly document her eligibility with a profile. Mr. Hale's 2-paragraph boilerplate document was the sole justification for all three recipients' eligibility.

## Susan McDougal and the Master Marketing Loan

### Capital Management Records of the Master Marketing Loan

In April 1986, Capital Management Services provided a \$300,000 loan<sup>10</sup> to Susan McDougal, wife of James McDougal, who was president of Madison Guaranty Savings and Loan Association.<sup>11</sup> The McDougals were the majority shareholders of Madison Guaranty. The loan was ostensibly given to provide working capital for Mrs. McDougal's newly created advertising firm, Master Marketing, and was secured by equipment, inventory, commissions, and the personal guarantees of Mr. and Mrs. McDougal. At the time of the loan, both Mr. and Mrs. McDougal provided a combined financial statement reporting a net worth of \$2.2 million. Mrs. McDougal's

<sup>10</sup>The loan was a 12-percent promissory note for \$300,000, dated Apr. 3, 1986, with payment of \$36,000 of interest only for the first and second years, then \$14,122.05 a month including interest. It matured Apr. 19, 1991.

<sup>11</sup>A review of the \$300,000 Capital Management canceled check payable to Susan McDougal, doing business as Master Marketing, revealed that the check was cleared through Madison Guaranty with a stamped endorsement that read "DEPOSIT TO THE ACCOUNT OF THE NAMED PAYEE MISSING ENDORSEMENT GUARANTEED BY MADISON GUARANTY SAVINGS AND LOAN LITTLE ROCK." There was no indication as to which account this check was deposited. We were unable to obtain information that would document how these funds were subsequently disbursed.

eligibility was documented in the boilerplate document "Determination of Disadvantaged Small Business Concern." On April 3, 1987, Mrs. McDougal wrote Mr. Hale stating that her payment of interest on the loan would be 30 to 60 days late. On April 22, 1987, while SBA examiners were at Capital Management, Mr. and Mrs. McDougal assigned to Capital Management 5,745 shares of common stock (representing majority shares) of Madison Guaranty as additional collateral for the \$300,000 loan.<sup>12</sup>

Capital Management filed suit against Mrs. McDougal for nonpayment of the loan and on February 6, 1989, received a judgment against her for \$396,262.91 (\$300,000 principal and \$96,262.91 interest).

#### SBA Examination Regarding Master Marketing

SBA's May 31, 1991, examination report cited the Susan McDougal loan as an example of the questionable value of Capital Management's loan and equity portfolio. The report stated that Master Marketing specialized in television marketing for real estate development companies and financial institutions in Arkansas and never made a payment to Capital Management. Mr. Hale attributed Master Marketing's failure to the savings and loan crisis and told the examiners that although no assets were then available, he expected to recover a substantial amount of the loan. As a result of the question raised by the examiners, Mr. Hale falsely reported to SBA that the Susan McDougal/Master Marketing loan had been satisfied in full.

#### Cole Masonry Construction Company

During the 1993 SBA compliance examinations, the examiners requested support for a loan to Cole Masonry Construction Company, Little Rock, Arkansas. After reviewing this information, the examiners determined that this loan was merely an exchange for the Susan McDougal loan, which had previously been reported as being fully satisfied after the 1991 examination.

SBA's March 11, 1993, report of examination described the exchange as follows: On April 12, 1991, Capital Management loaned \$400,000<sup>13</sup> to Cole Masonry, which was incorporated on April 8, 1991, to purchase Capital

<sup>12</sup>On its face, this assignment gave Mr. Hale the power to transfer these shares on Madison Guaranty's books and conveyed to Capital Management a majority interest in Madison Guaranty. A letter from Capital Management to another bank, however, indicated that the McDougals had pledged these shares as collateral on a different transaction and the stock was subject to a previous lien. The assignment appeared to provide Capital Management with voting rights. However, despite this apparent assignment, the McDougals subsequently appointed Capital Management as their proxy to vote the shares. We found no evidence, however, that Mr. Hale had exercised any voting rights or other ownership interest in Madison Guaranty during the relevant time period.

<sup>13</sup>The loan was a 10-percent promissory note for \$400,000, dated Apr. 12, 1991, with annual payments of interest only for the first 5 years and annual payments of interest and principal for the next 5 years.

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Management's investments in Master Marketing (\$380,622) and Insurance Economists (\$23,301).

SBA officials interviewed Tommy C. Cole, president and owner of Cole Masonry. According to Mr. Cole, on April 12, 1991, Mr. Hale exchanged the Master Marketing and Insurance Economists notes for a promissory note from Cole Masonry. Mr. Cole stated that Mr. Hale had told him that he needed to "clean up his books" at Capital Management. SBA officials believe the exchange was done to remove worthless loans from Capital Management's books to avoid reporting a loss.

The examiners further noticed that Mr. Hale had attempted another exchange to get Cole Masonry off the books. In June 1992, Capital Management sold, at cost, its investment in Cole Masonry. This sale, a focus of the March 1993 examination report, was subsequently referred to SBA'S OIG.

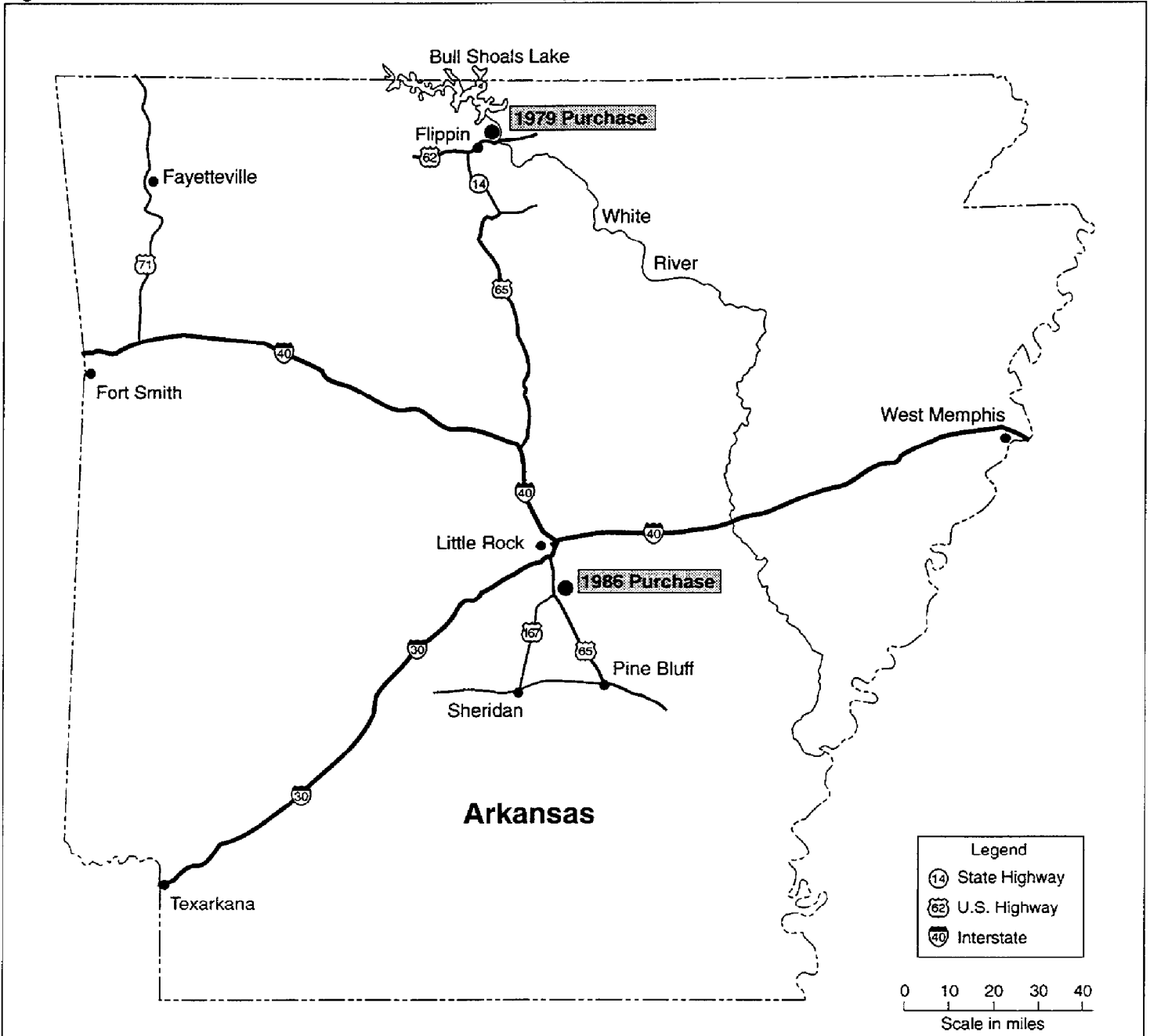
**Land Purchase From  
International Paper Realty  
Corporation**

In approximately February 1986, James McDougal began negotiations with International Paper Realty Corporation, a subsidiary of International Paper Company, to purchase approximately 810 acres of property located in Pulaski and Saline Counties, Arkansas. This property is located south of Little Rock and is close to the Pine Bluff Highway. (See fig. 1.) International Paper Realty entered into a contract dated March 4, 1986, with Whitewater Development Corporation; and the transaction was closed on October 10, 1986. The total sales price was \$550,950, of which \$80,190<sup>14</sup> was collected at closing. The balance was represented by a \$30,000 promissory note due December 15, 1986, and a \$440,760 promissory note payable over 6 years. Mr. McDougal personally guaranteed both promissory notes.

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<sup>14</sup>The \$80,190 collected at closing included a check drawn on a McDougal account at Madison Guaranty for \$25,000, dated Apr. 29, 1986, and a cashier's check for \$55,190, dated Oct. 10, 1986.

Figure 1: 1979 and 1986 Land Purchases of Whitewater Development Corporation





The McDougals had informed International Paper that they were the sole owners of Whitewater Development Corporation and that James McDougal was its president and Susan McDougal was its secretary.

On December 15, 1986, the \$30,000 promissory note was paid in full. A deed was executed on this same date, which conveyed title of the 810 acres from Whitewater Development Corporation to Great Southern Land Company, Inc. In International Paper correspondence with the McDougals, Great Southern Land Company is described as wholly owned by James and Susan McDougal. After acquiring the property, the McDougals subdivided and sold some lots. Either James McDougal or Susan McDougal signed sales contracts for both Whitewater Development Corporation and Great Southern Land Company. Mrs. McDougal's brother also signed for Great Southern Land Company. In 1989, International Paper reacquired the land following foreclosure and judgment, although litigation continues with respect to certain parcels.

Whitewater Development Corporation is an Arkansas corporation formed in the late 1970s by James and Susan McDougal and then Governor William Clinton and Mrs. Hillary Rodham Clinton. Reportedly, Mr. and Mrs. Clinton disposed of their interest in this corporation in December 1992. Newspaper accounts have occasionally confused the land acquired from International Paper in 1986 with the original Whitewater Development property that was acquired in 1979. The land acquired by the McDougals in a venture with the Clintons in 1979 is located approximately 100 miles north of Little Rock on the White River near the Missouri border. The land purchased by the McDougals from International Paper in 1986 is located a few miles south of Little Rock. (See fig. 1.)

Document Provided by  
Mr. Hale's Attorney

In January 1994, Mr. Hale's attorney provided us a copy of an undated, unsigned document titled, "Confidential Data, Master Marketing," which he said Mr. Hale had given him. (See app. II.) This document offers another possible explanation for the use of the \$300,000 loan to Mrs. McDougal. However, we have determined neither the authenticity nor the accuracy of the document since we have been unable to interview Mr. Hale or either of the McDougals.

SBA officials informed us that they had requested that the FBI review all the Capital Management documents in its possession to determine if the

document was there.<sup>15</sup> As of March 14, 1994, SBA had received no response from the FBI.

### Conflicting Claims Regarding the Susan McDougal Loan

While both David Hale and James McDougal were unavailable for interview, we noted their conflicting claims, in newspaper accounts, regarding the use of the \$300,000 that Capital Management had loaned to Susan McDougal. In a 1993 newspaper article, David Hale alleged that during the mid-1980s, then Governor Clinton and James McDougal, president of Madison Guaranty, pressured him to make an SBA-backed loan to Mrs. McDougal's firm, Master Marketing. Mr. Hale alleged that Mr. McDougal had told him that the loan could help with "cleaning up" problems at Madison Guaranty, which was under pressure from federal regulators.

In contrast, Mr. McDougal was quoted in news accounts as stating that the Susan McDougal loan proceeds were deposited at Madison Guaranty and that he had used part of the money to make the 1986 property purchase for Whitewater Development Corporation from International Paper Realty. He added that then Governor and Mrs. Clinton had not been informed of this purchase.

We found no evidence to support or refute either of these conflicting claims.

### Castle Sewer and Water Corporation and Southloop Construction Corporation Loans

Capital Management financed loans to Castle Sewer and Water Corporation<sup>16</sup> and to Southloop Construction Corporation<sup>17</sup> in February 1986 and October 1987, respectively.

Castle was incorporated on December 31, 1985, under Arkansas state law to purchase and operate a water and sewer system in Pulaski County,

<sup>15</sup>Mr. Hale's attorney had said that the document was part of the Master Marketing files that the FBI had obtained under a search warrant executed on July 21, 1993. However, according to the attorney, the document was missing when the FBI returned a copy of the file.

<sup>16</sup>The loan was a 12.5-percent promissory note for \$150,000, dated Feb. 28, 1986, with monthly payments of \$1,562.50 for the first 2 years and monthly payments of \$2,295.66 thereafter, until maturity on Apr. 1, 1993. Castle made sporadic payments until Jan. 1990.

<sup>17</sup>The loan was an 11-percent promissory note for up to \$150,000, dated Oct. 3, 1987, with payments of interest only for the first 2 years and monthly payments of \$2,174.24 thereafter, until maturity on Oct. 3, 1993. Capital Management provided only \$100,000. No payments were made—by Southloop or Castle—on the first or second mortgages.

Arkansas.<sup>18</sup> Castle formed Southloop—as a wholly owned subsidiary—in June 1987 for the purpose of holding title to real estate for which it hoped to develop sewer and water customers.

#### Castle Sewer and Water Loan

Castle used the \$150,000 loan from Capital Management for working capital and to purchase a water and sewer facility. Capital Management documented Castle's eligibility for the loan with the boilerplate document titled, "Determination of Disadvantaged Small Business Concern."

Jim Guy Tucker<sup>19</sup> and R.D. Randolph jointly owned Castle. In October 1987, Capital Management became an equal owner in Castle. According to Mr. Tucker's attorney, in April 1989, Mr. Tucker transferred his remaining stock in Castle to R.D. Randolph.

#### Southloop Construction Corporation Loan

Southloop purchased a Little Rock, Arkansas, property from Mr. Tucker for \$353,000, subject to a first mortgage of \$275,000 (original mortgage balance of \$260,000 plus accrued interest of \$15,000) to Madison Guaranty. Southloop used the \$100,000 loan from Capital Management both to purchase and clean up the real estate located at the intersection of Pratt Road and Pine Bluff Highway in Little Rock. Southloop paid a portion of this—\$78,000—to Tucker for reimbursement of expenses.

In response to concerns about the Castle and Southloop financings raised in the May 31, 1991, SBA report of examination, Mr. Hale told SBA examiners that the corporations' assets had been appraised at twice their total liabilities. Further, he told the examiners that Castle and Southloop stockholders were in the process of selling the corporations' assets. However, Capital Management records indicate that Mr. Hale was aware that Madison Guaranty had reduced the original Castle mortgage of \$1,050,000 to \$525,000 in 1987 to reflect the declining value of the property.

SBA's March 11, 1993, report of examination for Capital Management stated that the Castle and Southloop loans had been delinquent for 3 years and that the value of the loans had not been depreciated. Mr. Hale told the

<sup>18</sup>Madison Guaranty provided a first mortgage of \$1,050,000 toward Castle's \$1.2-million purchase of the sewer and water facility. Capital Management loaned Castle \$150,000 for the balance. That note was secured by all of Castle's stock, inventory, and fixtures; a second mortgage; and the personal guarantee of Castle's president, R.D. Randolph.

<sup>19</sup>Mr. Tucker and his wife, Betty Tucker, had prior dealings with Capital Management. The Tuckers had assumed existing Capital Management loans when they acquired County Cable, Inc.; D & L Communications; and Cablevision Management, Inc. The cable company loans totaled approximately \$425,000. For one of the loans, Capital Management used Mrs. Tucker's joint ownership as the basis for company ownership/control/management by economically or socially disadvantaged individuals. SBA and Capital Management records indicate that all of the loans have been repaid in full.

examiners that the reason that the loans had not been depreciated was because of Castle's and Southloop's strong collateral positions. He then provided to the examiners an August 1990 appraisal that valued the water and sewer facility at \$1.5 million. Further, Mr. Hale told the examiners that no payments had been made because Castle had problems with the Resolution Trust Corporation (RTC) due to the failure of the first lien holder—Madison Guaranty. He assured them that payments would be made once the problems were resolved. He reminded them that Capital Management held a second lien mortgage position behind Madison Guaranty. The examiners concluded that the loans should be considered delinquent and their value depreciated to reflect the collection problem.

## Scope and Methodology

We conducted our investigation of the operations of Capital Management from December 1, 1993, through March 5, 1994.

Our investigation was restricted by the unavailability of certain key witnesses and documentation. David Hale, James McDougal, and Susan McDougal were unavailable for interview, according to their respective attorneys, because they were under either indictment or subpoena to testify before the federal grand jury. In conjunction with SBA's Office of General Counsel, we interviewed individuals who were associated with Capital Management and with David Hale.

We interviewed SBA officials involved in the SSBIC program and analyzed the agency's administrative, audit, and receivership files for Capital Management and Capital Management's corporate books and records for its 14 years of operation.

In addition, we analyzed files—related to Capital Management, David Hale, Madison Guaranty, and James and Susan McDougal—that we had specifically requested from the RTC and the Department of the Treasury's Office of Thrift Supervision. We also obtained documents from International Paper Realty pertaining to the purchase of land south of Little Rock, Arkansas.

We contacted the Office of the Independent Counsel—which is investigating David Hale, Madison Guaranty, and Whitewater Development Corporation—to request access to Whitewater Development Corporation books and records. We were informed that because the Independent Counsel had obtained the Whitewater records pursuant to a grand jury

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subpoena, the records were subject to the nondisclosure provisions<sup>20</sup> and could not be shared.

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While GAO policy is to allow requesters to restrict further distribution of a report for up to 30 days, we will be contacting your office to arrange for an earlier release of this report to other interested parties. If you have any questions concerning this report, please contact me or Assistant Director Donald G. Fulwider of my staff on (202) 512-6722. Major contributors to this report are listed in appendix III.

Sincerely yours,



Richard C. Stiener  
Director

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<sup>20</sup>Rule 6(e)(6) of the Federal Rules of Criminal Procedure requires that records, orders, and subpoenas relating to grand jury proceedings be kept under seal to the extent and for such time as is necessary to prevent disclosure of matters occurring before a grand jury.

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# Contents

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Letter	1
Appendix I “SBA Policy and Procedural Release #2017”	22
Appendix II Document Provided by Mr. Hale’s Attorney	24
Appendix III Major Contributors to This Report	27
Figure	14

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Figure 1: 1979 and 1986 Land Purchases of Whitewater  
Development Corporation

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## Abbreviations

AFMD	Accounting and Financial Management Division
FBI	Federal Bureau of Investigation
GAO	General Accounting Office
OIG	Office of Inspector General
OSI	Office of Special Investigations
RCED	Resources, Community, and Economic Development Division
RTC	Resolution Trust Corporation
SBA	Small Business Administration
SSBIC	Specialized Small Business Investment Company



# "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



2

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

# Document Provided by Mr. Hale's Attorney

CONFIDENTIAL DATA  
MASTER MARKETING  
1308 Main  
Little Rock, Arkansas

This report is prepared for and provided to Capital Management Corporation for its exclusive internal use in evaluating a loan application by Master Marketing. Any third party disclosure of this proprietary information is specifically prohibited.

Master Marketing is a general purpose real estate brokerage and land development firm with Susan McDougal, a well-known Little Rock real estate executive as sole owner. It's offices are located at 1308 Main Street, Little Rock, Arkansas. In 1985, her tenth year in real estate sales and development, Mrs. McDougal had sole responsibility as principal broker, major participation in development decisions of several highly successful subdivisions and improved commercial properties, as well as sole marketing responsibilities for the t.v., radio,

Page 2 - MASTER MARKETING

and newspaper advertising which produced successful advertising campaigns for the success of the subdivisions.

During applicant's highly successful career as a broker and developer, she has been involved either as a principal or broker in the development and sales of the following successful subdivisions and commercial properties:

Park Place, Inc., Little Rock, 21 units,

Flowerwood Farms I and II,

Saltillo Heights, Mayflower - 1200 acres,

Maple Creek Farms, Little Rock - 1300 acres,

Whitewater Estates, Cotter - 212 acres,

Greentree Farms, Camden - 157 acres

All of the above have experienced sales at a rate far in excess of industry standards.

A loan of \$300,000 is requested - approximately

Page 3 - MAS...R MARKETING

\$107,000 of the proceeds will be used to complete Phase 2 of Flowerwood Farms II by the extension of water and sewer lines to 127 lots. It is anticipated the improved lots will sell over a 3-year period for \$230,000. This underlying land in this project is free of debt.

The remaining proceeds will be used to complete surveying and road building on approximately 700 acres 8 miles south of Little Rock within 1,300 feet of the Pine Bluff Freeway in an area where applicant has had a highly successful career selling tracts of land. Underlying debt of this property, which has water and sewer available, is approximately \$500,000.

# Major Contributors to This Report

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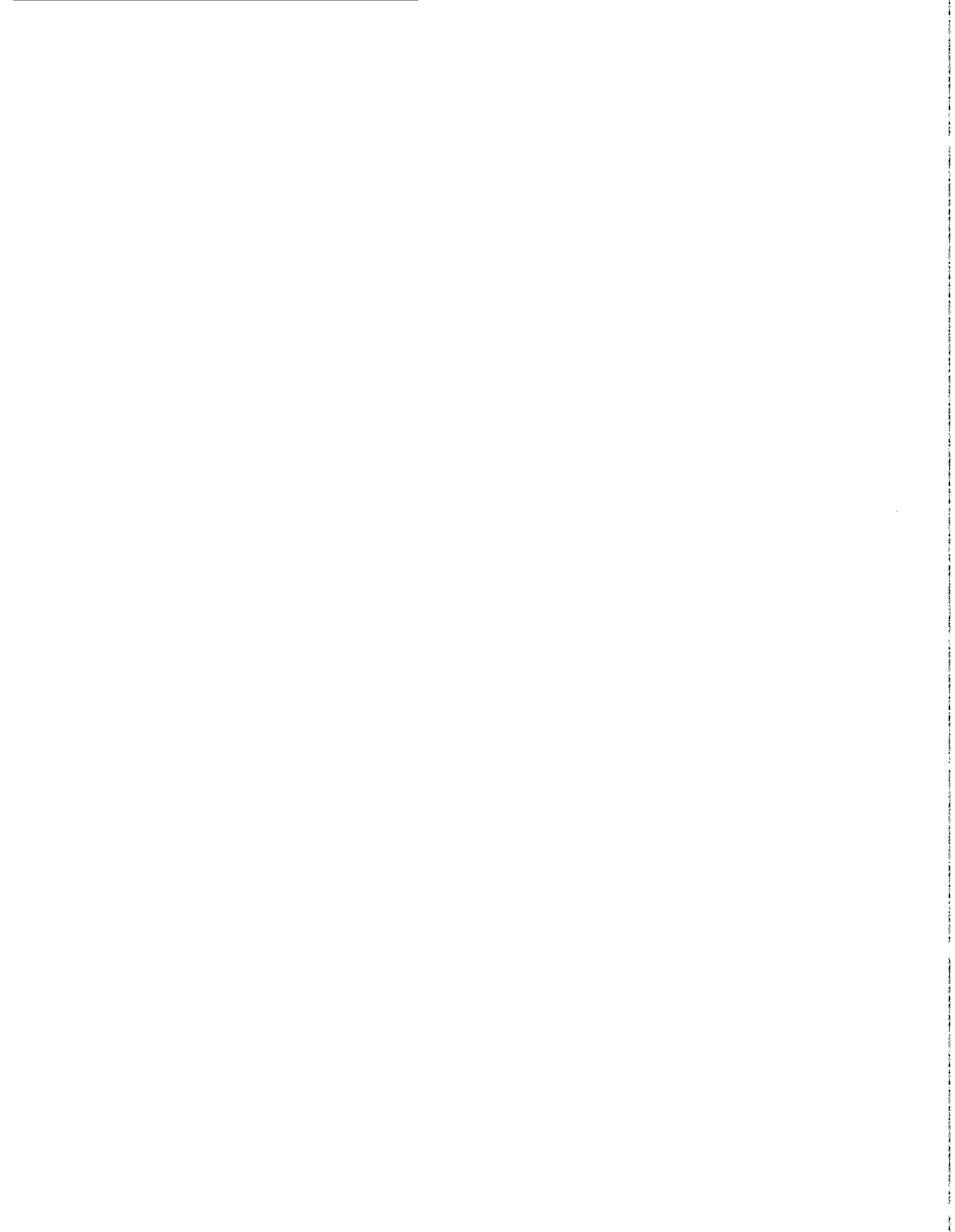
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