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SMALL BUSINESS ADMINISTRATION

Prohibited Practices and Inadequate Oversight in SBIC and SSBIC Programs

Statement of
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Madame Chair and Members of the Committee:

We are pleased to be here today to discuss the Small Business Administration's (SBA) Small Business Investment Company (SBIC) and Specialized Small Business Investment Company (SSBIC) programs.[1] Five hundred ninety companies that participated in these programs have failed and gone into liquidation since October 1, 1966. We previously reported that Capital Management Services, Inc. (CMS), an SSBIC, engaged in such improper management practices as making loans to business associates and purchasing real estate that violated SBA regulations.[2] We also reported that SBA's oversight of CMS was clearly inadequate.

This morning I will discuss a myriad of improper management practices engaged in by the SBICs and SSBICs that we reviewed and SBA's indecisiveness in responding to regulatory violations. Next, Ms. England-Joseph, Director of Housing and Community Development Issues, will discuss specific initiatives that SBA should take to improve its ability to correct the types of management problems that we identified.

This testimony is based on information that we obtained at your and then Chairman John LaFalce's request. Using case studies, we determined whether SBICs and SSBICs (1) had engaged in improper management practices, including regulatory violations and suspected criminal misconduct, and (2) took timely corrective actions for the regulatory violations identified by SBA. At our request, SBA identified 111 SBICs and SSBICs--half active and half currently in liquidation--that had regulatory violations. We selected 12--7 SSBICs and 5 SBICs--for investigation, focusing on SBICs and SSBICs that had been (1) transferred to SBA's Office of Liquidation, (2) found to have engaged in serious regulatory violations or were on SBA's "Watch List" because they were in danger of becoming capitally impaired, or (3) had been referred to SBA's Office of Inspector General (OIG) because of suspected criminal activities.

In summary, we found that:

-- The SBICs and SSBICs we investigated engaged in improper management practices similar to those found in our investigation of CMS. These improper practices included such regulatory violations as loans to associates, including officers and directors of the licensees; loans for prohibited

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[1]For information on the manner in which SBA examines, licenses, and liquidates SBICs and SSBICs, see Small Business Administration: Status of Small Business Investment Companies (GAO/T-RCED-95-145, Mar. 28, 1995).

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

real estate purchases; and loans to individuals of questionable eligibility. A number of these regulatory violations should have been red flags, or indicators, of potential criminal misconduct.

Two of the licensees we examined are currently being investigated by U.S. Attorney's Offices. The investigation of a third resulted in the conviction of its president for soliciting and receiving cash payments in return for approving loans.

-- In addition, the SBICs and SSBICs seldom took timely corrective actions for regulatory violations. Furthermore, SBA did not ensure that the violations were corrected. For the SBICs and SSBICs that we reviewed, some violations went unresolved for 2 to 5 years or more. Estimated losses for 3 of the 5 companies that have gone into liquidation, receivership, or bankruptcy exceeded $4 million.

IMPROPER SBIC AND SSBIC MANAGEMENT PRACTICES

We found that SBA had identified improper management practices with all 12 SBICs and SSBICs that we investigated. The SBICs and SSBICs, located in seven states, provided loans to business associates, for prohibited real estate purchases, and to recipients with questionable eligibility.

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. In addition to being regulatory violations, loans to associates that may involve misrepresentations in loan documents that conceal the true recipient or purpose of the loan should be red flags to SBA examiners that possible criminal violations--such as false statements, mail fraud, or wire fraud--may exist. The following are examples of some of the problems that SBA identified.

-- Square Deal Venture Capital Corporation, an SBIC, of New Square, New York, made four loans totaling $240,000 to a realty corporation, between 1982 and 1989, that were prohibited loans to associates. Public documents reflect Chaim Berger, a director of Square Deal, as the president and secretary of the realty corporation.

-- Metro-Detroit Investment Company, an SSBIC, of Farmington Hills, Michigan, made various loans totaling over $220,000 to a health care facility. Prior to these loans, certain Metro-Detroit officers had personally guaranteed other loans to the same health care facility. The Metro-Detroit loans released the Metro-Detroit chairman of the board, his wife, and Metro-Detroit's president from their personal loan guarantees to the facility.

-- Between 1986 and 1990, First American Capital Funding, Inc., an SSBIC, of Fountain Valley, California, made 15 loans to relatives, partners, and other associates totaling $692,000. SBA became aware of 12 loans in 1993 and directed First American to divest itself of the loans. Subsequently, SBA learned of three additional loans to associates, including one for $100,000, of which $40,000 was then loaned back to the president of the SSBIC. As of September 20, 1995, six of the 15 loans were unresolved.

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 details some of the violations that SBA identified.

-- Alliance Business Investment Company, an SBIC, of Tulsa, Oklahoma, held and operated substantial prohibited real estate and oil and gas properties. SBA first reported these ineligible holdings in 1990, but not until 1994 did Alliance submit to SBA an acceptable plan to divest itself of the properties. As of August 1995, Alliance had divested itself of ineligible oil and gas holdings but had not sold the ineligible real estate properties in accordance with the divestiture plan.

-- Square Deal made a $150,000 equity investment in the New Square Hotel, New Square, New York. According to documents in the SBA loan file, Square Deal's president approved the investment. However, public documents show him as the president of the New Square Hotel. Furthermore, rather than being used to develop a commercial hotel, the loan proceeds were used to acquire and operate low-income housing, a prohibited real estate practice. In its 1994 examination report, SBA did not identify the conflict of interest, but noted that the purchase violated regulations prohibiting this type of real estate investment. Square Deal is currently under investigation by the U.S, Attorney's Office in New York.

-- Four Providence, Rhode Island, SBICs were associated with Arnold Kilberg, a Rhode Island accountant. Mr. Kilberg served as president of Moneta Capital Corporation; as investment adviser and manager of Richmond Square Capital Corporation and Fairway Capital Corporation, the latter of which was owned in part by his children; and as an independent accountant to Wallace Capital Corporation. These SBICs were all engaged in prohibited real estate transactions. SBA believes that one of the transactions, involving all 4 SBICs, was designed so that Mr. Kilberg realized a $900,000 profit from the sale of downtown Providence, Rhode Island, property. According to SBA, in doing so, Mr. Kilberg engaged in a scheme to misapply SBIC funds to pay off personal financial obligations.

Loans to Individuals With Questionable Eligibility

SSBICs invest in disadvantaged small businesses--those at least 50 percent owned, controlled, and managed by socially or economically disadvantaged individuals. Neither the law nor SBA regulations define "social or economic disadvantage." However, SBA policy provides criteria and procedures for establishing social or economic disadvantage. SBA requires SSBICs to prepare profiles of small business concerns to document their eligibility to receive financing. Eligibility factors include minority status, low income, unfavorable location of business, limited education, physical or other handicap, past or prevailing marketplace restrictions, and Vietnam-era service in the Armed Forces.

Some SSBICs dispersed loans to individuals whose eligibility was questionable. The loan recipients were not economically or socially disadvantaged individuals. Some loans were to disadvantaged businesses, but the disadvantaged owner did not control the operations of the business as required by SBA regulations. Several of these involved the use of minority fronts that were controlled by the SSBIC that provided the financing. The specifics on some of these loans are described below.

-- According to SBA examination findings, FJC Growth Capital Corporation, an SSBIC, of Huntsville, Alabama, made loans to businesses whose eligibility SBA questioned. For example, a clothing manufacturer in Alabama was owned by an individual who was neither economically nor socially disadvantaged. He was not a member of a designated minority group and neither his home nor his company were in an unfavorable location. Furthermore, the individual owned two other clothing companies, had a personal net worth of over $12 million in February 1993, and had a $575,000 residence.

-- SBA examinations determined that both Metro-Detroit Investment Company and Mutual Investment Company, Inc., two SSBICs in Michigan, had 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 a designated minority group. Similar to our findings in our March 1994 report on CMS, the eligibility profiles for these individuals were boilerplate checklists that demonstrated no social or economic disadvantage. Mutual's 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 is in a recession.

Metro-Detroit provided $250,000 to a supermarket owner whose assets were valued at $64.4 million and whose net worth was $24.6 million. In another instance, over a period of years, approximately $313,000 went to a grocery/party store owner whose net worth was $2.8 million, exclusive of his residence valued at $360,000. Mutual also made a $260,000 loan to a liquor store owner whose net worth was $642,565. SBA determined that the borrower used at least $58,332--and possibly over $126,800--toward the purchase of a home.

In August 1994, Mutual's president was convicted of receiving an unlawful benefit for soliciting and receiving cash payments in return for approving loans. Mutual is in liquidation and SBA estimates a loss of over $1.5 million. Metro is on SBA's Watch List because of an ongoing criminal investigation.

-- In 1986, allegations arose that CVC Capital Corporation, an SSBIC in New York City, made loans to companies controlled by its president, Jeorg Klebe. An SBA OIG investigation concluded that Mr. Klebe had devised a scheme to unlawfully obtain loans from the SSBIC program. He created four corporations. Fifty-one percent of the stock of these corporations was held by a minority, but Mr. Klebe actually controlled the corporations. He also made a loan to another company by channeling the funds through one of the four corporations that he created.

In September 1992, more than 5 years after the original allegations, SBA conducted its first follow-up examination and found that CVC had violated the regulation that prohibits loans to nondisadvantaged individuals. SBA transferred CVC to liquidation for such reasons as conflict-of-interest transactions, impermissible investments, improper use of funds, and excessive management fees. CVC received a total of $5 million from SBA. SBA has projected a $1 million loss.

SBICs AND SSBICs DID NOT TAKE TIMELY ACTIONS TO CORRECT VIOLATIONS

For the SBICs and SSBICs we reviewed, some violations went unresolved for 2 to 5 years or more. Furthermore, SBA did not ensure that the violations were corrected. According to SBA, its usual response was to accept from the SBICs and SSBICs written assertions that corrective actions had been taken, and to wait for the next examination for verification. As a result, SBA found continuing and recurring violations in successive examinations. The following provides some examples of the recurrent problems that SBA identified.

-- SBA cited an SBIC in Tulsa, Oklahoma, in 1990 for holding prohibited oil and gas properties. Although SBA directed the SBIC to divest itself of all such properties, it had not fully complied as of August 1995.

-- SBA instructed a California SSBIC in 1993 to divest itself of 12 loans to associates and relatives. Between 1993 and April 1995, SBA had identified one additional loan and was notified by the SBIC of two additional loans. As of September 1995, the SSBIC had not resolved six of these loans.

-- An SBA examination determined that a Louisiana SSBIC had overvalued 11 of 14 delinquent loans by more than 200 percent--the SSBIC's valuation was $518,178; SBA examiners' valuation was $168,798--increasing the SSBIC's capital impairment from 47 to 70 percent. The settlement agreement between SBA and the SSBIC required the SSBIC to reduce its impairment in 180 days. After 180 days, the SSBIC's capital impairment had instead risen to 84 percent; but SBA gave it an additional 180 days to comply. Ultimately, the SSBIC failed and went into bankruptcy. SBA projects that the government's loss will be more than $1.6 million.

-- SBA substantiated allegations that a New York SSBIC was making loans to minority businesses that the SSBIC controlled. Over 5 years after SBA had substantiated this activity, it transferred the SSBIC into liquidation and the government incurred a $1 million loss.

Even though SBA has taken important steps to improve its examination process, its response to examination findings is insufficient to reduce the likelihood of repeat violations and financial loss to the government. For example, SBA has decreased the period of time between examinations (from 22 to 14 months on average), expanded the comprehensiveness of the examinations, and required site visits of portfolio investments and assessments of small businesses' eligibility requirements. However, SBA does not ensure that licensees take effective and timely actions to correct examination findings related to improper management practices.

According to the Director of the Office of Liquidation, SBA's failure to identify and correct examination findings precludes it from helping companies to avoid serious capital impairment and financial loss to the government. The Director said that almost every company that had gone into liquidation had also gone into receivership.

CONCLUSION

Although SBA identified numerous regulatory violations for the 12 SBICs and SSBICs we examined, the agency has not acted decisively to ensure that the companies take the required corrective actions. Without effective corrective actions on regulatory violations by the companies and aggressive oversight by SBA, improper management practices will continue and significant government investment will be at risk. Most of the companies that enter liquidation subsequently move to receivership, at which point the government is likely to incur a loss. Furthermore, if history repeats itself, a significant number of currently active SBICs and SSBICs could enter liquidation and receivership. Only with timely and effective follow up on findings of serious regulatory violations can SBA ensure accountability of troubled companies and prevent further financial losses to the program.

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This concludes my prepared remarks. We will be pleased to answer any question that you or other members of the Committee may have at this time.

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