

UNITED STATES SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C.

_____)	FINAL AGENCY DECISION
In the Matter of)	PERMANENTLY REVOKING
EDF RESOURCE CAPITAL, INC.)	AUTHORITY TO PARTICIPATE IN
(Certified Development Company))	504 LOAN PROGRAM AND
_____)	PERMANENTLY TRANSFERRING
)	504 LOAN PORTFOLIO

This Final Agency Decision (Decision) relates to EDF RESOURCE CAPITAL, INC. (EDF), a California non-profit corporation authorized by the U.S. Small Business Administration (SBA or the Agency) to participate as a Certified Development Company (CDC) in the Agency's 504 Loan Program.

On February 18, 2011, pursuant to 13 C.F.R. § 120.1600(a)(1), the Agency served EDF with notice of (a) the proposed permanent revocation, pursuant to 13 C.F.R. § 120.1500(a)(3), of EDF's authority to participate in the 504 Loan Program, and (b) the proposed transfer, pursuant to 13 C.F.R. § 120.1500(e)(1), of EDF's 504 Loan Portfolio and all of its pending 504 loan applications to SBA, another CDC or entity designated by SBA.

Based upon a review of the record, including submissions by and on behalf of EDF, and for the reasons detailed below, the Agency hereby renders its Decision as follows:

- EDF's authority to participate in all aspects of SBA's 504 Loan Program, including all delegations and powers associated therewith, is hereby PERMANENTLY REVOKED pursuant to 13 C.F.R. § 120.1500(a)(3).
- Pursuant to 13 C.F.R. § 120.1500(e)(1), the SBA 504 Loan Portfolio and all of the pending SBA 504 loan applications, and all rights associated therewith (including all processing, closing, servicing, late and other fees received and/or due and payable after the date of this Decision), are hereby TRANSFERRED ON A PERMANENT BASIS to The Preston Group, LLC (as agent for SBA), KeyCorp Real Estate Capital Markets, Inc. (as agent for SBA), and such other entity or entities as the Agency shall hereafter direct.
- SBA's Central Servicing Agent, Colson Services Corp., and its successor, Wells Fargo Bank, N.A., are ordered to withhold from EDF and to transfer all processing, closing, servicing, late and other fees received and/or due and payable on the SBA 504 Loan Portfolio and the pending SBA 504 loan applications to SBA and/or such other entity or entities as the Agency shall hereafter direct.

- EDF is ordered to maintain all databases, records, files and documents associated with its dealings with SBA and its activities as a CDC, and to cooperate fully, allow such access, provide all such information and documents, and follow such instructions from SBA and its designated agents, The Preston Group, LLC and KeyCorp Real Estate Capital Markets, Inc., as well as Colson Services Corp. (as agent for SBA) and Wells Fargo Bank, N.A. (as agent for SBA), as are associated with administering and implementing the foregoing revocation and transfer.

This Decision is effective immediately.

I. SUMMARY OF DECISION

SBA's 504 Loan Program is a key component supporting the Agency's mission to assist small businesses by providing them with needed long-term capital not otherwise available to them to purchase or improve fixed assets or real estate. The purpose of the 504 Loan Program is to encourage economic development within a community. The 504 Loan Program is delivered through authorized CDCs, which act on the Agency's behalf to arrange, close, service and (when necessary) liquidate and collect on 504 Loans. CDCs arrange 504 Loans with pooled funds obtained through SBA from capital markets; CDCs do not use their own funds to make any 504 Loans. All 504 Loans are 100% guaranteed by SBA.

Currently, there are over 270 CDCs authorized to participate in SBA's 504 Loan Program with over \$25 billion in total SBA 504 Loans under management. EDF has been an Agency-authorized CDC for 31 years. Currently, EDF has approximately 2,381 loans in its portfolio with a total outstanding balance of just over \$1.3 billion. Most loans in EDF's portfolio were for the purchase of improved real estate, and thus are collateralized primarily by liens on the subject real property and improvements.

A subset of CDCs applies for and obtains delegated authority from the Agency to make determinations of creditworthiness for the 504 Loans they arrange on the Agency's behalf. (Ordinarily, this determination is reserved to the Agency.) This additional authority is called the "Premier Certified Lender Program," or "PCLP" program. EDF is a PCLP CDC, and the great majority of loans in its portfolio were made using its PCLP authority. In return for the delegated authority associated with PCLP status, to align incentives, and to reduce taxpayer exposure on 504 Loans arranged on a delegated basis, PCLP CDCs are statutorily required to bear a share of any losses suffered by the Agency on PCLP loans. In EDF's case, its share of any such losses is, in most cases, 15% of the SBA loss on defaulted PCLP loans.

To provide a fund to help ensure payment of such loss-share, PCLP CDCs are required to calculate, fund as needed, and maintain a Loan Loss Reserve Fund. A PCLP CDC is liable for its entire loss-share on its PCLP loans whether or not its Loan Loss Reserve has sufficient funds to cover that share; but the Loan Loss Reserve Fund is intended to provide a ready and secure source for payment to help protect the taxpayers from loss. In this respect, CDCs receive substantial fees, throughout the life of a loan, from payments made by borrowers on 504 Loans. PCLP CDCs are expected to husband this fee revenue carefully; to fund their Loan Loss Reserve Fund in a full and timely manner; and to pay their agreed share of any losses ultimately suffered

by the SBA on PCLP loans. If a PCLP CDC fails to pay its loss-share, SBA may, among other remedies, recover the funds from the CDC's Loan Loss Reserve Fund.

Ordinarily, PCLP CDCs are required to establish and maintain a Loan Loss Reserve Fund equal to 1% of the original principal amount of their outstanding PCLP loans, which amount must remain the same through the life of each PCLP loan. When it first gained PCLP status in 1997, EDF created and maintained a Loan Loss Reserve Fund using this standard 1% funding method. In 2004, EDF opted to participate in a statutory pilot Alternative Loan Loss Reserve program. This alternative program allowed EDF to employ a "Risk-Based Methodology" to fund its Loan Loss Reserve Fund. Congress directed SBA to allow a PCLP CDC to participate in the pilot if, inter alia, SBA determined that the PCLP CDC had established and was utilizing an appropriate and effective process for analyzing the risk of loss associated with its portfolio of PCLP loans and for grading each PCLP loan on the basis of the risk of loss associated with each loan. Congress did not require SBA to create by regulation the risk-based process for the PCLP CDC; the creation of the risk-based process was left to the PCLP CDC. EDF enthusiastically embraced the Alternative Loan Loss Reserve program and created its Risk-Based Methodology a year before the statute was enacted. EDF in its submissions to SBA purports to continue to use its Risk-Based Methodology and, at least in its internal documents, in fact generally applied that methodology. EDF's Risk-Based Methodology was intended to provide a method for determining, on a regular basis, how risky each PCLP loan in EDF's portfolio was at any point in time, so that an appropriate reserve amount could be placed in the fund for that loan. EDF was required by SBA regulation to report to the Agency, each quarter, the amount maintained from time-to-time in its Loan Loss Reserve Fund as a cumulative result of its risk-based rating of each PCLP loan in its portfolio.

The Alternative "Risk-Based" Loan Loss Reserve funding mechanism was just that: an alternative method for funding a loan loss reserve. It did not replace the obligation to have an adequate reserve to protect the taxpayers from loss on a CDC's PCLP loans. Accordingly EDF, like all PCLP CDCs, was at all times required to use one of the approved methods to fund and maintain an adequate Loan Loss Reserve Fund.

Against the foregoing background, the within enforcement action results from the manner in which EDF, a long-time participant in the 504 program, responded to changing economic conditions. Starting in or about 2007, economic stresses and real estate market changes led to a great increase in business failures and loan defaults in EDF's portfolio of SBA 504 Loans. As a regulated CDC managing a very large portfolio of 504 Loans, EDF was subject to an ongoing series of duties requiring prudent, honest and timely management and reporting with respect to its portfolio. It was also required to bear its share of loan losses as incurred, and to maintain sound financial footing. The evidence in the record, however, discloses the following:

1. Instead of properly evaluating and maintaining its Risk-Based Loan Loss Reserve Fund, EDF failed to monitor, evaluate and timely re-grade, on an ongoing basis as required, the risk level of the PCLP loans in its portfolio.
2. Instead of fully funding its Loan Loss Reserve Fund as required by its own Risk-Based Methodology, EDF intentionally failed to deposit into its Fund the sums that would have truthfully and accurately reflected the cumulative current risk level of all of the PCLP

loans in its portfolio. In so doing, EDF failed to comply with its own Methodology and also failed to fulfill its statutory and regulatory obligations to make such contributions to its Loan Loss Reserve Fund as are necessary to ensure that the amount of the Loan Loss Reserve Fund is sufficient to protect SBA from the risk of loss.

3. Instead of recording and reporting to the Agency accurate and timely information about its loan portfolio and Loan Loss Reserve Fund, EDF maintained two sets of accounting books and records, one disclosed to the Agency and one not. On the versions of its quarterly Loan Loss Reserve Fund Report disclosed to the Agency, EDF intentionally removed over time and failed to reserve for approximately 316 PCLP loans with an outstanding principal balance of approximately \$194 million as those loans became more risky and as borrowers defaulted. In so doing, EDF concealed from SBA the status of hundreds of defaulted loans, thus knowingly painting a materially incomplete, misleading and falsely positive picture of its Loan Loss Reserve Fund and of the Fund's ability to protect SBA from the risk of loss.
4. Instead of remitting faithfully to the Agency all sums due to it, EDF has failed and refused to pay over \$20 million in loss-share and other obligations currently due and owing to the Agency, including by wrongfully and without lawful basis retaining at least \$8.2 million in collections and other monies received on the Agency's behalf during the course of its servicing of its loan portfolio.
5. Instead of maintaining sound financial status, EDF is insolvent and not capable of paying its debts when due or otherwise timely or fully discharging its obligations, including those to the Agency. EDF's outside auditor has refused to issue an opinion on EDF's 2011 Financial Statements that were submitted to SBA on March 28, 2012.
6. Since 2006, EDF, a non-profit corporation, has received over \$49 million in fees from its participation in the 504 Loan Program. However, EDF is not currently in a position to manage or discharge (and is not willing to manage or discharge) its obligations as a CDC going forward. As of September 30, 2012, SBA has charged off 163 loans in EDF's portfolio. SBA's losses on these charged-off loans total over \$99 million. SBA has already invoiced EDF for \$11,448,899 based on EDF's 15% loss-share on the first group of these 163 loans, which sum EDF has failed and refused to pay and is due plus penalties and interest. SBA is in the process of invoicing EDF for another \$3.6 million for its 15% loss-share on the remainder of these loans. Further, as of September 30, 2012, EDF has approximately 334 other non-performing PCLP loans in its portfolio with a total outstanding balance of approximately \$198 million. EDF's potential PCLP loss reimbursement exposure on the 334 other non-performing PCLP loans totals approximately \$29 million.
7. Based on the foregoing, EDF has liquidated debts to SBA of approximately \$15 million to date and a potential exposure of an additional \$29 million, for a total of \$44 million. It refuses to pay these debts or even acknowledge its liability for these debts. In addition, its financial statements reveal that it has no funds or assets with which to discharge such debts. Further, EDF's Loan Loss Reserve Fund currently contains only \$1,979,526, an amount grossly insufficient to pay current or accruing loss share debts or to protect SBA from the risk of loss.

EDF and its representatives were provided an opportunity to respond to the Agency's Notice of Proposed Enforcement Action, as originally proposed and as clarified and supplemented, and

were provided with the audit reports that were considered by the Agency. EDF responded and provided extensive documentation, evidence and materials in support of its positions and contentions. Such submissions have been fully reviewed and considered, and all material arguments and submissions are addressed herein.

Essentially, EDF acknowledges that it has failed to fund its Loan Loss Reserve Fund in accordance with its Risk-Based Methodology, that it has provided repeated reports to the Agency which do not disclose truthful or timely information about all loans in its portfolio, and that it has refused to pay Agency loss-share invoices of over \$10 million and has no funds with which to do so. Nonetheless, it urges that its false reporting and concealments do not justify this enforcement action and that its long-standing statutory loss-share obligations cannot be enforced. For the reasons discussed more fully herein, EDF's submissions do not explain, ameliorate or justify the ongoing and fundamental breaches identified herein. Those breaches support the following determinations:

1. EDF has failed to establish or maintain (including failing to properly evaluate, risk rate, manage, fund and fully and accurately report on) a Loan Loss Reserve Fund as required by the PCLP Program. Thus, SBA has sufficient grounds for the enforcement action pursuant to 13 C.F.R. § 120.1400(f)(2).
2. EDF has failed to comply materially with SBA's Loan Program Requirement to pay invoiced obligations in a timely manner as required by 15 U.S.C. § 697e(b)(2)(C) and/or 13 C.F.R. § 120.847(h)(2). Thus, SBA has sufficient grounds for the enforcement action pursuant to 13 C.F.R. § 120.1400(c)(2).
3. EDF has failed to comply materially with SBA's Loan Program Requirement to maintain the financial ability to operate as required by 13 C.F.R. § 120.825. Thus, SBA has sufficient grounds for the enforcement action pursuant to 13 C.F.R. § 120.1400(c)(2).

It is SBA's determination that these grounds, either individually or in the aggregate, are sufficient to support the final decision.

The nature, extent and severity of EDF's breaches and violations, including the dollar magnitude of current losses and additional risk, along with EDF's insolvency and unwillingness to correct identified problems, and program integrity considerations, warrant the revocation of EDF's authority to participate as a CDC in the 504 Loan program. The revocation of EDF's 504 program authority precludes EDF from continuing to close and service its SBA 504 Loan portfolio and process its pending SBA 504 Loan applications, requiring the transfer of those functions to an entity or entities authorized by SBA to perform such functions in accordance with applicable law. For the above reasons, and based upon the detailed discussion set forth below, the Agency has decided to affirm and proceed with the proposed enforcement action and renders its Final Decision as set forth herein.

II. FACTUAL BACKGROUND

A. Overview of SBA's 504 Loan Program

The mission of SBA, an independent Federal agency, is to “aid, counsel, assist, and protect, insofar as is possible, the interests of small-business concerns in order to preserve free competitive enterprise.” *See* 15 U.S.C. § 631. SBA carries out this mission, in part, through two flagship loan programs that provide small business concerns with access to capital. One of the SBA loan programs is the 504 Loan Program, authorized by Title V of the Small Business Investment Act of 1958.¹ *See* 15 U.S.C. § 695 *et seq.* The purpose of the 504 Loan Program is to foster economic development, create or preserve job opportunities, and stimulate growth, expansion and modernization of small business concerns by providing long-term financing not otherwise available to small business concerns for the acquisition, construction, conversion or expansion of fixed assets, including real estate and heavy machinery and equipment. *See* 15 U.S.C. §§ 695(a) and 696(a). SBA's regulations governing the 504 Loan Program are located in Subpart H of Title 13, Part 120 of the Code of Federal Regulations. The outstanding balance of SBA's active portfolio of over 58,000 504 Loans exceeds \$25 billion.

SBA does not make loans directly to small business concerns under the 504 Loan Program. *See* 15 U.S.C. § 695. Instead, as required by statute, CDCs deliver SBA's 504 Loan Program to small business borrowers on behalf of SBA. *Id.* CDCs are generally (but not exclusively) non-profit corporations certified and regulated by SBA that are organized to contribute to the economic development of a particular community or region. *See* 13 C.F.R. § 120.820. CDCs receive processing and closing fees for originating 504 Loans on behalf of SBA and servicing fees for servicing 504 Loans on behalf of SBA. *See* 13 C.F.R. § 120.971. There are currently more than 270 CDCs participating in SBA's 504 Loan Program.

SBA agrees to provide 504 project financing to a small business borrower by issuing an Authorization for Debenture Guarantee--SBA 504 Loan (Loan Authorization) outlining the terms and conditions of the financing. Financing of a 504 project typically has three components:

- A loan from a private Third Party Lender secured by a senior lien covering up to 50 percent of the project cost (Senior Third Party Lender Loan)
- A loan from a CDC (made on behalf of SBA and funded through the CDC's issuance of a 100% SBA-guaranteed debenture) secured by a junior (subordinate) lien covering up to 40 percent of the project cost (504 Loan)
- An equity contribution from the small business borrower of at least 10 percent of the project cost (Borrower Contribution)

See 13 C.F.R. § 120.801.

The Senior Third Party Lender Loan is generally closed first, with the small business borrower executing loan documents in favor of the Senior Third Party Lender and the Senior Third Party

¹ This program has been operating in various forms since 1958.

Lender recording a mortgage or deed of trust in first position on the 504 project property. *See* 13 C.F.R. § 120.921. The 504 Loan is closed next, with the small business borrower executing loan documents in favor of the CDC and the CDC recording a subordinate mortgage or deed of trust on the 504 project property. *See* Loan Authorization. At closing, the CDC immediately assigns and delivers the executed 504 Loan documents and recorded subordinate mortgage or deed of trust to SBA. *See* 504 Debenture Closing Checklist, SBA Form 2286.

No CDC monies are used to fund a 504 Loan. A 504 Loan is funded by the sale of a CDC debenture that is 100% guaranteed by SBA and backed by the full faith and credit of the United States. *See* 15 U.S.C. § 697 and 13 C.F.R. § 120.801(d). SBA conducts monthly sales of pooled SBA-guaranteed CDC debentures to investors in conjunction with SBA's Fiscal and Transfer Agent.

SBA's Central Servicing Agent (CSA), Colson Services Corp., a subsidiary of BNY/Mellon, and its successor, Wells Fargo Bank, N.A., collect borrower payments on 504 Loans through monthly Automated Clearing House (ACH) debits.² The CSA pays out various fees from the borrower's monthly payment, including servicing fees to the CDC, and holds the remaining monthly payment amount. *See* Servicing Agent Agreement, SBA Form 1506. The CSA then makes semi-annual payments to the investors on the SBA-guaranteed CDC debentures using the monthly payment amounts collected from the borrowers. *Id.*

If a 504 Loan defaults and the borrower does not resume regular payments within a certain time period, SBA is obligated under the terms of its guarantee to purchase the full amount (principal and accrued interest) of the SBA-guaranteed CDC debenture from the investor holding the debenture.³ *See* 13 C.F.R. § 120.938. SBA, as the 100% owner of the defaulted 504 Loan, then seeks to recover from the small business borrower through collection activities carried out by SBA or by a CDC on behalf of SBA.⁴ *See* 13 C.F.R. § 120.975(a). As with any commercial real estate loan to a business borrower, there are a number of possible avenues for recovery. First, because SBA has a lien on the real estate comprising the 504 project, SBA can seek to recover on the collateral. *See* SBA SOP 50 51 3, ch. 13. However, because SBA is always in a subordinate position on the collateral for up to 40% of the project cost, it is subject to the actions of the Senior Third Party Lender that holds the senior lien on the collateral for 50% of the project cost. *See* SBA SOP 50 10 5(E), sub. C, ch. 1, para. IV. Second, because SBA's regulations require that all owners of 20% or more of a small business borrower must guarantee the loan, SBA can also seek to recover on the personal guarantee of the business owner or owners. *See* 13 C.F.R. § 120.160. Recovery on the guarantee can be consensual through an offer in compromise or through forced collection (*e.g.*, judgment or garnishment). *See* SBA SOP 50 51 3, chs. 15 and 16. When SBA receives liquidation recoveries on defaulted 504 Loans, the liquidation recoveries are placed in SBA's "financing" account, an account containing the federal funds that

² SBA is currently in the process of transitioning CSA functions from Colson Services Corp. to Wells Fargo Bank, N.A. The CSA contract transition period began on October 1, 2012, and is expected to last approximately 120 days. Wells Fargo Bank, N.A. will not begin to perform the CSA function until the transition from the incumbent, Colson Services Corp. is complete.

³ SBA uses federal funds for these purchases. *See* Small Business Investment Act, 15 U.S.C. § 697(g).

⁴ Generally, if the 504 Loan goes into default, the Senior Third Party Lender Loan defaults as well.

SBA uses to support the 504 Loan program.⁵ *See* 15 U.S.C. § 697(g); *see also* 2 U.S.C. § 661a(5)(A) and (7).

B. CDC Role in 504 Loan Program and SBA Oversight of CDCs

In order to become a CDC, an entity submits an application to SBA for CDC certification. *See* 13 C.F.R. § 120.810. Certification by SBA is the sole method for being recognized as a CDC. To be designated as a CDC, the applicant must demonstrate that it satisfies the CDC certification and operational requirements identified in 13 C.F.R. § 120.810(c).

A CDC must be a non-profit corporation with at least 25 members representing government organizations, financial institutions, community organizations and businesses actively supporting economic development in the CDC's Area of Operations.⁶ *See* 13 C.F.R. § 120.822. The CDC must have a Board of Directors chosen from the CDC membership, which is required to meet quarterly and be responsible for CDC staff decisions and actions. *See* 13 C.F.R. § 120.823. A CDC is also required to have full-time professional management and staff to carry out its daily operations. *See* 13 C.F.R. § 120.824. Unless otherwise approved by SBA, a CDC must operate only within its Area of Operations, which generally means the state where the CDC is incorporated. *See* 13 C.F.R. § 120.821. A CDC must maintain the financial ability to operate, which is defined as the ability to "sustain its operations continuously, with reliable sources of funds." *See* 13 C.F.R. § 120.825. Any funds generated by the CDC from 504 Loan Program activity that remain after payment of staff and overhead expenses must be retained by the CDC as a reserve for future operations or for investment in other local economic development activity. *Id.* A CDC must maintain good standing in the CDC's state of incorporation, and have satisfactory SBA performance as determined by SBA in its discretion. *See* 13 C.F.R. § 120.820.

Most importantly, a CDC must comply with all of SBA's Loan Program Requirements. *See* 13 C.F.R. § 120.826. The definition of Loan Program Requirements is found in SBA's regulations at 13 CFR 120.10 as follows:

. . . [R]equirements imposed upon Lenders or CDCs by statute, SBA regulations, any agreement the Lender or CDC has executed with SBA, SBA SOPs, official SBA notices and forms applicable to the 7(a) and 504 loan programs, and loan authorizations, as such requirements are issued and revised by SBA from time to time. For CDCs, this term also includes requirements imposed by Debentures, as that term is defined in § 120.802.

See 13 C.F.R. § 120.10.

⁵ This SBA account is funded, in part, by fees collected by SBA from 504 Loan Program participants and 504 Loan recoveries. *Id.* When SBA is obligated to purchase a CDC debenture on a defaulted 504 Loan, SBA uses funds in this account for the purchase. SBA has permanent borrowing authority with the U.S. Department of Treasury to fund any shortfalls on the account. The loans from Treasury to SBA must be repaid by SBA. *See infra* Section IV.B.2.e.

⁶ SBA's regulations grandfathered in for-profit CDCs certified by SBA prior to January 1, 1987. *See* 13 C.F.R. § 120.820. There are 6 for-profit CDCs currently participating in the 504 Loan Program. EDF is a non-profit CDC.

SBA is the primary regulator of CDCs.⁷ In order to carry out its regulatory and oversight responsibilities, SBA requires a CDC to submit an Annual Report within 180 days after the end of the CDC's fiscal year and such interim reports as SBA may require. *See* 13 C.F.R. § 120.830(a). If the CDC has a 504 Loan portfolio balance of \$20 million or more, the CDC's annual report must contain audited financial statements, with an auditor's opinion as to the fairness of the financial statements and their compliance with Generally Accepted Accounting Principles (GAAP). *See* 13 C.F.R. § 120.826(c). CDCs are also subject to SBA's risk-based lender oversight regulations contained in Subpart I of 13 C.F.R. Part 120. SBA's oversight of CDCs includes the right to review, inspect and copy all records and documents, and to perform periodic on-site reviews and off-site monitoring.⁸ *See* 13 C.F.R. §§ 1025 and 1050. Finally, CDCs are subject to SBA's lender enforcement process at 13 C.F.R. § 120.1400 *et seq.*

C. EDF Began Participating as a CDC in 1981

EDF is a non-profit corporation organized under the laws of the State of California. *See* EDF Articles of Incorporation, as amended (August 15, 1979). In 1981, SBA certified EDF as a CDC and EDF began participating in the 504 Loan Program. *See* Letter from Edwin T. Holloway, SBA Acting Associate Administrator for Financial Assistance, to Mary Sherman, EDF President (August 27, 1981). EDF has the second largest SBA 504 Loan portfolio of the CDCs currently participating in the 504 Loan Program, with a 504 Loan portfolio outstanding balance of approximately \$1.3 billion on over 2,300 504 Loans. From fiscal years 2006 through 2011, according to EDF's annual financial statements, EDF, a non-profit corporation, received over \$49 million in fees from its participation in the 504 Loan Program. *See* EDF Financial Statements (2006-2011).

EDF's CEO, Frank Dinsmore, has been serving in that or a similar capacity since EDF's inception.⁹ *See* EDF Articles of Incorporation, as amended (August 15, 1979) (listing Frank Dinsmore as Executive Director). EDF's current Board of Directors has at least 4 members, including Mr. Dinsmore.¹⁰ EDF's authorized Area of Operations includes the state of California

⁷ CDCs are not depository institutions, and therefore are generally not subject to periodic examinations by any other federal or state regulatory authority. *See* SOP 51 00, ch. 1, para. 1.

⁸ SBA performs periodic onsite risk-based reviews of CDCs with outstanding 504 loan balances of \$30 million or more. *See* SBA SOP 51 00, ch. 1, para. 4. The review components for CDCs are (1) portfolio performance, (2) SBA management and operations, (3) credit administration, and (4) compliance. *See* SBA SOP 51 00, ch. 5, para. 1. SBA also has the right to conduct targeted reviews of CDCs where the circumstances warrant. *See* SBA SOP 51 00, ch. 2, para. 12(c).

⁹ The EDF REsource Capital, Inc. umbrella includes various for profit and non-profit entities related in some way to Mr. Dinsmore. Mr. Dinsmore's spouse, Marlies Dinsmore, is the CEO of SEM Resource Capital, Inc. (SEM), a non-profit PCLP CDC headquartered in Michigan. Georgia Resource Capital, Inc. (GA), a non-profit CDC headquartered in Georgia, is also included in this group of entities. EDF services the 504 Loans made by SEM and GA, and EDF has made several large inter-company loans to SEM and GA. Mr. Dinsmore owns Anchor Commercial Services, Inc., a for profit company that provides loan application and closing documentation software to the 504 Loan Program industry. Mr. Dinsmore owns Dinsmore Properties, LLC, a for profit entity that owns the building leased to EDF for its business operations. Additionally, Mr. Dinsmore owns Redemption Reliance, LLC (Redemption), a for profit loan servicing company. *See* EDF Financial Statements (2010).

¹⁰ EDF may be in violation of 13 C.F.R. § 120.823 which requires that a CDC have a minimum of 5 Board members.

and certain contiguous counties in Nevada and Oregon.¹¹ Most of the 504 Loans in EDF's portfolio are subordinate position commercial real estate loans made to California small business borrowers.

D. CDC Statuses (Regular, ALP and PCLP)

Prior to 1994, all CDCs submitted SBA 504 Loan applications to SBA for SBA review and approval. This process involved an SBA review of each application to determine if the borrower met SBA's eligibility requirements, including creditworthiness. Upon approval, SBA would issue a Loan Authorization signed by SBA. In 1994, Congress statutorily authorized SBA to implement two programs to provide qualified CDCs with delegated authority to carry out certain functions previously reserved for SBA. *See* Small Business Administration Reauthorization and Amendments Act of 1994, Pub. L. 103-403, 108 Stat. 4175. Those two programs are the Accredited Lenders Program (ALP) authorized by 15 U.S.C. § 697d and the Premier Certified Lenders Program (PCLP) authorized by 15 U.S.C. § 697e. SBA's regulations governing the ALP program are located at 13 C.F.R. § 120.840 *et seq.* SBA's regulations governing the PCLP program are located at 13 C.F.R. § 120.845 *et seq.*

Upon application, SBA may designate a CDC as an ALP CDC provided that the CDC meets certain statutory and regulatory requirements. *See* 15 U.S.C. § 697d. The ALP CDC designation is for two years, with periodic renewals. *See* 13 C.F.R. § 120.840(e). ALP CDCs are delegated responsibility for thorough credit and eligibility analysis on loan applications. *See* SBA SOP 50 10 5(E), sub. A, ch. 3, para. V.B. SBA relies on the ALP CDC's credit analysis in making the decision to approve the 504 Loan and to complete the processing of the loan application in a reduced timeframe. When SBA approves a 504 Loan application submitted by an ALP CDC, SBA issues a Loan Authorization signed by SBA. *Id.*

Upon application, SBA may designate a CDC as a PCLP CDC provided that the CDC meets certain additional statutory and regulatory requirements. *See* 15 U.S.C. § 697e. The PCLP CDC designation is for two years, with periodic renewals. *See* 13 C.F.R. § 845(e). Upon approval and at each renewal as a PCLP CDC, the CDC must sign a PCLP Loan Guaranty Agreement (PCLP Agreement) that requires the PCLP CDC to follow the SBA Loan Program Requirements for the PCLP Program. *See* SBA SOP 50 10 5(E), sub. A, ch. 3, para. V.C. PCLP CDCs have delegated authority to process (underwrite) and close 504 Loans.¹² *See* 13 C.F.R. § 845(a). Instead of

¹¹ *See* Administrative Actions, dated May 19, 2006 (Oregon Local Economic Area Expansion) and June 6, 2006 (Nevada Local Economic Area Expansion). The counties in Oregon include Curry, Jackson, Josephine, and Klamath Lake, while the counties in Nevada include Clark, Douglas, Esmeralda, Lyon, Mineral, Nye, Storey, Washoe, and Carson City.

¹² Congress modeled the PCLP program after the Preferred Lender Program (PLP) that it authorized by statute (15 U.S.C. § 634(b)(7)) in 1980 for SBA's other flagship business loan program, the 7(a) program. *See* H.R. Rep. No. 108-153 (2003). Delegating lending functions to SBA lenders allows small business borrowers faster, more efficient, access to capital. When the PCLP CDC Program was authorized, CDCs found the program attractive due to the shortened time period for obtaining SBA approval of 504 Loans. SBA did not perform a credit review on PCLP loan applications. The shortened time period for SBA approval gave PCLP CDCs a competitive advantage over Regular CDCs. This allowed the PCLP CDCs to grow their 504 Loan portfolios and increase the amount of origination and servicing fees received by the CDCs.

SBA, PCLP CDCs make the credit decisions on PCLP loan applications. *See* 13 C.F.R. § 120.848. SBA does not review the PCLP CDC’s credit decision. *See* SBA SOP 50 10 5(E), sub. A, ch. 3, para. V.C. The only review that SBA performs on these loan applications is a review of an eligibility checklist submitted to SBA by the PCLP CDC. *See* SBA SOP 50 10 5(E), sub. C, ch. 4, para. III.B. The SBA review of the form is a “quick look” at eligibility intended to provide limited protection to SBA and the CDC from making an ineligible loan. *See* Eligibility Information Required for PCLP Submission, SBA Form 2234 (Part C). After SBA has determined that the 504 Loan is eligible based on the checklist review, SBA issues a PCLP loan number to the CDC. The CDC then issues a Loan Authorization and signs it *on behalf of* SBA. *See* Authorization for Debenture Guarantee (SBA 504 Loan).

A PCLP CDC is not required to make all 504 Loans using its PCLP delegated authority. It may elect to submit loan applications to SBA for Regular or ALP processing and approval by SBA. All 504 Loans made by a PCLP CDC using its PCLP delegated authority are treated as “PCLP Loans.” *See* PCLP Loan Guaranty Agreement, para. 2.

PCLP CDCs also have delegated authority to service and liquidate 504 Loans and may be given increased authority to litigate 504 Loans. *See* 13 C.F.R. § 120.848(f). In contrast to non-PCLP CDCs where SBA handles liquidation and collection activities on defaulted 504 Loans, a PCLP CDC must service, liquidate and handle debt collection litigation with respect to all PCLP loans in its portfolio *on behalf of* SBA. *See* 13 C.F.R. §§ 120.848(f) and 120.975.

EDF received its ALP designation in 1991,¹³ and received its PCLP CDC status in 1997. *See* Letter from Charles R. Hertzberg, SBA Assistant Administrator for Financial Assistance, to Frank Dinsmore, Executive Director of EDF (July 8, 1991); *see also* PCLP Loan Guaranty Agreement (April 14, 1997). EDF has entered into six PCLP Guaranty Agreements with SBA since 1997, including the currently applicable agreement dated June 12, 2009. *See* PCLP Loan Guaranty Agreements between EDF and SBA (April 14, 1997, April 14, 1999, April 14, 2001, April 14, 2003, April 14, 2005, and June 12, 2009). EDF’s ALP and PCLP statuses were scheduled to expire on April 28, 2011 and June 11, 2011, respectively. *See* Letter from Grady Hedgespeth, Director, SBA Office of Financial Assistance, to Kim Ioanidis, EDF C.O.O. (April 28, 2009); *see also* PCLP Loan Guaranty Agreement dated June 12, 2009. This action was commenced before such expiration dates. However, to avoid prejudicing EDF prior to the final determination of this action, in the period since the foregoing expiration dates, SBA has provided EDF with temporary extensions of its ALP and PCLP statuses through the date of this Decision, without prejudice to the instant enforcement proceeding.¹⁴

¹³ The ALP program began as a demonstration program in 1991 before being made permanent by statute in 1994. *See* Small Business Administration Reauthorization and Amendments Act of 1994 § 212, 15 U.S.C. § 697d.

¹⁴ EDF’s ALP status was extended separately in the following correspondence: E-mail from A.B. McConnell, Jr., Chief, 504 Program Branch, to Frank Dinsmore, EDF C.E.O. (June 30, 2011) (extension through 8/31/11); E-mail from A.B. McConnell, Jr., Chief, 504 Program Branch, to Frank Dinsmore, EDF C.E.O. (August 31, 2011) (through 9/30/11); E-mail from A.B. McConnell, Jr., Chief, 504 Program Branch, to Frank Dinsmore, EDF C.E.O. (September 30, 2011) (through 10/31/11); E-mail from A.B. McConnell, Jr., Chief, 504 Program Branch, to Frank Dinsmore, EDF C.E.O. (October 31, 2011) (through 11/30/11); E-mail from A.B. McConnell, Jr., Chief, 504 Program Branch, to Frank Dinsmore, EDF C.E.O. (November 30, 2011) (through 12/31/11); E-mail from Warren Boyd, Acting Chief, 504 Program Branch, to Frank Dinsmore, EDF C.E.O. (December 28, 2011) (through 1/31/11); E-mail from Grady B.

E. PCLP Reimbursement and Loan Loss Reserve Fund Requirements

In exchange for the delegated authority to approve and make the credit decisions on 504 Loan applications, PCLP CDCs are ordinarily required by statute to reimburse SBA for 10% of any

Hedgespeth, Director, Office of Financial Assistance, to Frank Dinsmore, EDF C.E.O. (January 25, 2012) (through 2/29/12); E-mail from Warren E. Boyd, Jr., Financial Analyst, to Frank Dinsmore, EDF C.E.O. (February 27, 2012) (through 3/31/12); and E-mail from Grady B. Hedgespeth, Director, Office of Financial Assistance, to Frank Dinsmore, EDF C.E.O. (March 28, 2012) (through 4/30/12).

EDF's PCLP status was extended separately in the following correspondence: E-mail from Felicia Daniels Smith, Supervisory Financial Analyst, to Frank Dinsmore, EDF C.E.O. (June 28, 2011) (extension through 8/31/11); E-mail from Eugene D. Stewman, Acting Director, Office of Credit Risk Management, to Frank Dinsmore, EDF C.E.O. (August 30, 2011) (through 9/30/11); E-mail from John M. White, Deputy Director, Office of Credit Risk Management, to Frank Dinsmore, EDF C.E.O. (September 30, 2011) (through 10/31/11); E-mail from Eugene D. Stewman, Acting Director, Office of Credit Risk Management, to Frank Dinsmore, EDF C.E.O. (October 31, 2011) (through 11/30/11); E-mail from John M. White, Deputy Director, Office of Credit Risk Management, to Frank Dinsmore, EDF C.E.O. (November 30, 2011) (through 12/31/11); E-mail from John M. White, Deputy Director, Office of Credit Risk Management, to Frank Dinsmore, EDF C.E.O. (December 27, 2011) (through 1/31/12); E-mail from Felicia D. Smith, Supervisory Financial Analyst, to Frank Dinsmore, EDF C.E.O. (January 24, 2012) (through 2/29/12); E-mail from Felicia D. Smith, Supervisory Financial Analyst, to Frank Dinsmore, EDF C.E.O. (February 27, 2012) (through 3/30/12); and E-mail from Felicia Daniels Smith, Supervisory Financial Analyst, to Frank Dinsmore, EDF C.E.O. (March 28, 2012) (through 4/30/12).

EDF's ALP and PCLP statuses were extended simultaneously in the following correspondence: Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (April 26, 2012) (through 5/18/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (May 18, 2012) (through 5/25/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (May 25, 2012) (through 6/1/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (May 31, 2012) (through 6/15/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (June 15, 2012) (through 6/29/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (June 29, 2012) (through 7/13/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (July 13, 2012) (through 7/27/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (July 26, 2012) (through 8/10/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (August 10, 2012) (through 8/24/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (August 23, 2012) (through 9/7/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (September 6, 2012) (through 9/21/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (September 21, 2012) (through 10/5/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (October 4, 2012) (through 10/19/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (October 19, 2012) (through 11/2/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (November 1, 2012) (through 11/16/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (November 15, 2012) (through 11/30/12); Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (November 29, 2012) (through 12/14/12); and Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (December 13, 2012) (through 12/28/12).

loss sustained by the SBA as a result of a default under a PCLP Loan. *See* 15 U.S.C. § 697e(b)(2)(C). The PCLP CDC is statutorily required to establish and maintain a Loan Loss Reserve Fund sufficient for the CDC to meet its obligations to protect SBA from the risk of loss. *See* 15 U.S.C. § 697e(b)(2)(D). The statute also requires a PCLP CDC to provide a collateral assignment of its Loan Loss Reserve Fund to SBA in order to secure repayment of its PCLP reimbursement obligations. *See* 15 USC § 697e(c)(3)(A).

By statute, the standard amount of a PCLP CDC's Loan Loss Reserve Fund ordinarily must be 10% of the PCLP CDC's exposure (i.e., 10% of the PCLP CDC's 10% loss reimbursement requirement to SBA on each PCLP Loan). *See* 15 U.S.C. § 697e(c)(2). SBA's regulations require that for each PCLP Loan, the PCLP CDC must ordinarily establish and maintain a Loan Loss Reserve Fund equal to one percent (10% of 10%) of the original principal amount of each PCLP Loan (Standard Loan Loss Reserve Fund). *See* 13 C.F.R. § 120.847(b). The amount the PCLP CDC must maintain in the Standard Loan Loss Reserve Fund for each PCLP Loan remains the same even as the principal balance of the PCLP Loan is paid down over time. *Id.* The statute and SBA's regulations provide a schedule for the PCLP CDC to make the required Standard Loan Loss Reserve Fund deposits for each PCLP Loan, with the full deposit amount required to be made no later than two years after the PCLP Loan closing. *See* 13 C.F.R. § 120.847(e) and 15 USC 697e(c).

The purpose of the reserve amount required by the statute is to ensure that there are sufficient funds available, in reserve, for the PCLP CDC to pay its PCLP reimbursement obligation to SBA should the PCLP CDC fail to obtain 100% repayment on a defaulted 504 Loan after exhaustion of reasonable collection efforts. *See* Cong. Rec. S14229 (1994). The reserve provides SBA with security for the repayment of the PCLP CDC's reimbursement obligations to SBA. *Id.* SBA's regulation requires the PCLP CDC to diligently monitor its Loan Loss Reserve Fund to ensure that it contains sufficient funds to cover its PCLP reimbursement obligation for its entire portfolio of PCLP loans, and within 30 days of the date it becomes aware of a deficiency, make additional contributions to the Loan Loss Reserve Fund to remedy the deficiency. *See* 13 C.F.R. § 120.847(j).

A PCLP CDC's Loan Loss Reserve Fund must be a deposit account (or accounts) with a federally insured depository institution selected by the PCLP CDC. *See* 13 C.F.R. § 120.847(c). A PCLP CDC is required to give SBA a first priority, perfected security interest in the Loan Loss Reserve Fund to secure repayment of the PCLP CDC's reimbursement obligation. *See* 13 C.F.R. § 120.847(d); *see also* 15 U.S.C. § 697e(c)(3)(A). The PCLP CDC must grant to SBA the security interest in the Loan Loss Reserve Fund pursuant to a security agreement between the PCLP CDC and SBA, and a control agreement between the PCLP CDC, SBA, and the applicable depository institution(s) where the Loan Loss Reserve Fund accounts are maintained. *Id.* The control agreement must include provisions requiring the depository institution(s) to follow SBA instructions regarding withdrawal from the accounts without a requirement for obtaining further consent from the PCLP CDC, and must restrict the PCLP CDC's ability to make withdrawals from the account without SBA consent. *Id.*

After EDF became a PCLP CDC in 1997, it established a Loan Loss Reserve Fund as required by SBA's regulations. On September 12, 2003, EDF executed a security agreement granting

SBA a security interest in EDF's Loan Loss Reserve Fund to secure EDF's PCLP reimbursement obligations. *See* PCLP Security Agreement (September 12, 2003). EDF, SBA and various depository institutions have entered into numerous control agreements acknowledging SBA's security interest in the deposit accounts comprising EDF's Loan Loss Reserve Fund, providing SBA with the ability to direct the disposition of funds in the accounts without further consent by EDF, and prohibiting EDF from withdrawing funds from the accounts without SBA's prior written consent. *See* Loan Loss Reserve Fund Deposit Account Control Agreements between SBA and Citizens Bank of Nevada County (August 20, 2003); Plumas Bank (August 20, 2003); American River Bank (September 9, 2003); Five Star Bank (September 10, 2003); Auburn Community Bank (September 12, 2003); Community 1st Bank (May 31, 2006); Citizens Bank of Northern California (February 15, 2007); First Business Bank (August 1, 2007); Zions First National Bank (April 1, 2008); Sierra Vista Bank (July 7, 2009); Citizens Business Bank (July 10, 2009); and Community 1st Bank (March 11, 2010).

F. Alternative Loan Loss Reserve Pilot Program

In 2004, ten years after the enactment of the PCLP program, Congress authorized by statute a pilot program permitting qualified PCLP CDCs to use an alternative method to calculate the total sums required to be funded, from time-to-time, into their Loan Loss Reserve Fund. *See* 15 U.S.C. § 697e(c)(7). This Alternative Loan Loss Reserve pilot program allowed PCLP CDCs to use a risk-based approach, like private sector banks, to calculate the required total funding of their Loan Loss Reserve Fund, instead of funding their Loan Loss Reserve Fund using a straight mathematical calculation as required under the Standard Loan Loss Reserve Fund provisions. *Id.* Congress authorized the pilot program in response to complaints by certain PCLP CDCs that the amount of reserves required by statute and regulation under the Standard Loan Loss Reserve Fund (1% of the original PCLP Loan balance with no corresponding reduction as the loan is repaid) was well beyond what was prudently required. *See* H.R. Rep. No. 108-153 at 5 (2003). PCLP CDCs asserted that the requirement to maintain unnecessarily large Loan Loss Reserve Fund accounts reduced their ability to serve additional small businesses. *Id.*

A PCLP CDC electing to use the Alternative Loan Loss Reserve pilot program is required to “make such contributions to its Loan Loss Reserve Fund so as to ensure that its Loan Loss Reserve Fund is sufficient, as determined by a qualified independent auditor, for the PCLP CDC to meet its obligations to protect SBA from the risk of loss.” *See* 15 U.S.C. § 697e(c)(7). The PCLP CDC must establish and utilize an “appropriate and effective process for analyzing the risk of loss associated with its portfolio of PCLP Loans and for grading each PCLP Loan made by the company on the basis of the risk of loss associated with such loan.”¹⁵ *See* 15 U.S.C. § 697e(c)(7)(F).

In granting PCLP CDCs the authority to calculate their Loan Loss Reserve Fund using a risk-based approach rather than by a straight mathematical calculation as with the Standard Loan

¹⁵ For all CDCs, the Board of Directors is required by regulation to adopt an internal control policy that directs the operation of a program to review and assess the CDC's 504 Loan portfolio and that contains loan quality classification standards consistent with the standardized classification systems used by the Federal Financial Institution Regulators. *See* 13 C.F.R. § CFR 120.826(b).

Loss Reserve Fund, Congress determined that it was necessary to compensate for the increased risk by requiring PCLP CDCs electing to use the Alternative Loan Loss Reserve pilot program to agree to reimburse SBA for 15% of the SBA loss on defaulted PCLP Loans, not the 10% required under the Standard Loan Loss Reserve Fund. *See* H.R. Rep. No. 108-153 at 17 (2003). It appears that Congress increased the reimbursement requirement from 10% to 15% so that the pilot program would not have a subsidy cost and therefore would have no effect on the federal budget. The Congressional Budget Office (CBO), in reviewing the proposed legislation, determined the following:

Under current law, the Administrator of SBA must adjust an annual fee on CDC loans to produce an estimated subsidy rate of zero at the time the loans are guaranteed. Enacting H.R. 923 could affect the subsidy rates for previous cohorts of CDC loans. Decreasing the loss reserve requirement for PCLs would cause SBA to collect a smaller amount of recoveries if a small business defaults on a loan and a PCL is unable to pay its portion of SBA's total loss. However, increasing the required loss coverage to 15 percent for PCLs who opt to maintain a loss reserve level based on risk would increase SBA's recoveries on default [sic] CDC loans. . . . CBO estimates that the net result of those two effects would not have a significant impact on the federal budget.

See H.R. Rep. No. 108-153 at 7 (2003). The House Report also states: "This exchange of enhanced authority for increased loss exposure is consistent with the intent of the original PCLP, which provided CDCs with delegated loan approval authority in exchange for increased loss exposure." *Id.* at 17. The 15% loss reimbursement requirement applies to any PCLP Loan disbursed during the calendar quarters in which the PCLP CDC elected to participate in the Alternative Loan Loss Reserve pilot program, regardless of whether the PCLP CDC eventually stops participating in the Alternative Loan Loss Reserve pilot program. *See* 15 USC § 697e(b)(2)(C).

The legislation required SBA to issue regulations implementing the Alternative Loan Loss Reserve pilot program within 45 days after enactment. SBA drafted and published proposed regulations, and received comments, but did not issue final regulations. However, the statute is self-executing and provides that PCLP CDCs may elect to use the Alternative Loan Loss Reserve program in the first calendar quarter that begins after the end of the 90 day period beginning with the date of enactment of the statute. *See* 15 USC 697e(c)(7)(A) and 697e(c)(7)(J); *see also* H.R. Rep. No. 108-153 at 17 (2003). The House Report acknowledged that PCLP CDCs would be able to start using the pilot program regardless of whether or not SBA issued regulations to implement the pilot program. *See* H.R. Rep. No. 108-153 at 17 (2003).

The Alternative Loan Loss Reserve pilot program was originally authorized for two years, but was extended through subsequent legislation. The statutory authority for the Alternative Loan Loss Reserve pilot program eventually lapsed on July 31, 2011. *See* Small Business Additional Temporary Extension Act of 2011, Pub. L. No. 112-17, § 2, 125 Stat. 221 (June 1, 2011). Because of the lapsed statutory authority, PCLP CDCs participating in the Alternative Loan Loss Reserve pilot program are required to establish and maintain a Loan Loss Reserve Fund using the straight mathematical calculation required for the Standard Loan Loss Reserve Fund program under 15 USC § 697e(c)(2) and 13 CFR § 120.847(b)---i.e., 1% of the original principal amount

(face amount) of each PCLP loan in the PCLP CDC's portfolio. 15 USC § 697e(c)(7)(D) provides that if the requirements of the Alternative Loan Loss Reserve statute apply to a PCLP CDC that has elected Alternative Loan Loss Reserve program participation for any calendar quarter and cease to apply to the PCLP CDC for any subsequent calendar quarter, the PCLP CDC shall make a contribution to its Loan Loss Reserve Fund in an amount required by SBA that is not in excess of the amount that would have been required in the Loan Loss Reserve Fund had the PCLP CDC not elected to participate in the Alternative Loan Loss Reserve program, in other words, the Standard Loan Loss Reserve Fund amount.

G. EDF Elected to Participate in Alternative Loan Loss Reserve Pilot Program

EDF established a Loan Loss Reserve Fund after it became a PCLP CDC in 1997. It was a Standard Loan Loss Reserve Fund of 1% because that was the only method available at that time. On May 28, 2004, the Alternative Loan Loss Reserve pilot program legislation described above was enacted. Because the statute was self-executing, EDF was eligible to begin using it in the first calendar quarter that began after the end of the 90-day period after enactment of the statute, regardless of whether SBA had issued regulations relating solely to the statutory Alternative Loan Loss Reserve pilot program. *See Premier Certified Lenders Program Improvement Act of 2004, Pub. L. 108-232, 118 Stat. 649; see also H.R. Rep. No. 108-153 at 17 (2003); see also 15 U.S.C. §697e(c)(7)(J).* As defined in the statute, the first such calendar quarter began on October 1, 2004 and ended on December 31, 2004. *See 15 U.S.C. § 697e(c)(7)(K)(iv).*

On September 3, 2004, EDF sent a letter to SBA advising that EDF was electing to use an Alternative Loan Loss Reserve Fund beginning on the first eligible calendar quarter:

H.R. 923, which was signed into law on May 27, 2004 and went into effect August 27, 2004, allows for creation of a risk-based loan loss reserve program. The law requires the PCL CDC to notify SBA of their intention to participate in the program at the start of the following fiscal year quarter. *We are opting to begin our risk-based loan loss reserve program effective October 1, 2004*, which constitutes not only a fiscal year quarter, but also the beginning of a new fiscal year. In accordance with law we are required to name our auditor. We designate Perry-Smith in that capacity.

With mutual knowledge that SBA has not established guidelines as of the date of this correspondence, along with SBA's knowledge that [EDF] Resource Capital takes its role as a responsible CDC [sic], we are moving ahead with what we consider will be adopted as the model risk-based loan loss reserve program. We have established an effective process for analyzing the risk of loss associated with our PCL portfolio and grade each loan. In further preparation Perry-Smith is coming to the audit required prior to the beginning of the federal fiscal quarter. This will be the sixth audit we have received on our PCL portfolio. We have in fact been pretending the legislation was in place and have been shadowing the 1 percent reserve requirement with the simulated risk-based system.

As of this date, we have \$1,618,080.92 in our loan loss reserve funds. In view of the fact that our risk-based program indicates we only need \$338,607, we propose not adding any

additional funds to the Loan Loss Reserve Fund, but neither do we intend to withdraw funds at this time. . . .

See Letter from Frank F. Dinsmore, EDF C.E.O., to Jim O’Neal, SBA’s District Director of the Sacramento District Office (September 3, 2004) (emphasis added).

EDF continued to express its eagerness to move forward with its election in a letter dated November 22, 2004 to SBA that states as follows:

We are interested and ready to implement the Loan Loss Reserve Fund risk-based system that was passed into law by Congress in August 2004 [sic; May 2004]. . . .

At this time, we are looking for appropriate recognition from SBA to fully move onto the risk-based system and remove funds from the Loan Loss Reserve Fund that are deemed in excess of necessary Loan Loss Reserve Fund balance as calculated by our current risk based analysis.

See Letter from Frank F. Dinsmore, EDF C.E.O., to Charlie Thomas, Director of SBA’s Office of Program Development (November 22, 2004).

On December 14, 2004, SBA agreed to recognize EDF’s election of the Alternative Loan Loss Reserve program, in the absence of SBA regulations:

As you may know, the SBA is continuing to work through several issues related to the publication of regulations concerning this mandate, but we believe these issues will be resolved shortly. . . .

As we continue to work through this process, we have concluded that the program as well as the procedural guidance will greatly benefit from the experience and assistance of selected Premier Certified Lenders participating in a pilot test of the alternative Loan Loss Reserve Fund concept. The SBA is thus amenable to Resource Capital’s request to initiate, on a pilot basis, an alternative risk-based system to calculate the amount of its required Loan Loss Reserve Fund and to adjust the level of its Loan Loss Reserve Fund as prescribed by that system. However, we would ask that Resource Capital work closely with the Agency to implement this initiative in a joint effort to ensure fully effective management controls are established . . .

As you know, P.L. 108-232 sets forth a number of important statutory requirements regarding the alternative Loan Loss Reserve Fund concept, and we in SBA must ensure conformance with those requirements. These include a number of eligibility requirements, the majority of which Resource Capital clearly meets. For example, Resource Capital . . . has developed, based on SBA’s preliminary review, an apparently effective process for grading each PCLP loan and analyzing the risk of loss associated with its portfolio; and, has apparently contracted with a knowledgeable independent auditor to evaluate the efficacy of Resource Capital’s alternative Loan Loss Reserve Fund methodology and the adequacy of its Loan Loss Reserve Fund.

See Letter from Charles W. Thomas, Director of SBA's Office of Program Development to Frank F. Dinsmore, EDF C.E.O. (December 14, 2004).

On a quarterly basis, PCLP CDCs are required to file with SBA a report showing the amount in the Loan Loss Reserve Fund in a form that will readily demonstrate the basis for showing that the amount actually maintained in the Loan Loss Reserve Fund is the amount required to be maintained in the Loan Loss Reserve Fund based upon the applicable funding formula. See 13 C.F.R. § 120.847(f). The Quarterly Report must also contain copies of bank statements verifying that the Loan Loss Reserve Fund funds are on deposit. See PCLP Quarterly Loan Loss Reserve Report, SBA Form 2233. SBA is then able to reconcile the required Loan Loss Reserve Fund amount with the amount reported by the PCLP CDC on its Quarterly Report.

After EDF's election of the Alternative Loan Loss Reserve program, EDF began submitting Quarterly Loan Loss Reserve Fund Reports to SBA that contained the following:

- Bank statements showing the funded amount of EDF's Loan Loss Reserve Fund
- EDF's Loan Rating Report listing PCLP Loans in its portfolio and EDF's risk-based grading of each of the listed loans
- EDF's calculated Loan Loss Reserve Fund amount based on EDF's Risk-Based Methodology using the outstanding loan balances and the corresponding risk-based grading for each listed PCLP Loan
- A Perry-Smith LLP Report on Credit Classification and Review of Loan Origination and Documentation Requirements for a sample of EDF's PCLP Loans¹⁶

See, e.g. Declaration of Kim Ioanidis, Tab 23; see also Quarterly Loan Loss Reserve Reports, June 30, 2004 to present (as of September 30, 2012).

H. EDF's Alternative Loan Loss Reserve Risk-Based Methodology

Under EDF's Alternative Loan Loss Reserve Risk-Based Methodology, which has remained substantially the same since EDF elected to begin using it on October 1, 2004, EDF assigns a grade (or loan rating) to "every PCLP loan made" by EDF. See EDF's Risk-Based Methodology (defined below) at 2. The highest, or best, grade, a "1," is "Substantially Risk Free." *Id.* at 2. The lowest, or worst, grade, a "7," is a "Loss." *Id.* at 3. Each grade is assigned a "Risk Factor" and each Risk Factor has an associated percentage. *Id.* at 2-3. Under the Risk Based-Methodology, EDF is to fund its Loan Loss Reserve Fund by applying the assigned Risk Factor to EDF's 15% PCLP reimbursement obligation to SBA with respect to the current balance on the PCLP Loan, and confirming that the cumulative dollar amount resulting from that calculation is funded in EDF's Loan Loss Reserve Fund. *Id.* at 11 and 14. For example, if a PCLP Loan is graded a "7," EDF determines its 15% reimbursement obligation with respect to the current outstanding balance of that PCLP Loan, and the Loan Loss Reserve Fund must contain 100%

¹⁶ Perry-Smith LLP merged with Crowe Horwath LLP in November, 2011. For ease of reference, Crowe Horwath LLP f/k/a Perry-Smith LLP will be referred to as "Perry-Smith" in this Decision.

(i.e., the Risk Factor of a loan rated a “7”) of that 15% reimbursement obligation for that particular loan. Similarly, if a PCLP Loan is graded a “6,” EDF determines its 15% reimbursement obligation with respect to the current outstanding balance of that PCLP Loan, and the Loan Loss Reserve Fund must contain 30 % (i.e., the Risk Factor of a loan rated a “6”) of that 15% reimbursement obligation for that particular loan. Loans graded a “7” have a higher Risk Factor and therefore a higher reserve dollar amount than those similarly-sized loans graded lower. *Id.* at 3 and 11.

The current loan grades and associated risk factors for Loan Loss Reserve Fund funding under EDF’s Risk-Based Methodology are listed below:

GRADE NUMBER	GRADE NAME	SUMMARY DESCRIPTION	RISK FACTOR (% of 15%)
1	Substantially Risk Free	Extremely low credit risk with no late payments	0.20%
2	Minimal Risk	Low credit risk with no late payments in last 12 months	0.40%
3	Acceptable Business Risk	Average credit risk with no more than 2 late payments in last 12 months	0.60%
4	Special Mention	Performs below RMA industry averages and shows potential weakness deserving management’s close attention	1.00%
5	Substandard	Well-defined weakness or weaknesses that jeopardize the continuing performance of the loan	10.00%
6	Doubtful	Same weakness(es) as Substandard, plus the weakness(es) make collection or liquidation of the debt highly likely	30.00%
7	Loss	No longer a performing loan and is under collection via liquidation efforts, does not mean that there is absolutely no recovery value	100.00%

The Risk-Based Methodology requires that subsequent to the initial grading at the time of loan approval, “all loans will be graded on an annual basis, at a minimum.” If indicated, the loan is to be moved into a new risk category. *Id.* at 13-14. Additionally, reviews are to take place more often if data indicating a change in the loan rating is found (e.g., delinquencies or non-payment of real estate taxes). *Id.* at 13. EDF’s Risk-Based Methodology also requires that the “Portfolio

Manager will keep the CEO apprised of loans that decline in category on a weekly basis. The impact such down grades have via the risk-based analysis will be applied immediately.” *Id.* at 13.

The Risk-Based Methodology states that EDF’s Board has approved the “overall Loan Loss Reserve Fund policy and system.” *Id.* at 13. Under the Risk-Based Methodology, the CEO is to review the reserve, at least quarterly, to ensure appropriate funds have been set aside. *Id.* at 13. The Risk-Based Methodology provides: “*Ultimately, the responsibility to ensure required funds are set aside resides with the CEO*” (emphasis added). *Id.* at 13. The Risk-Based Methodology also states: “[s]uch amounts set aside in the Loan Loss Reserve Fund will be reviewed and confirmed by an outside CPA firm *for appropriateness*, at least quarterly.” *Id.* at 13 and 16 (emphasis added).

Finally, the Risk-Based Methodology provides for payment of EDF’s 15% PCLP reimbursement obligation to SBA as follows:

When the Portfolio Manager notifies the CEO that a loss, if any, has been determined, the Controller is then notified of the anticipated payout amount. SBA sends a demand for payment of the identified loss to the CDC for collection. The identified amount will be rendered from the Loan Loss Reserve Fund special allocation of reserves to SBA. The typical time it takes SBA to assess a loss is several months.

Id. at 15.

When EDF first elected to participate in the Alternative Loan Loss Reserve pilot program on October 1, 2004, its Loan Loss Reserve Fund had approximately \$1.6 million in it. Under the Standard Loan Loss Reserve Fund that amount protected SBA from the risk of loss on approximately \$160 million in outstanding PCLP loans (1% of \$160 million equals \$1.6 million). *See* Quarterly Loan Loss Reserve Report (September 30, 2004). From October 1, 2004 to September 30, 2011 (the quarter end after the Alternative Loan Loss Reserve statute lapsed), EDF approved 1,696 PCLP loans in the total dollar amount of approximately \$1.15 billion. (This represents a potential maximum of \$172 million in PCLP reimbursement obligation exposure.) From December 31, 2007 to September 30, 2011, while the commercial real estate market in the Central Valley of California was in steep decline, 336 of EDF’s PCLP loans in the total dollar amount of approximately \$207 million became non-performing and were purchased by SBA. Yet, as of September 30, 2011, EDF’s Loan Loss Reserve Fund had only approximately \$1.97 million in it. *See* PCLP Loan Loss Reserve Requirements report (September 30, 2011). The record shows that during the entire time its Alternative Loan Loss Reserve election was in effect, EDF’s Loan Loss Reserve Fund never exceeded \$1.97 million. While participating in the Alternative Loan Loss Reserve pilot program, EDF added a net of only \$370,000 to its Loan Loss Reserve Fund, which represents approximately .03% of the face amount of PCLP loans added to EDF’s portfolio during that time period.

Under the Standard Loan Loss Reserve Fund requirements (1% of the original principal amount of its PCLP loans under 13 CFR § 120.847(b)) that now apply to EDF due to the Alternative Loan Loss Reserve Program statutory lapse, EDF is required as of September 30, 2012 to have

approximately \$9.4 million in its Loan Loss Reserve Fund accounts. Thus, EDF's Loan Loss Reserve Fund accounts are deficient by at least \$7.4 million under the Standard Loan Loss Reserve Fund calculation. (The Standard Loan Loss Reserve Fund calculation does not include the \$11.4 million for which SBA has already invoiced EDF.)

I. SBA Loss, PCLP CDC Reimbursement Obligation, and SBA Invoicing Procedures

When a PCLP CDC has concluded the liquidation of a defaulted PCLP Loan and has submitted a wrap-up report to SBA, or when SBA otherwise determines that the PCLP CDC has exhausted all reasonable collections efforts with respect to the PCLP Loan, SBA will determine the amount of the loss to SBA. *See* 13 C.F.R. § 120.847(h).

SBA then sends an invoice notifying the PCLP CDC of the amount of its reimbursement obligation to SBA and explains how SBA calculated the loss. *Id.* If the PCLP CDC agrees with SBA's calculations of the loss, it must reimburse SBA for 10 or 15 percent (as the case may be) of the loss no later than 30 days after SBA sends the invoice to the PCLP CDC. *Id.*

If the PCLP CDC disputes SBA's calculations, the PCLP CDC may file a written appeal with SBA within 30 days of the date of the invoice. *Id.* The PCLP CDC must include with the appeal an explanation of its reasons for the disagreement. *Id.* Upon SBA's final decision as to the disputed amount of the loss, the PCLP CDC must pay the invoiced amount that SBA has determined is due and owing. *Id.* A PCLP CDC may use funds in the Loan Loss Reserve Fund, or other funds, to pay the invoice. *Id.*

After receiving the PCLP CDC's payment of the invoice, SBA records on its books the interest in the PCLP loan that the PCLP CDC receives in exchange for its payment. *See* PCLP Loan Guaranty Agreement, para. 11. The PCLP Loan Guaranty Agreement provides as follows:

Upon full payment by CDC to SBA of CDC's share of any loss on a PCLP loan, SBA will issue to CDC a certificate of interest evidencing the percentage of the loan in which CDC has an interest. Thereafter, all security interests and rights, all reasonable expenses incurred by SBA or CDC which are not recoverable from the Borrower, and all sums which SBA or CDC recover from any source will be shared by SBA and CDC according to their respective interests in the loan. All ordinary expenses of servicing and liquidation a PCLP loan will be paid by, or be recoverable from, the borrower.

Id. (emphasis added). To illustrate, when the PCLP CDC pays to SBA the invoice for the PCLP CDC's 10% reimbursement obligation, SBA records on its books that the PCLP CDC has a 10% interest in the PCLP loan. SBA's ownership interest is then reduced from 100% to 90% of the PCLP loan. The net result of this transaction is that any future recoveries on the PCLP loan are shared *pro rata* by the PCLP CDC and SBA. The PCLP CDC's payment to SBA does not reduce the amount owed by the borrower to SBA and the PCLP CDC.

J. EDF Began Experiencing Increasing Delinquencies

In 2008, EDF began to experience increasing delinquencies on its 504 Loan portfolio. Because 504 Loans are in a subordinate position behind Senior Third Party Lender Loans for 50% of the 504 project cost, the substantial decrease in real estate values due to the commercial real estate market decline in California left, in most cases, very little remaining equity available to cover the 504 Loan amount. Most of these delinquencies were on 504 Loans where EDF, as a PCLP CDC, performed the underwriting and made the credit decision to lend to the small business borrower. The increasing risk in the portfolio placed EDF in the position of being required to fund increasing amounts in its Loan Loss Reserve Fund under its Risk-Based Methodology that graded all of its PCLP loans based on risk.

As the Senior Third Party Lenders began to foreclose on their delinquent loans, the impact of the market decline on EDF's 504 loan portfolio became clear. As the junior lienholder, SBA's secured interest in each of these properties would be wiped out by a foreclosure by the Senior Third Party Lender. As is true for any junior lienholder, SBA therefore had the choice whenever a property was to be foreclosed to use additional taxpayer funds to buy out the Senior Third Party Lender at a foreclosure sale of the property.

SBA policy required that in order for SBA to agree to essentially double its exposure by expending federal funds to buy out the Senior Third Party Lender Loan by the entry of a protective bid at foreclosure, the 504 project property had to have at least 25% remaining equity available to apply to the 504 Loan amount.¹⁷ See SBA SOP 50 51 2, ch. 21. EDF has conceded that because of the market decline, most of its delinquent PCLP Loans did not meet the SBA criteria for the entry of a protective bid. See May 18, 2011 Response, Larsen Declaration, Exhibit 6. This meant that after the Senior Third Party Lender foreclosed and any excess proceeds were paid to EDF on behalf of SBA, EDF was required to pursue an offer in compromise with the small business owners who had guaranteed the loan or seek a judgment against the guarantors.¹⁸ See SBA SOP 50 51 3, Chapters 15 and 16. Once EDF exhausted its reasonable collection efforts, EDF would then be responsible for payment of 15% of SBA's loss on the PCLP loan. See 13 C.F.R. § 120.847(h); see also EDF's Risk-Based Methodology at 14.

¹⁷ A creditor with a junior lien on real estate may consider entering a protective bid at a foreclosure sale conducted by a senior lienholder in order to preserve the equity remaining in the property for payment of the junior lienholder's debt. If the junior creditor does not enter a protective bid, and the property sells for more than the senior lienholder's debt, then by law the junior creditor is entitled to be paid the excess amount received over the amount of the senior lienholder's debt plus expense of the foreclosure sale; if the property fails to sell for more than the senior lienholder's debt, the junior creditor receives nothing on its debt and its lien is foreclosed out. Because the purchase of real estate involves carrying costs, such as taxes, maintenance, security and selling costs, the junior creditor must consider whether the entry of a protective bid is a financially viable step. The junior lienholder may not be able to recoup its investment in the property (let alone pay down any of its debt) if it cannot sell the property for a price that will cover the amount paid for the senior lien and the carrying costs. The threshold amount of equity at which SBA will consider a protective bid was lowered to 10% in November, 2010. See SOP 50 51 3, ch. 10, para. D(1).

¹⁸ Because of the economic downturn, the value of the personal guaranties and other collateral securing the 504 loans also declined or disappeared when the small business borrower struggled or went out of business.

With the growing number of delinquencies that EDF was experiencing on its PCLP loan portfolio during this time period, it was clear that the reimbursement obligations that EDF was facing would be substantial.

K. EDF Requested a Liquidation Pilot Program

EDF began to complain to SBA that SBA's protective bid formula requiring 25% remaining equity prior to expending federal funds to buy out the Senior Third Party Lender Loan was "leaving money on the table." *See* Letter from Frank Dinsmore, EDF C.E.O., to Walter Intlekofer, Director, SBA Portfolio Management Division (May 19, 2008). In essence, EDF argued to SBA that it should use additional taxpayer funds to buy out the first lien at foreclosure (and thus to own the first and second liens on the property) because, over time, the real estate market would come back, values would rise, and the property would ultimately sell to a third party for an amount which would recoup all taxpayer dollars placed at risk plus interest, fees and carrying costs. In a rapidly-falling real estate market such as that in Central California after 2008, EDF was basically arguing that SBA should change its long-standing policy and accept *more* risk than it had previously accepted in foreclosure situations before the market began to fall.

Nonetheless, in order to test the proposition, in early 2009, at the request of EDF, SBA agreed to allow EDF to participate in a liquidation pilot. Based on the recommendation of EDF, SBA would fund the entry of a protective bid at a foreclosure sale on certain loans where the remaining equity in the property was less than 25%. *See* May 18, 2011 Response, Ioanidis Declaration, Exhibit 33. The purpose of the liquidation pilot was to test whether SBA could achieve recoveries through the prompt and diligent actions of EDF that otherwise would not have been available to SBA. *Id.* (*see e.g.* Emails from Kim Ioanidis, EDF C.O.O., to Walter Intlekofer, Chief, SBA Portfolio Management Division, dated November 13 and December 4, 2008). SBA restricted the liquidation pilot to ten PCLP Loans, each of which was not eligible for a protective bid by SBA under SBA's 25% available equity formula. *Id.*

As part of the pilot, SBA agreed to advance sufficient funds to purchase the Senior Third Party Lender Loan and also to pay past due property taxes.¹⁹ However, because the available equity in the property did not meet SBA's protective bid formula, and to provide SBA with additional protection, EDF agreed to repay the advance to SBA with interest at the Treasury rate, regardless of whether the ultimate proceeds of the sale of the property were sufficient to repay the SBA advance.²⁰ Repayment of the SBA advance was due upon the sale of the property or two years

¹⁹ SBA agreed to advance funds for the payment of past due real estate taxes because unpaid real estate taxes can result in a priority tax lien on the property and possibly a tax sale of the property. *See Redevelopment Agency of the City and County of San Francisco v. Pacific Vegetable Oil Corporation*, 241 Cal.App.2d 606 (1966).

²⁰ *See* Liquidation Proposal from EDF to SBA dated February 25, 2009 (Thomas Zorich Chiropractic, SBA Loan No. 1951366001); Liquidation Proposal from EDF to SBA dated April 29, 2009 (PMS Treatment Center, SBA Loan No. 2504456007); Liquidation Proposal from EDF to SBA dated April 30, 2009 (Nevada R.E. Marketing, Ltd., SBA Loan No. 8956584006); Liquidation Proposal from EDF to SBA dated May 1, 2009 (Green Road Hotels, SBA Loan No. 2571256006); Liquidation Proposal from EDF to SBA dated May 7, 2009 (Ainsworth I, SBA Loan No. 2218006000); Liquidation Proposal from EDF to SBA dated May 7, 2009 (Ainsworth II, SBA Loan No. 2905296008); Liquidation Proposal from EDF to SBA dated May 13, 2009 (Familia Flores, SBA Loan No. 8982114009); Liquidation Proposal

from the date of the SBA advance, *whichever occurred first*.²¹ The provision was designed to set an outer limit on the time during which SBA's dollars would remain at risk. As an additional part of the liquidation pilot, SBA also agreed to allow EDF to share in any upside of a sale of 504 project property that resulted in proceeds in excess of the amount advanced by SBA for purchase of the Senior Third Party Lender Loan and payment of past due property taxes. *See* Liquidation Pilot Proposals. EDF's share of the upside was 50% of the excess proceeds (after payment of liquidation costs); the remaining 50% of any excess proceeds was to be remitted to SBA by EDF. *Id.* Finally, under the liquidation pilot, EDF also agreed to pay SBA its 15% PCLP reimbursement obligation on any resulting loss on the loan. *Id.*

The following chart illustrates the agreed flow of funds for the liquidation pilot loans:

from EDF to SBA dated May 18, 2009 (Quality One Engineering, SBA Loan No. 2910186004); Liquidation Proposal from EDF to SBA dated May 20, 2009 (Careways Children's Health, SBA Loan No. 9014624006); and Liquidation Proposal from EDF to SBA dated June 2, 2009 (Frutos Polishing, SBA Loan No. 8896414009) (collectively, "Liquidation Pilot Proposals").

²¹ *See* Assignment of Deed of Trust and Promissory Note dated March 16, 2009 (Thomas Zorich Chiropractic, SBA Loan No. 1951366001); Assignment of Deed of Trust and Promissory Note dated June 2, 2009 (Nevada R.E. Marketing, Ltd., SBA Loan No. 8956584006); Assignment of Deed of Trust and Promissory Note dated May 29, 2009 (PMS Treatment Center, SBA Loan No. 2504456007); Assignment of Deed of Trust and Promissory Note dated June 12, 2009 (Careways Children's Health, SBA Loan No. 9014624006); Assignment of Deed of Trust and Promissory Note dated June 12, 2009 (Ainsworth I, SBA Loan No. 2218006000); Assignment of Deed of Trust and Promissory Note dated June 12, 2009 (Ainsworth II, SBA Loan No. 2905296008); Assignment of Deed of Trust and Promissory Note dated August 3, 2009 (Familia Flores, SBA Loan No. 8982114009); Assignment of Deed of Trust and Promissory Note dated August 4, 2009 (Frutos Polishing, SBA Loan No. 8896414009); Assignment of Deed of Trust and Promissory Note dated August 4, 2009 (Quality One Engineering, SBA Loan No. 2910186004); Assignment of Deed of Trust and Promissory Note dated June 4, 2009 (Green Road Hotels, SBA Loan No. 2571256006) (collectively, "Liquidation Pilot Assignments of Deed of Trust and Promissory Note).



Under the liquidation pilot, SBA advanced funds for the purchase of the Senior Third Party Lender Loans and payment of real estate taxes for ten 504 projects. *See* December 14, 2011 Response, Second Declaration of Kim Ioanidis, Exhibit 39.²² SBA's advances totaled approximately \$12 million. *Id.* On June 26, 2009, SBA sent EDF an e-mail limiting the liquidation pilot to the properties already purchased until SBA could assess the results of the liquidation pilot. *See* May 18, 2011 Response, Ioanidis Declaration, Exhibit 33 at 62 (Email from Walter Intlekofer, Chief, SBA Portfolio Management Division, to Frank Dinsmore, EDF C.E.O. (July 8, 2009)).

L. SBA Began Invoicing EDF for its 15% PCLP Reimbursement Obligation

In late 2009 and early 2010, SBA sent EDF four 15% PCLP reimbursement obligation invoices totaling \$239,632 in accordance with the procedures in 13 C.F.R. § 120.847.²³ EDF paid the SBA invoices in a timely manner and without objection by using funds from EDF's Loan Loss Reserve Fund with SBA's consent.²⁴

Between May 31, 2010 and June 10, 2010, as more and more loans in EDF's portfolio defaulted and proceeded through liquidation, collections and into final charge-off status, SBA issued twenty-five 15% PCLP reimbursement invoices to EDF totaling \$2,120,478.23.²⁵ On June 10, 2010, EDF advised SBA as follows:

²² *See also* Letter from Frank Dinsmore, EDF C.E.O., to Leslie Niswander of SBA regarding Nevada RE Marketing (May 28, 2009); Letter from Frank Dinsmore to Leslie Niswander regarding Ainsworth Financial Mortgage Corporation (#1) (June 9, 2009); Letter from Frank Dinsmore to Leslie Niswander regarding Ainsworth Financial Mortgage Corporation (#2) (June 9, 2009); Letter from Frank Dinsmore to Leslie Niswander regarding Careways Children's Health Associates (June 10, 2009); Letter from Frank Dinsmore to Leslie Niswander regarding Premenstrual Syndrome Treatment Center (May 27, 2009); Letter from Frank Dinsmore to Leslie Niswander regarding Green Road Hotels LLC (May 27, 2009); Letter from Frank Dinsmore to Leslie Niswander regarding Quality One Engineering (June 25, 2009); Letter from Frank Dinsmore to Leslie Niswander regarding Familia Flores (July 29, 2009); Letter from Frank Dinsmore to Leslie Niswander regarding Frutos Polishing (July 2, 2009); and Letter from Frank Dinsmore, EDF C.E.O. to Leslie Niswander regarding Thomas Zorich (February 26, 2009) (collectively the "Liquidation Pilot Loan Agreements").

²³ Invoice dated September 8, 2009 for Ray's Market (SBA loan number 2855766509) in the amount of \$72,853.22; Invoice dated September 8, 2009 for TOSH (SBA loan number 5293354502) in the amount of \$69,543.23; Invoice dated January 30, 2010 for Expect A Lot (SBA loan number 2187896506) in the amount of \$54,253.97; and Invoice dated January 30, 2010 for Peoples Direct Lending (SBA loan number 2111796504) in the amount of \$42,983.97.

²⁴ SBA's records also show that EDF paid its 10% PCLP reimbursement obligation on two loans in 2002 and 2003, Red Tower Enterprises, LLC (SBA Loan No. 2526234510) and Tiny Pines Family Daycare (SBA Loan No. 1867764509). These payments occurred before the Alternative Loan Loss Reserve Program was enacted into law.

²⁵ *See* Invoice letters from Leslie Niswander, SBA Assistant Center Director, Commercial Loan Servicing Center, to Kim Ioanidis, EDF C.O.O. (May 31, 2011 – June 10, 2011). Loans invoiced and amounts are as follows: D Martel Plumbing (SBA Loan No. 1545506501) for \$28,337; Peter Taylor Interior (SBA Loan No. 7559044500) for \$10,791; Mercer Group (SBA Loan No. 3149446504) for \$60,372; Stagegear, Inc. (SBA Loan No. 2729636504) for \$81,846; Empire Consulting (SBA Loan No. 2782606505) for \$76,451; Tala Brothers Corp. (SBA Loan No. 2961346505) for \$134,139; Rene Gutierrez (SBA Loan No. 3106796504) for \$31,405; Mountain Carpets (SBA Loan No. 2360296508) for \$97,457; Hwy 50 Gas & Mkt (SBA Loan No. 4950134502) for \$32,742; Champion Auto Site (SBA Loan No. 7465394510) for \$65,537; Eva Correa & Assoc. (SBA Loan No. 2652466502) for \$141,054; Popeye's Chicken (SBA

. . . [T]he current working capital shows that REsource Capital is very healthy financially and will continue to operate and meet expenses. Further, the CDC has paid all CDC debenture losses timely and *has reserves set up for future payments due*. Although we may disagree on the payment of these fees, *the CDC has the financial wherewithal to continue making these payments*.

See Letter from Frank Dinsmore, C.E.O. of EDF, to Grady Hedgespeth, Director, SBA Office of Financial Assistance (June 10, 2010) (emphasis added).

By letter dated July 13, 2010, EDF appealed the twenty-five outstanding invoices pursuant to 13 CFR § 120.847. See Letter from Frank Dinsmore, C.E.O. of EDF, to Grady Hedgespeth, Director, SBA Office of Financial Assistance (July 13, 2010). In its appeal, EDF asserted that by failing to fund the entry of protective bids on the invoiced loans, SBA did not mitigate its losses on the loans and therefore, SBA could not hold EDF responsible for 15% of SBA's losses. *Id.* In other words, EDF argued that SBA's standard application of its long-standing formula for deciding when to use additional taxpayer funds to buy out a first lien at foreclosure, had in 2010 transformed into a "failure to mitigate" which exonerated EDF from its loss-share obligations if the application of the standard formula resulted in a "no bid" decision. EDF also asserted that should SBA desire to hold EDF responsible for the 15% PCLP reimbursement obligation, SBA should be required to assign its loan and collateral documents to EDF so that EDF could pursue recovery of the 15% PCLP reimbursement obligation amount for EDF's own benefit. *Id.* In this respect, EDF for all practical purposes asserted that if it was required actually to honor its long-standing 15% loss-share obligation, it would then be entitled to keep further collections for its own account, thus voiding the taxpayers' right to receive their pro-rata 85% share of all further collections. By letter dated August 25, 2010, SBA issued a final decision denying EDF's appeal on the grounds that (1) there was no basis for EDF's assertion that if SBA decides not to expend government funds to enter a protective bid that EDF is excused from its 15% PCLP reimbursement obligation; and (2) SBA had no legal authority to transfer the government's interest in collateral to the benefit of EDF. See Letter from Grady Hedgespeth, Director, SBA Office of Financial Assistance, to Frank Dinsmore, C.E.O. of EDF (August 25, 2010). SBA directed EDF to pay the full amount of the invoices by September 24, 2010. *Id.*

After receiving SBA's final decision on the appeal, EDF advised SBA that EDF could not meet its statutory obligation to reimburse SBA for 15% of the Agency's losses on EDF's PCLP loans. EDF conceded that if it were required to do so, EDF would not remain viable as a going concern.

Loan No. 1008636510) for \$27,655; Sahara Motors (SBA Loan No. 2958996500) for \$125,036; Estie's International (SBA Loan No. 2359396506) for \$90,161; Y&K Associates, Inc. (SBA Loan No. 2539846507) for \$74,489; MLK Carwash (SBA Loan No. 8945804506) for \$149,050; DJMS & Associates (SBA Loan No. 2821496502) for \$23,988; Pimoris Lumen (SBA Loan No. 1559026500) for \$73,713; ACG-Abayan Group (SBA Loan No. 2643916504) for \$98,176; BEK Ltd Corp (SBA Loan No. 2989076509) for \$107,037; William Hannah (SBA Loan No. 9290374500) for \$103,241; 74 Motorsports (SBA Loan No. 1991546502) for \$48,692; Fort Bragg Circle K (SBA Loan No. 3001296500) for \$74,153; E Real Mortgage (SBA Loan No. 9658344501) for \$283,412; and Harman Motive Inc. (SBA Loan No. 2823486503) for \$81,533.

See Letter from Frank Dinsmore, C.E.O. of EDF, to Grady Hedgespeth, Director, SBA Office of Financial Assistance (September 9, 2010). In that letter, EDF informed SBA:

When considering a worst case scenario, [EDF] could allegedly owe up to \$6 million in PCLP obligations. This level of obligation would be impossible for any CDC to meet *In an effort to maintain the viability of the CDC as an ongoing concern, we ask that you consider applying the recoveries we obtain as a means to meet our PCL obligation.*

Id. (emphasis added).

M. Summary of EDF Obligations Due to SBA

Since its September 9, 2010 concession that it would be unable to remain viable as a going concern if forced to meet its statutory PCLP reimbursement obligations, EDF’s debt to SBA has increased from approximately \$2.1 million to approximately \$20 million, and will continue to grow. As of the date of this Decision, EDF owes to SBA, *inter alia*, the following amounts for which SBA has demanded payment, but remain unpaid by EDF:

Unpaid 15% PCLP Reimbursement Obligation on 124 Invoices	\$11,448,899 plus interest and penalties
Unpaid Liquidation Pilot Loan Advances	\$8,900,000 plus interest and penalties

In addition, EDF will soon be receiving the following invoices from SBA:

15% PCLP Reimbursement Obligation on 39 Additional Charged Off Loans	Approximately \$3.6 million
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Further, EDF is required to fund additional millions of dollars in its Loan Loss Reserve Fund to cover the approximately 1,500 additional PCLP loans in its portfolio, as discussed herein.

EDF’s obligations referenced in this Decision reflect what is currently due and payable. SBA has invoiced EDF for 124 PCLP loans. Additionally, SBA has charged off and will be invoicing EDF for 39 other PCLP loans. As of September 30, 2012, EDF has approximately 334 other non-performing PCLP loans in its portfolio with a total outstanding balance of approximately \$198 million. EDF’s potential PCLP loss reimbursement exposure on the 334 additional non-performing PCLP loans totals approximately \$29 million. Losses will continue to emerge and develop in EDF’s PCLP loan portfolio, and SBA will continue to bill EDF for its 15% PCLP reimbursement obligations on those losses after the date of this Decision.

N. 15% PCLP Reimbursement Obligation Invoices and Associated Loan Loss Reserve Fund Deficiency

As of the date of this Decision, SBA has sent 124 PCLP reimbursement obligation invoices to EDF for a total of approximately \$11.4 million (plus interest and penalties). EDF has failed to pay these invoices. EDF’s Loan Loss Reserve Fund as reported to SBA is deficient by

approximately \$9.4 million on billed invoices alone. A summary of the unpaid invoiced 15% PCLP reimbursement obligations and the deficiency in EDF's Loan Loss Reserve Fund to cover those invoices is set forth below:

Invoice Issued	Total Amount	Appealed?	Final SBA Decision?	Loan Loss Reserve Fund (reported end of quarter)	Loan Loss Reserve Fund Deficiency on Billed Invoices
3Q 2010	\$2,120,467	Yes	Yes, appeal denied.	\$1,645,707	\$474,760
4Q 2010	None	N/A	N/A	\$1,969,663	\$150,804
2Q 2011	\$809,075 ²⁶	No	N/A	\$1,973,165	\$956,377
3Q 2011	\$604,332 ²⁷	Yes ²⁸	Yes, appeal denied. ²⁹	\$1,765,070	\$1,768,804

²⁶ See Invoice letters from Leslie Niswander, SBA Assistant Center Director, Commercial Loan Servicing Center, to Kim Ioanidis, EDF C.O.O. (October 16, 2011 - January 24, 2011). Loans invoiced and amounts are as follows: Acquire Educational Services (SBA Loan No. 2793106503) for \$155,083; Aqua Service (SBA Loan No. 2804736500) for \$56,772; Max's Gallery Fine Jewelry (SBA Loan No. 5721774507) for \$85,655; ARC International Corp. (SBA Loan No. 3090246508) for \$299,379; Golden State Concrete (SBA Loan No. 9005244509) for \$39,937; TPS Steel Inc. (SBA Loan No. 9104374508) for \$101,610; Realty World (SBA Loan No. 9280854509) for \$21,410; and Mac Transportation (SBA Loan No. 9666034502) for \$49,229.

²⁷ See Invoice letters from Leslie Niswander, SBA Deputy Center Director, Commercial Loan Servicing Center, to Kim Ioanidis, EDF C.O.O. (May 5, 2011). Loans invoiced and amounts are as follows: Help U Sell (SBA Loan No. 7414724502) for \$59,204; Harman Dermatology Medical (SBA Loan No. 8087014508) for \$97,985; Lathrop Chevron (SBA Loan No. 9450154504) for \$85,570; GTT International Inc. (SBA Loan No. 2195826507) for \$180,146; Futtatini LLC (SBA Loan No. 2775656500) for \$65,229; Auto America (SBA Loan No. 2984406502) for \$55,569; and Valley Fleet and Lease (SBA Loan No. 1566506500) for \$60,629.

²⁸ See letter from Jerry Stouck of Greenberg Traurig, to SBA's Grady Hedgespeth and Leslie Niswander (June 3, 2011)

²⁹ The appeal has been denied. See Section IV.B.2.e. below.

4Q 2011	\$1,633,365 ³⁰	No	N/A	\$1,975,794	\$3,191,445
1Q 2012	\$304,722 ³¹	No	N/A	\$1,976,863	\$3,495,098
2Q 2012	\$181,836 ³²	No	N/A	\$1,977,824	\$3,675,973
3Q 2012	\$3,647,983 ³³	No	N/A	\$1,978,699	\$7,323,081

³⁰ See Invoice letters from Leslie Niswander, SBA Deputy Center Director, Commercial Loan Servicing Center, to Kim Ioanidis, EDF C.O.O. (September 26, 2011 and September 30, 2011). Loans invoiced and amounts are as follows: Blue Collar Inc. (SBA Loan No. 2795216505) for \$41,980; C&T Truck Sales Inc. (SBA Loan No. 2721886504) for \$46,427; Exclusive Real Estate Corporation (SBA Loan No. 2887816505) for \$275,678; Galt Inn (SBA Loan No. 2541486505) for \$171,006; Gas Depot (SBA Loan No. 4868394500) for \$30,820; Gold Crown Home Loans Inc. (SBA Loan No. 1005996507) for \$47,712; Hamedan Enterprises Inc. (SBA Loan No. 3044686510) for \$187,769; Health Link Insurance Solution (SBA Loan No. 2662556509) for \$87,727; J 1 Auto Repair (SBA Loan No. 2146376507) for \$36,081; Lodi Equipment (SBA Loan No. 5660574501) for \$1,791; Loma Vista Bed & Breakfast (SBA Loan No. 2383826504) for \$110,003; Oak Creek Manor LLC (SBA Loan No. 2321386508) for \$220,791; The Finish Works Inc. (SBA Loan No. 2701266509) for \$25,805; Top Crain, LLC (SBA Loan No. 2493286509) for \$84,936; Wholesale Magazine Distribution (SBA Loan 2238966504) for \$61,049; and Asset Escrow Services Inc. (SBA Loan No. 1326436504) for \$203,790.

³¹ See Invoice letters from Leslie Niswander, SBA Deputy Center Director, Commercial Loan Servicing Center, to Kim Ioanidis, EDF C.O.O. (December 5, 2011 & December 14, 2011). Loans invoiced and amounts are as follows: CDC Enterprises, Inc. (SBA Loan No. 1851826501) for \$23,014; Wink 2K Inc. (SBA Loan No. 9815764503) for \$64,514; Coastal Serenade LLC (SBA Loan No. 2157186504) for \$63,159; and Nevada RE Marketing Ltd. (SBA Loan No. 8956584507) for \$154,035.

³² See Invoice letters from Leslie Niswander, SBA Deputy Center Director, Commercial Loan Servicing Center, to Kim Ioanidis, EDF C.O.O. (February 1, 2012, February 2, 2012, & February 9, 2012). Loans invoiced and amounts are as follows: Aureus & Associates Inc. (SBA Loan No. 2779156500) for \$61,756; Liberty Foil Company Inc. (SBA Loan No. 7733564504) for \$24,327; and Direct Security (SBA Loan No. 7606704501) for \$95,753).

³³ See Invoice Letters from Leslie Niswander, SBA Deputy Center Director, Commercial Loan Servicing Center, to Kim Ioanidis, EDF C.O.O. (March 30, 2012, April 20, 2012, April 23, 2012, May 17, 2012, May 18, 2012, & June 7, 2012). Loans invoiced and amounts are as follows: Signature Furniture (SBA Loan No. 9060294505) for \$98,418; Garcia's Flooring Inc. (SBA Loan No. 2247356500) for \$42,250; Edward A. Shepard CPA Inc. (SBA Loan No. 3073616510) for \$31,842; The Harty House Doctor Inc. (SBA Loan No. 2957946505) for \$76,221; and Southern California Tow & Tran (SBA Loan No. 2550236502) for \$82,234; Capital Loan Specialists (SBA Loan No. 2603856505) for \$216,170; Tarzana Beauty Collections, Inc. (SBA Loan No. 2202706505) for \$137,160; Engen Consultants (SBA Loan No. 9008424510) for \$67,047; Etamadi Star Dental Corporation (SBA Loan No. 1786876508) for \$217,024; Exhibit Space Works, Inc. (SBA Loan No. 3177766503) for \$215,984; Citizens Capital Corporation (SBA Loan No. 2692486502) for \$69,015; San Diego Real Estate Owned, Inc. (SBA Loan No. 9154804504) for \$152,990; Villa Lanta, LLC (SBA Loan No. 3297836505) for \$95,409; Citizens Capital Corporation (SBA Loan No. 2692566502) for \$80,664; Central Visual Information System (SBA Loan No. 2703606508) for \$97,663; Alpine Tendercare LLC (SBA Loan No. 9592554501) for \$87,330; Primestar Financial Group (SBA Loan No. 2406806502) for \$65,660; Lou Hernandez Inc. (SBA Loan No. 9256464510) for \$86,803; Happy Team Inc. (SBA Loan No. 9597644503) for \$278,372; WCMA Inc. (SBA Loan No. 2952636507) for \$60,896; Primo Derma Inc. (SBA Loan No. 3232106508) for \$87,505; SEEM LLC (SBA Loan No. 2990636508) for \$101,774; Gregory C. Curtis (SBA Loan No. 2762316504) for \$24,555; Big Vision Inc. (SBA Loan No. 9008804506) for \$128,512; Fender Bender International Inc. (SBA Loan No. 3262086505) for \$117,373; Desert Dynamics Inc. (SBA Loan No. 9365054504) for \$42,261; DEG Welt Pocket & Embroidery (SBA Loan No. 2318626507) for \$76,771; House of Cars Inc. (SBA Loan No. 2418806510) for \$89,414; Amighini Architectural Inc. (SBA Loan No. 3162526509) for \$94,473; Frank J. Lizarraga (SBA Loan No. 2983996502)

4Q 2012	\$1,276,800 ³⁴	No	N/A	\$1,979,526	
1Q 2013	\$870,319 ³⁵	Due 12/27/12		Not yet reported	
TOTAL DUE	\$11,448,899 plus interest and penalties			Total Deficiency on Billed Invoices	\$9,469,373 plus interest and penalties

If the approximately \$3.6 million in 15% PCLP reimbursement obligations that are ready to be invoiced on the 39 additional charged off PCLP loans are included in the Loan Loss Reserve Fund deficiency calculation, the amount of the deficiency increases to approximately \$13 million.

O. Unpaid Liquidation Pilot Loan Advances and Obligations

The ten liquidation pilot loan advance repayment due dates fell between August, 2010 and August 31, 2011. *See* Liquidation Pilot Loan Agreements. EDF has foreclosed upon all ten of the liquidation pilot properties, and has sold seven of the pilot properties to third party

for \$191,522; Matthew Kolb (SBA Loan No. 2389646510) for \$83,456; JDS Lost Oaks, LLC (SBA Loan No. 2763786507) for \$60,372; Tax Enterprises Inc. (SBA Loan No. 3149456507) for \$180,947; and K&K Supply and Printing Co. (SBA Loan No. 2789386503) for \$109,896.

³⁴ See Invoice Letters from Leslie Niswander, SBA Deputy Center Director, Commercial Loan Servicing Center, to Kim Ioanidis, EDF C.O.O. (June 22, 2012 and July 17, 2012). Loans invoiced and amounts are as follows: Alice and Helen Enterprises (SBA Loan No. 2980366005) for \$102,825; Clear Point Solutions (SBA Loan No. 3099956004) for \$31,240; Sanhtai (SBA Loan No. 2811796004) for \$122,491; Ivan J. Freyre Real Estate (SBA Loan No. 9202124006) for \$66,054; JJS Inc General Contractors (SBA Loan No. 9308394004) for \$153,200; Loren Distributors Intl (SBA Loan No. 2278246004) for \$72,919; AC General Engineering (SBA Loan No. 2877816000) for \$15,173; Left Field Productions (SBA Loan No. 2770206506) for \$65,490; Kit A. Enger and JoAnn Enger (SBA Loan No. 2752576508) for \$192,109; Loren Distributors Intl (SBA Loan No. 2278286506) for \$70,807; Colfax City Carwash (SBA Loan No. 2857216501) for \$60,315; AC General Engineering (SBA Loan No. 2877056509) for \$93,090; Edith Morre, Inc. (SBA Loan No. 2756746508) for \$125,645; and Misk Investments, LLC (SBA Loan No. 3075906507) for \$105,442.

³⁵ See Invoice Letters from Leslie Niswander, SBA Deputy Center Director, Commercial Loan Servicing Center, to Kim Ioanidis, EDF C.O.O. (November 26, 2012 and November 28, 2012). Loans invoiced and amounts are as follows: SRS Engineering Corporation (SBA Loan No. 9257374509) for \$53,963; Inn 4 Site, Inc. (SBA Loan No. 3242936503) for \$174,224.31; 7YP Inc./First Choice Roofing (SBA Loan No. 3147846502) for \$95,184; Vitiello & Hansen, Inc. (SBA Loan No. 2336436502) for \$48,248; JBL Home Appliance Center, Inc. (SBA Loan No. 3145046505) for \$42,333; Ivies Drywall, Inc. (SBA Loan No. 2605076500) for \$32,753; Chaparral Metals Transport, Inc. (SBA Loan No. 2868446506) for \$44,934; H2 Insurance Services (SBA Loan No. 2192046503) for \$68,608; Walter Roger Holding Group, LLC (SBA Loan No. 3181266509) for \$61,559; Graphic Impressions (SBA Loan No. 2187346505) for \$53,343; At Home Theater & Audio (SBA Loan No. 8835574508) for \$8,711; Hyun Gu Oh (SBA Loan No. 2705426506) for \$119,365; and New Image Commercial Flooring (SBA Loan No. 1705286507) for \$67,094.

purchasers.³⁶ As of the date of this Decision, EDF has repaid SBA on only three of the ten advances (Nevada RE Marketing, Careways and Ainsworth I). *See* Second Declaration of Kim Ioanidis, Exh. 39; *see also* Liquidation Pilot Table below. EDF has failed to pay SBA the amounts due on seven of the ten advances (Thomas Zorich, PMS Treatment, Green Road Hotels, Ainsworth II, Familia Flores, Quality One and Frutos Polishing). The amount of unpaid pilot loan advances due to SBA by EDF as of the date of this Decision is \$8.9 million, plus interest and penalties. *Id.* EDF has failed to repay these advances, despite SBA demand. *See* Letters from Gary A Wamhof, Acting Center Director, SBA Commercial Loan Servicing Center, to Frank Dinsmore, EDF C.E.O. on Ainsworth II, PMS Treatment and Green Road Hotels (July 22, 2011) and from Leslie Niswander to Frank Dinsmore on Quality One, Familia Flores, Frutos Polishing and Thomas Zorich (September 1, 2011).

EDF owes SBA more than just the \$8.9 million plus interest and penalties. First, as was noted in the prior paragraph, EDF has sold seven of the foreclosed properties, but possibly for more than the advances made by SBA for the purchase of those properties. SBA is unable to calculate the exact amount of retained sale proceeds because EDF has failed and refused to provide SBA with an accounting on the property sales, despite SBA demand. *Id.* EDF has failed to remit to SBA at least \$7.3 million in proceeds from the sale of four of the pilot properties to be applied to the four SBA advances on those properties, despite SBA demand (Quality One Engineering, Frutos Polishing, Familia Flores and Green Road Hotels) . *See* Letter from Joel Stiner, Center Director, SBA Commercial Loan Servicing Center, to Frank Dinsmore, EDF C.E.O. on Quality One Engineering, Frutos Polishing and Familia Flores (November 10, 2011); *see also* Letter from Leslie Niswander, SBA Assistant Center Director, to Frank Dinsmore, EDF C.E.O. on Green Road Hotels (February 16, 2012). SBA has determined from a review of the public records that EDF has sold these properties. SBA has not received an accounting of these sales from EDF, as required, thus SBA can only estimate the amount of sale proceeds being retained by EDF. The public records appear to show that EDF is retaining proceeds of at least \$7.3 million. If those proceeds were turned over to SBA by EDF as required, the proceeds would be applied to EDF's \$8.9 million obligation, thereby reducing the obligation to \$1.4 million.³⁷

Second, EDF has remitted SBA's 50% share of the sale proceeds on only one pilot property (Nevada RE Marketing). EDF has failed to remit SBA's 50% share, if any, from the sale of six of the pilot properties (Ainsworth I, Careways, Quality One Engineering, Frutos Polishing, Familia Flores and Green Road Hotels). Based on a review of the public records, SBA has determined that the unremitted 50% share could be as much as \$900,000.³⁸ As set forth in the Liquidation Pilot Proposals, proceeds from the sales of the pilot properties were to be used to

³⁶ EDF's related party, Redemption, conducted the foreclosure sales and took title to the properties, without SBA authorization.

³⁷ SBA added the \$8.9 million in advances made by SBA to EDF for purchase of the Senior Third Party Lender Loans on the pilot loans to the principal balance of the underlying 504 loans (second lien) as care and preservation of collateral expenses. EDF's wrongful failure to repay the SBA advances and/or remit the sale proceeds to SBA means that the small businesses that are the borrowers on the 504 loans continue to owe SBA for the amount of the Senior Third Party Lender Loan and the amount of the 504 loan (second lien). EDF's failure to remit the sale proceeds to SBA, as required, has deprived the small business borrowers of the credit to which they are entitled on the amounts due to SBA.

³⁸ It will likely be much less once EDF's liquidation expenses are netted out.

repay the SBA advances (for the purchase of the first lien) and EDF's reasonable liquidation expenses. Any remaining funds were to be shared 50/50 by EDF and SBA. SBA's 50% share was to be applied to the underlying 504 Loan (the second lien on the property). The requirement that EDF remit the 50% shares is in addition to the requirement to repay the \$8.9 million in SBA advances. SBA cannot determine the amount of the 50% share owed, if any, because EDF has failed to provide SBA with the required accountings on the six sold properties.

Finally, on the one advance (Nevada RE Marketing) where SBA billed EDF for its 15% PCLP reimbursement obligation (a stated condition of the liquidation pilot), EDF has failed and refused to pay its \$154,035 PCLP reimbursement obligation, despite the fact that EDF retained \$160,000 (its 50% share) of the excess proceeds from the sale of SBA's collateral. EDF has not asserted any defense to payment of this invoice---it has simply failed to pay SBA.

A summary of the status of the liquidation pilot loan advances is set forth below:

Loan Name	Liquidation Pilot Advance Amount	Due Date**	Property Sale Date and Sale Price	Advance Repaid?	50% Share Remitted?	If Sold, Sale Proceeds Retained by EDF?	Underlying 504 Loan Amount
Thomas Zorich	\$496,073*	3/16/11	N/A	No	N/A	N/A	\$430,000
Nevada RE	\$1,554,060	5/31/10	8/3/10 \$2.1 M	Yes	Yes, \$160,000 remitted to SBA (EDF also retained \$160,000)	No	\$1,216,000+
PMS Treatment	\$692,887	5/31/11	N/A	No	N/A	N/A	\$497,000
Green Road Hotels	\$5,041,939*	6/30/11	2/3/12 \$5.6 M plus 9/27/12 \$278,000 from Receiver	No	No	Yes***	\$2,000,000 (SEM)
Careways	\$806,447	6/30/11	8/11/10 and 2/9/11 \$1.4 M	Yes	No	Yes***	\$554,000
Ainsworth I	\$667,246	6/30/11	6/22/11 \$735,000	Yes	No	Yes***	\$536,000
Ainsworth II	\$413,255*	6/30/11	N/A	No	N/A	N/A	\$324,000
Familia Flores	\$1,044,520*	8/31/11	9/27/11 \$1 M	No	No	Yes***	\$721,000
Quality One	\$745,965*	8/31/11	6/11/11 \$825,000	No	No	Yes***	\$543,000
Frutos	\$555,563*	8/31/11	7/13/11 \$810,000	No	No	Yes***	\$437,000

***TOTAL UNPAID ADVANCES - \$8.9 million plus interest and penalties**

****If property not sold *before* this date**

*****ESTIMATED SALE PROCEEDS AND 50% SHARE RETAINED BY EDF - \$8.2 million**

+UNPAID 15% REIMBURSEMENT OBLIGATION INVOICE - \$154,035

See Liquidation Pilot Loan Agreements and Liquidation Pilot Proposals.

In its December 14, 2011 Response, EDF said as follows with respect to its Liquidation Pilot obligations to SBA:

. . . [I]n addition to the SBA advances on three Pilot Program loans that EDF has already repaid, EDF has sold three additional collateral properties on Pilot Program loans [Familia Flores, Quality One and Frutos] and expects to repay those advances as soon as related expenses are paid. *See id.* The sale of the collateral property on a fourth Pilot Program loan [Green Road Hotels], by far the largest loan among the group, is currently pending and when it closes, will allow EDF to repay SBA the underlying advance as well as SBA's agreed one-half share of the amount attributable to the 504 loan. *See id., see also* Second Declaration of Joey Larsen ("12/14/11 Larsen Decl.") ¶ 50. In short, EDF has fulfilled and will continue to fulfill its obligations to SBA regarding the Pilot Program advances.

Id. at p. 47.

A year has passed since EDF made this statement, and it has failed to make any payments or remit any sale proceeds to SBA on the liquidation pilot advances.

Additionally, SBA has uncovered certain irregularities in connection with EDF's handling of the liquidation pilot advances. SBA has determined that without SBA's authorization, EDF took title to the Senior Third Party Lender Loans purchased by SBA with the pilot loan advances in the name of EDF's related party, Redemption. *See* EDF Audited Financial Statements (as of September 30, 2010). EDF also transferred, without SBA's authorization, over \$600,000 in unused SBA pilot loan advance proceeds to a bank account in the name of Redemption and has failed to return the unused proceeds to SBA, despite written demand. *See* Letter from Leslie Niswander, Deputy Center Director, SBA Commercial Loan Servicing Center, to Frank Dinsmore, EDF C.E.O (November 10, 2011). Additionally, because it holds the first lien on the properties, Redemption has taken title to the properties at foreclosure and subsequently sold certain of the properties without turning over proceeds to SBA, all without SBA's authorization. *See* Letter from Joel Stiner, Center Director, SBA Commercial Loan Servicing Center, to Frank Dinsmore, EDF C.E.O. (November 10, 2011); *see also* Letter from Leslie Niswander, SBA Assistant Center Director, to Frank Dinsmore, EDF C.E.O. (February 16, 2012). The only consideration for the unauthorized transfers to Redemption appears to be a receivable on the books of EDF from Redemption in the total amount of the outstanding pilot loan advances made by SBA. *See* EDF Audited Financial Statements (2010). Additionally, EDF's 2011 Annual Financial Statements reflect cash advances of over \$800,000 from Redemption to EDF, which may be liquidation pilot sale proceeds being used by EDF to fund its operating expenses. *See* EDF Resource Capital, Inc., 2011 Financial Statements.

III. ENFORCEMENT ACTION HISTORY

A. Notice of Proposed Enforcement Action issued February, 18 2011

On February 18, 2011, SBA issued a Notice of Proposed Enforcement Action against EDF. *See* Letter from Janet Tasker, Acting Director, SBA Office of Credit Risk Management, to Frank Dinsmore, EDF C.E.O. (February 18, 2011). In accordance with the procedure required by 13 CFR § 120.1600(a)(1), the Notice advised EDF that SBA was proposing the permanent revocation, pursuant to 13 C.F.R. § 120.1500(a)(3), of EDF's authority to participate in SBA's 504 Loan Program and the transfer, pursuant to 13 C.F.R. § 120.1500(e)(1), of all of EDF's existing SBA 504 loan portfolio and all of EDF's pending SBA 504 loan applications to SBA, another CDC or entity designated by SBA. *Id.* at 1.

The Notice set forth the following grounds for the proposed enforcement action:

- I. 13 C.F.R. § 120.1400(f)(2) - Failure to establish or maintain a loan loss reserve fund as required by the PCLP, including non-compliance with EDF's Risk-Based Methodology
- II. 13 C.F.R. § 120.1400(c)(2) - Failure to comply materially with SBA's Loan Program Requirements, including the failure to pay invoiced obligations in a timely manner and the failure to maintain the financial ability to operate
- III. 13 C.F.R. § 120.1400(c)(4) - Not performing actions in a commercially reasonable and prudent manner
- IV. 13 C.F.R. § 120.1400(c)(9) - SBA's determination that EDF has increased SBA's financial risk

Id. at 2.

As required by 13 C.F.R. § 120.1600(a)(1)(i), the Notice set forth in reasonable detail the underlying facts and reasons for SBA's proposed enforcement action. *Id.* The Notice was signed by Janet Tasker, former Acting Director of SBA's Office of Credit Risk Management. *Id.* at 9.

SBA advised EDF that pursuant to 13 C.F.R. § 120.1600(a)(2)(i), EDF had the right to object to the proposed enforcement action by filing a written objection with SBA within 30 calendar days of receipt, and that the objection must (1) set forth all grounds known to EDF to contest the proposed enforcement action, (2) set forth all mitigating factors, and (3) include documentation that EDF believes is most supportive of the objection. *Id.* at 6. SBA also advised EDF that pursuant to 13 C.F.R. § 120.1600(a)(2)(iii), EDF could request within 30 days of receipt of the Notice a clarification of the reasons given by SBA in the Notice. *Id.* at 6. Further, SBA advised EDF that pursuant to 13 C.F.R. § 120.1600(a)(2)(iv), EDF could request within 30 days of receipt of the Notice additional time to respond to the Notice. *Id.* at 7.

B. EDF's Letter dated 3/9/11 Requesting Clarification Pursuant to 13 C.F.R. § 120.1600(a)(2)(iii) and Additional Response Time Pursuant to 13 C.F.R. § 120.1600(a)(2)(iv)

By letter dated March 9, 2011, counsel for EDF requested, pursuant to 13 C.F.R. § 120.1600(a)(2)(iii), clarification of the reasons for the proposed enforcement action given by SBA in the Notice. Counsel also requested, pursuant to 13 C.F.R. § 120.1600(a)(2)(iv), additional time to respond to the Notice. *See* Letter from Jerry Stouck and David P. Callet of Greenberg Traurig, to Janet Tasker, Acting Director, SBA Office of Credit Risk Management (March 9, 2011). In the letter, EDF's counsel submitted more than 250 separate requests for SBA to define, clarify, identify, specify or produce documents so that EDF could better understand the reasons specified by SBA as the basis for the proposed enforcement action. *Id.* SBA granted EDF's extension request until 30 days after receipt of SBA's response to EDF's clarification request. *See* Email from from Janet Tasker, Acting Director, SBA Office of Credit Risk Management, to Frank Dinsmore, EDF C.E.O. (March 11, 2011).

C. SBA's 4/18/11 Clarification of Notice of Proposed Enforcement Action

SBA considered each of EDF's numerous requests for clarification and, where appropriate, augmented the Notice in a letter delivered to EDF on April 18, 2011. *See* Letter from Janet Tasker, Acting Director, SBA Office of Credit Risk Management, to Jerry Stouck and David P. Callet of Greenberg Traurig (April 18, 2011). The clarification letter alleged the same grounds contained in the Notice, but provided further clarification of the bases for those grounds. *Id.*

D. SBA's April 26, 2011 Notice of Targeted Review and Request for Information Regarding Unreported PCLP Loans

On April 26, 2011, SBA notified EDF that as a result of SBA's review of EDF's audited financial statements dated September 30, 2010 that had recently been submitted to SBA, SBA had serious concerns about EDF's financial condition and compliance with applicable law and regulations. *See* Letter from Janet Tasker, Acting Director, SBA Office of Credit Risk Management to Frank Dinsmore, C.E.O. of EDF (April 26, 2011). Because of SBA's responsibility to uphold the integrity of the 504 Loan Program, SBA believed that it was prudent to conduct a targeted review of EDF, pursuant to 13 CFR § 120.1050, in order to better understand the current condition of EDF's non-performing portfolio and its resulting financial condition.³⁹ *Id.* at 2. SBA noted that it would provide EDF with appropriate due process, including an opportunity to respond fully, if SBA chose to rely in the pending enforcement proceeding on any information obtained in the targeted review. *Id.* at 4.

In the same letter, SBA noted that it had recently received EDF's 12/31/10 Quarterly Loan Loss Reserve Fund Report. SBA noted several reporting discrepancies in the report. In particular, SBA's records showed that EDF had 350 non-performing PCLP loans as of 12/31/10, but 263 of

³⁹ SBA and its contractor, Fuentes-Fernandez & Company (FFC), conducted a prior targeted review of EDF in December, 2010, before EDF submitted its 2010 Financial Statements to SBA. SBA does not rely on any of the findings of FFC in this Decision.

these loans were missing from EDF's Quarterly Loan Loss Reserve Fund Report. SBA asked EDF to explain the discrepancy and for each of the 263 missing loans, provide the outstanding balance of the loan, EDF's risk classification for the loan and the amount reserved for each loan. *Id.* at 3. SBA attached a table with a list of the 263 missing loans for EDF to complete and return to SBA.

E. EDF's 5/18/11 Response to Notice of Proposed Enforcement Action

On May 18, 2011, EDF, through counsel, submitted to SBA, pursuant to 13 C.F.R. § 120.1600(a)(2)(i), a 104-page Response to the Notice, together with Declarations of EDF's Chief Operating Officer and Chief Portfolio Officer, and a number of exhibits. *See* Letter from Jerry Stouck and David P. Callet of Greenberg Traurig, to Janet Tasker, Acting Director, SBA Office of Credit Risk Management (May 18, 2011) (May 18, 2011 Response). EDF's Response addressed the two main grounds for enforcement cited by SBA in the Notice, failure to establish and maintain a Loan Loss Reserve Fund as required and failure to comply with SBA's Loan Program Requirements, and also raised certain due process arguments.⁴⁰ *Id.*

F. EDF's 5/18/11 Response to SBA's April 26, 2011 Letter

On May 18, 2011, EDF also submitted a letter to SBA responding to SBA's April 26, 2011 request for EDF to explain why hundreds of non-performing PCLP loans were missing from EDF's 12/31/10 Quarterly Loan Loss Reserve Fund Report. *See* Letter from Frank Dinsmore, EDF C.E.O. to Janet Tasker, Acting Director, SBA Office of Credit Risk Management (May 18, 2011). In its letter, EDF failed to comply with SBA's request to provide the outstanding balance of each unreported loan, EDF's risk classification for each unreported loan, and the amount reserved for each unreported loan. Instead, EDF stated the following: "The basis for EDF's reporting on the Quarterly Loan Loss Reserve Fund Report is fully described in [EDF's May 18, 2011 Response], which demonstrates that there is no discrepancy." *Id.*

In its May 18, 2011 Response, EDF says that starting in 2008, it dropped loans from its reports and reserve because "EDF's growing experience with troubled loans in 2008 and 2009 confirmed to it that the EDF Methodology was ill-suited to serve the purpose for which it was designed . . . [a]ccordingly, during that period, EDF began modifying its application of the EDF Methodology to exclude from consideration loans in liquidation that did not satisfy the 'SBA Formula' [pertaining to when SBA will enter a protective bid and purchase the first lien interest on the project property]" *See* EDF's May 18, 2011 Response at 32 (IV.C). EDF also asserted in its May 18, 2011 Response that SBA acquiesced in EDF's concealment of the dropped loans in EDF's Quarterly Loan Loss Reserve Fund Reports to SBA and EDF's failure to

⁴⁰ 13 C.F.R. § 120.1600(a)(3) provides that SBA will issue a notice of decision within 90 days of receiving an objection to a notice of proposed enforcement, unless SBA provides notice that it requires additional time. On August 15, 2011 and October 13, 2011, SBA provided EDF with notice that SBA required additional time. *See* Letter from Eugene D. Stewman, Acting Director, Office of Credit Risk Management, to Frank F. Dinsmore, EDF C.E.O. (August 15, 2011) and Letter from Eugene D. Stewman, Acting Director, Office of Credit Risk Management, to Frank F. Dinsmore, EDF C.E.O. (October 13, 2011).

fund a reserve for those loans because SBA did not object or comment on the incomplete and misleading reports. *Id.*

G. August, 2011 Targeted Review of EDF

By letter dated July 5, 2011 SBA followed up on the April 26, 2011 letter notifying EDF of SBA's intent to conduct a targeted review of EDF. *See* Letter from Eugene D. Stewman, Acting Director, SBA Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (July 5, 2011). SBA notified EDF that SBA was in the process of arranging for auditors to conduct the targeted review, and that SBA expected to complete the arrangements in the near future. *Id.* SBA advised EDF that SBA would be conducting the targeted review in three stages. First, SBA and the auditors would meet on-site at EDF with management and review EDF's financial books and records. Second, the auditors would be conducting an off-site review of a sample of EDF's SBA loan files. Third, after the auditors completed the off-site file review, SBA and the auditors would return on-site to EDF to discuss questions arising from the off-site review, and meet with EDF's management, EDF's outside auditors (Gallina LLP (Gallina) and Perry-Smith) and representatives of Redemption. *Id.* In preparation for the targeted review, SBA requested that EDF deliver to SBA on or before July 25, 2011 media disks containing EDF's electronic loan files for the 360 non-performing PCLP loans in EDF's portfolio as of April 30, 2011. *Id.* EDF delivered the electronic loan files to SBA as requested. *See* Letter from Frank Dinsmore, C.E.O. of EDF to Paul Kirwin, Financial Analyst, SBA Office of Credit Risk Management (July 22, 2011).

By letter dated July 19, 2011, SBA notified EDF that SBA would be starting the on-site portion of the targeted review on August 8, 2011, and provided EDF with a list of documents which SBA required EDF to produce in connection with the targeted review. *See* Letter from Eugene D. Stewman, Acting Director, SBA Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (July 19, 2011). On July 26, 2011, EDF's counsel advised SBA that EDF would not be able to comply with SBA's request to begin the targeted review on the scheduled date. *See* Letter from Jerry Stouck and David Callet, Greenberg Traurig, LLP, to Michael Chodos, SBA Deputy General Counsel (July 26, 2011). On July 27, 2011, SBA notified EDF that SBA would delay the start date of the targeted review by one week. *See* Letter from Eugene D. Stewman, Acting Director, SBA Office of Credit Risk Management to Frank F. Dinsmore, EDF C.E.O. (July 27, 2011). SBA also agreed to divide up its document request into two parts--the documents listed on Exhibit A to SBA's July 27, 2011 letter were to be provided to SBA on the targeted review start date, while the documents listed on Exhibit B were to be provided electronically one week after the targeted review start date. *Id.*

On August 16, 2011, SBA and its contractor Bazilio Cobb Associates f/k/a Thompson, Cobb, Bazilio & Associates, PC, a Certified Public Accounting firm (the auditor), began the targeted review of EDF. *See* Report on Targeted Review of EDF REsource Capital, Inc. dated October 28, 2011 (Audit Report) at 4. SBA and the auditor went on-site at EDF from August 16, 2011 to August 24, 2011 to review EDF's financial condition and the financial condition of EDF's affiliates and related parties, including SEM, GA and Redemption Reliance. EDF's counsel was

present for the on-site portion of the review. Simultaneously, the auditor performed an off-site review of a sample of 117 of the non-performing loans.⁴¹

At the initial on-site meeting on August 16, 2011, EDF presented the auditor with a disk labeled “Exhibit A - Item 4.” See Exhibit A – Item 4. This disk was provided by EDF in response to the document request attached as Exhibit A to SBA’s July 27, 2011 letter to EDF. Item 4 of Exhibit A required EDF to produce the following:

4. Copies of all risk-based methodologies for PCLP loans used by EDF from 2004 to the present, all documents showing any and all changes to the risk-based methodologies, all documents regarding EDF’s policies for implementing the risk-based methodologies, and all documents regarding EDF’s policies for quarterly loan loss reserve reporting to SBA.

Id.

The EDF disk labeled Exhibit A – Item 4 contained several versions of EDF’s Risk-Based Methodology documents dating from May, 2003 to April, 2010, and other material including the following:

- Five versions of loan grading and review policies, which EDF advised the auditor included the most current version, Update Number 5 dated April, 2010⁴²
- Two versions of Loan Loss Reserve Fund policies
- An undated memorandum from CEO Frank Dinsmore changing the names of the 1-7 grades
- An eight-page undated memorandum explaining the history of EDF’s Risk-Based Methodology

See Audit Report at 4.

The five versions of EDF’s Risk-Based Methodology (dated from 2003 to 2010) provided by EDF to the auditor show very little in the way of major changes. Each version contains the same loan grades and loan grade names, and each version applies a risk factor to each grade to determine the amount to be funded in EDF’s Loan Loss Reserve Fund. The auditor determined that Update 5, the April, 2010 version of the Risk-Based Methodology (provided by EDF to SBA in connection with the August, 2011 targeted review), is the most current version of EDF’s Risk-Based Methodology (Risk-Based Methodology). See Audit Report at 4.

The undated memorandum from CEO Frank Dinsmore, which the auditor determined was prepared by EDF’s counsel the week before the August, 2011 targeted review, changes the

⁴¹ SBA selected the sample of 117 loans from the then universe of EDF’s 360 non-performing loans. SBA decided to look at the worst loans first because these were the loans about which SBA had the greatest concern. SBA is not using the results of the sample to extrapolate to a population.

⁴² The version of the Risk-Based Methodology provided to SBA and FFC at the December, 2010 targeted review appears to be the document titled “Loan Grading and Review Update 3” on the disk given to the auditor in August, 2011.

names of the grades assigned to each PCLP Loan. *See* Memorandum from Frank Dinsmore, EDF C.E.O. to “Kim” and “Pete” (not dated). It appears that this change had not been implemented as of September 30, 2011.⁴³ The eight-page undated memorandum, which the auditor determined was also prepared by EDF’s counsel the week before the August, 2011 targeted review, is titled “EDF Resource Capital, Inc.’s Revised Risk Based Methodology.” It is a memorandum that essentially repeats the contentions of EDF’s May 18, 2011 Response to SBA’s Notice.

During the targeted review, the auditor also reviewed the following documents, among others:

- Annual audited financial statements (and selected workpapers) of EDF and its affiliates GA and SEM for years ending September 30, 2009 and 2010, and for its affiliate Redemption for year ending September 30, 2010 (no audit of Redemption was conducted for 2009), all prepared by Gallina, LLP
- Various interim financials of EDF, GA, SEM and Redemption
- EDF general ledgers for periods ending September 30, 2009, September 30, 2010, April 30, 2011 and June 30, 2011
- Redemption general ledger for June 30, 2011
- Credit files for the 117 non-performing Loan sample as of July 11, 2011

The auditor also performed site visits of the collateral for 52 of the 117 loans in the sample. *See* Audit Report at 3.

For the off-site loan file review portion of the review, SBA asked the auditor to assess 22 factors for each PCLP Loan reviewed. *Id.* at 3. For each loan, SBA asked the auditor to determine whether a wrap-up report on the loan had been submitted to SBA by EDF or if EDF had exhausted all reasonable collection efforts on the loan. *Id.* at Appendices B and G. SBA asked the auditor to assess these factors because 13 C.F.R. § 120.847(h) provides that SBA may bill a CDC for its PCLP reimbursement obligation when the CDC “has submitted a liquidation wrap-up report to SBA, or when SBA otherwise determines that the PCLP CDC has exhausted all reasonable collection efforts with respect to that 504 loan.” For those loans where the auditor determined that wrap-ups had been submitted or where EDF had exhausted all reasonable collection efforts, SBA asked the auditor to calculate the 15% PCLP reimbursement obligation owed by EDF to SBA. *See* Audit Report at Appendix G. Additionally, SBA asked the auditor to review EDF’s March 31, 2011 Quarterly Loan Loss Reserve Fund Report and determine if the sample loans appeared on the report. If the loan did not appear on the report, SBA asked the auditor to analyze when the loan dropped off EDF’s Quarterly Loan Loss Reserve Fund Reports to SBA. *Id.* at Appendix C.

⁴³ On November 15, 2011, EDF submitted its Quarterly Loan Loss Reserve Fund Report to SBA for the quarter ending September 30, 2011. *See* Letter from Frank Dinsmore, EDF C.E.O., to James Bryant, SBA Lead Lender Relations Specialist (November 15, 2011). The report states that as of September 30, 2011, EDF was still using the old grade names when grading loans from 1 to 7. *Id.* Additionally, EDF’s auditor, Perry-Smith, appears to be unaware of any loan grade name changes because their report dated October 7, 2011 (attached to EDF’s 9/30/11 Quarterly Loan Loss Reserve Fund Report) still uses the old grade names. *See* Perry-Smith Report on Credit Classification and Review of Loan Origination Documentation Requirements, at 5 (October 7, 2011).

By letter dated August 30, 2011, SBA notified EDF that the auditor would be returning on-site at EDF on September 15, 2011 to meet with EDF's management, Gallina and Perry-Smith, and representatives of Redemption. *See* Letter from Eugene D. Stewman, Acting Director, SBA Office of Credit Risk Management, to Frank F. Dinsmore, EDF C.E.O. (August 30, 2011). In preparation for the September 15, 2011 on-site meeting, by letter dated September 2, 2011, SBA requested that Gallina deliver to SBA on or before September 9, 2011 copies of Gallina's workpapers for the most recent annual audits of EDF, GA, SEM and Redemption, including the engagement letters for each audit and the letters of representation given to Gallina by the companies with respect to each audit. *See* Letter from Eugene D. Stewman, Acting Director, Office of Credit Risk Management, to Gallina LLP (September 2, 2011). Gallina delivered certain documents to SBA as requested, but refused to deliver the Redemption workpapers because Redemption would not consent to the release of the workpapers. *See* Letter from Eugene D. Stewman, Acting Director, Office of Credit Risk Management, to Frank F. Dinsmore, EDF C.E.O. (September 12, 2011). SBA also made a request to Perry-Smith to deliver to SBA copies of Perry-Smith's workpapers for its review of EDF's March 31, 2011 and June 30, 2011 Quarterly LLRF Reports. *See* Letter from Eugene Stewman, Acting Director, SBA Office of Credit Risk Management, to Perry-Smith, LLP (September 2, 2011). By letter dated September 8, 2011, Perry-Smith purported to provide SBA with the requested work papers. *See* Letter from Susan F. Cordonnier, Partner, Perry-Smith, LLP to Paul Kirwin, SBA Financial Analyst (September 8, 2011).

On September 15, 2011, SBA and the auditor returned on-site to EDF and interviewed EDF management as well as representatives of Gallina and Perry-Smith. EDF's counsel was again present for the targeted review. At the on-site meeting, SBA and the auditor reiterated SBA's request for the documents as set forth in SBA's September 2, 2011 letters to Gallina and Perry-Smith. Gallina provided SBA with certain of those documents on September 19 and 20, 2011. *See* E-mail from Paul Kirwin, SBA Financial Analyst, to David P. Callet, Esquire, of Greenberg Traurig (September 20, 2011).

Also, after the on-site meeting concluded and the auditor had left the EDF premises, Perry-Smith sent to SBA by overnight mail an additional document from Perry-Smith's workpapers that had been given to Perry-Smith by EDF. *See* Letter from Susan F. Cordonnier, Partner, Perry-Smith, LLP to Paul Kirwin, SBA Financial Analyst (September 15, 2011). The document is titled "EDF Resource Capital, Inc. Loan Rating Report" and states that it is for "Loans through 3/30/2011." The first part of the document is essentially the same as the EDF Loan Rating Report that EDF included with its March 31, 2011 Quarterly Loan Loss Reserve Fund Report to SBA that EDF sent to SBA on June 1, 2011. That portion of the document shows EDF's risk rating and calculated loss reserve for 1,456 PCLP loans (in grades 1 – 7). The calculated reserve for the loans listed in that section is approximately \$1.0 million, which is covered by the \$1.9 million on deposit in EDF's Loan Loss Reserve Fund accounts on that date.⁴⁴ The second part of the document titled "EDF Resource Capital, Inc. Loan Rating Report***Includes Only SBA Declined Loans***" was not included in EDF's March 31, 2011 Quarterly Loan Loss Reserve

⁴⁴ The amount of calculated reserves in EDF's 3/31/11 Quarterly Loan Loss Reserve Fund Report to SBA was slightly higher---\$1.3 million. *See* EDF's Quarterly Loan Loss Reserve Fund Report (March 31, 2011).

Fund Report to SBA. This section of the document shows EDF's risk rating and calculation of the reserve requirement for 316 PCLP loans (with an outstanding principal balance of approximately \$194 million) that EDF had dropped from EDF's report to SBA and dropped from EDF's reserve.⁴⁵ This section shows that EDF risk-rated the missing loans and calculated the reserve for the dropped loans based on the outstanding balance and risk factors. This document shows that EDF determined that an additional \$9.4 million was required in EDF's Loan Loss Reserve Fund under EDF's Risk-Based Methodology to cover the dropped loans, for a total required reserve of \$10.4 million.⁴⁶ Neither EDF (nor incidentally its auditor, Perry-Smith) disclosed these withheld—and clearly material and significant---reports to SBA previously. Indeed, EDF had failed to provide this information to SBA when asked directly to provide it in SBA's April 26, 2011 letter.

The auditor issued its Audit Report on October 28, 2011. *See* Audit Report. On November 2, 2011, SBA provided copies of the Audit Report to EDF, its counsel and all of EDF's then board members.⁴⁷ *See* Letter from Eugene Stewman, Acting Director, SBA Office of Credit Risk Management, to Frank Dinsmore, EDF C.E.O., and EDF Directors John Fenner, Michael Cross, Ian McDaniel, Dean Sanjay Varshney, and Eric Burnette (November 2, 2011).

H. SBA's November 14, 2011 Supplement to Notice of Proposed Enforcement Action

Upon consideration of the targeted review and Audit Report, SBA concluded that many of the findings of the targeted review and Audit Report provided additional support for the proposed enforcement action. Accordingly, on November 14, 2011, SBA issued a Supplement to its Notice (Supplement Letter), incorporating findings from the targeted review and Audit Report supporting the proposed enforcement action and attaching a copy of the Audit Report pursuant to 13 C.F.R. § 120.1600(a)(1)(ii). *See* Letter from Eugene Stewman, Acting Director, SBA Office of Credit Risk Management, to Frank Dinsmore, EDF C.E.O. (November 14, 2011). SBA provided EDF with 30 days to respond to the Supplement Letter. *Id.* at 3.

I. EDF's December, 14 2011 Response to Supplement Letter

On December 14, 2011, EDF, through its counsel, filed, pursuant to 13 C.F.R. § 120.1600(a)(2)(i), a 72-page Supplemental Response, together with the Second Declarations of EDF's Chief Operating Officer and Chief Portfolio Officer, the Declaration of an attorney, and multiple exhibits. *See* EDF's December 14, 2011 Response. EDF's December 14, 2011 Response sets forth some general arguments regarding the fairness of the proposed enforcement

⁴⁵ Because the number of loans on EDF's 3/31/11 Quarterly Loan Loss Reserve Fund Report to SBA was 1,435, not 1,456 as reflected in the first section of the document obtained from Perry-Smith, it appears that EDF dropped an additional 21 loans from the report to SBA. *See* EDF's Quarterly Loan Loss Reserve Fund Report (March 31, 2011).

⁴⁶ Because EDF was not timely and properly grading its loans in accordance with its Risk-Based Methodology, as discussed below, the \$10.4 million reserve calculated by EDF is lower than what would have been required had EDF fully complied with its Risk-Based Methodology.

⁴⁷ Upon information and belief, Messrs. Fenner and McDaniel are no longer EDF board members.

proceeding and addresses EDF's financial ability to operate and the sufficiency of EDF's Loan Loss Reserve Fund.⁴⁸ *Id.*

In its December 14, 2011 Response, EDF changed its May 18, 2011 explanation of the 263 missing PCLP loans. Paragraph 57 of the declaration of EDF's COO states as follows:

When the subject was called to my attention during the TCBA "targeted review," I ascertained that to the extent EDF did not include troubled loans on its quarterly Loan Loss Reserve Fund reports---a circumstance that did not occur prior to March 2009 and then not again until September 2009---*originally this was an unintended result of an internal modification of certain computer program codes*; beginning in late 2010, this was done as a result of EDF's recognition that its Risk-Based Methodology was misguided, particularly given that SBA was abandoning certain troubled loans and interfering with EDF's collection efforts on those loans.

See EDF's December 14, 2011 Response, Second Declaration of Kim Ioanidis (emphasis added).

IV. GROUNDS FOR ENFORCEMENT ACTION

A. EDF has failed to Establish or Maintain (including failing to properly evaluate, risk rate, manage, fund and fully and accurately report on) a Loan Loss Reserve Fund as Required by the PCLP Program. Thus, SBA has sufficient grounds for the Enforcement Action pursuant to 13 C.F.R. § 120.1400(f)(2).

In Section I of SBA's Notice, SBA charged EDF with the failure to establish or maintain a Loan Loss Reserve Fund as required by the PCLP Program. *See* February 18, 2011 Notice at 2-4 (Section I). The record shows that this charge is sustained.

Under the PCLP Program, EDF is required by statute to maintain a Loan Loss Reserve Fund that is sufficient for EDF to meet its obligations to protect the SBA from risk of loss. *See* 15 U.S.C. §§ 697e(b)(2)(D) and 15 USC 697e(c)(7)(B)(ii). For the Alternative Loan Loss Reserve program specifically, the statute requires EDF to establish and utilize an appropriate and effective process for analyzing the risk of loss associated with its portfolio of PCLP loans and for grading each PCLP loan made by EDF on the basis of the risk of loss associated with such loan. *See* 15 U.S.C. § 697e(c)(7)(F)(ii). EDF is required by regulation to diligently monitor its Loan Loss Reserve Fund to ensure that it contains sufficient funds to cover its reimbursement obligation for its entire portfolio of PCLP loans, and within 30 days of the earlier of the date it becomes aware of a deficiency or the date it receives notification from SBA of a deficiency, make additional contributions to the Loan Loss Reserve Fund. *See* 13 C.F.R. § 120.847(j). Further, on a

⁴⁸ Ninety days after receipt of EDF's December 14, 2011 objection, SBA provided EDF with notice pursuant to 13 C.F.R. § 120.1600(a)(3) that SBA required additional time to issue a notice of decision. *See* Letter from Brent M. Ciurlino, Director, Office of Credit Risk Management, to Frank F. Dinsmore, EDF C.E.O. (March 13, 2012). SBA has provided EDF with subsequent notices regarding the decision deadline in the ALP and PCLP status extension letters noted above.

quarterly basis, EDF is required to file with SBA a report showing the amount in EDF's Loan Loss Reserve Fund in a form that will readily facilitate reconciliation of the amount actually maintained in the Loan Loss Reserve Fund with the amount required to be maintained in the Loan Loss Reserve Fund. 13 C.F.R. § 120.847(f). The record shows that EDF has failed to comply with all of these requirements.

1. EDF's Loan Loss Reserve Fund is insufficient by millions of dollars under EDF's Risk-Based Methodology requirements

During the August, 2011 targeted review, the auditor reviewed a sample of 117 non-performing PCLP loans in EDF's portfolio. *See* Audit Report at 3. Based on a review of EDF's March 31, 2011 Quarterly Loan Loss Reserve Fund Report, the auditor determined that the amount reserved by EDF for those 117 loans was \$139,375. *Id.* Only 6 of the 117 loans in the sample are reported on EDF's March 31, 2011 Quarterly Loan Loss Reserve Fund Report. *Id.* The auditor applied EDF's Risk-Based Methodology to the 117 loan sample and found that the total reserve for the 117 loans should be \$13,544,559, an underfunding of \$13,405,184 for just the 117 loans in the sample. *Id.*

SBA has subsequently determined that 7 of the loans in the sample are not PCLP loans. Subtracting out the amount that the auditor calculated needed to be reserved for the non-PCLP loans yields a corrected required reserve amount of \$12,412,583, for an underfunding of \$12,273,208.⁴⁹

The auditor noted that the amount of EDF's Loan Loss Reserve Fund listed on its financial statements as of June 30, 2011 was \$1,974,592. *Id.* at 7. The auditor determined that \$1,974,592 is insufficient because that amount does not even cover the reserve required by EDF's Risk-Based Methodology on the 117 loan sample, much less the reserve required by EDF's Risk-Based Methodology on all the remaining approximately 1,500 PCLP loans in EDF's portfolio, hundreds of which are non-performing. *Id.* at 7.

EDF elected to participate in the Alternative Loan Loss Reserve program. *See* Letter from Frank F. Dinsmore EDF C.E.O., to Jim O'Neal, SBA's District Director of the Sacramento District Office (September 3, 2004). By failing to follow its Risk-Based Methodology requirements, EDF has failed to comply with its statutory obligation to grade its PCLP loans based on the risk of loss and to maintain a Loan Loss Reserve Fund that is sufficient for EDF to meet its obligations to protect SBA from the risk of loss. Thus, EDF has failed to maintain a Loan Loss Reserve Fund as required by the PCLP Program. (Of course, EDF could have elected after 2004 to continue to fund its Loan Loss Reserve Fund under the standard 1% funding method, but it did not choose to do so, either in 2004 or at any time thereafter. It should be noted that had EDF elected to do so, by February, 2011 it would have been required to have approximately \$10.1 million in its Loan Loss Reserve, which represents 1% of the total initial loan value of all PCLP loans then in its portfolio.)

⁴⁹ The auditor confirmed that EDF did not have a reserve for the non-PCLP loans.

2. EDF's Loan Loss Reserve Fund is insufficient by \$9,469,373 on billed PCLP reimbursement obligation invoices alone

As of the date of this Decision, SBA has billed EDF for a total of \$11,448,899 in 15% PCLP reimbursement obligations that remain unpaid. The last Quarterly Report EDF submitted to SBA (September 30, 2012) indicates that EDF's Loan Loss Reserve Fund has a balance of \$1,979,526. Thus, on billed invoices alone, EDF's Loan Loss Reserve Fund is insufficient by \$9,469,373.

EDF is required by regulation to diligently monitor its Loan Loss Reserve Fund to ensure that it contains sufficient funds to cover its reimbursement obligation for its entire portfolio of PCLP loans, and within 30 days of the earlier of the date it becomes aware of a deficiency or the date it receives notification from SBA of a deficiency, make additional contributions to the Loan Loss Reserve Fund. See 13 C.F.R. § 120.847(j). EDF's Loan Loss Reserve Fund does not contain sufficient funds to cover EDF's reimbursement obligation on just the 124 PCLP loans for which SBA has billed EDF as of the date of this Decision, let alone the 39 other charged off PCLP loans with PCLP reimbursement obligations of approximately \$3.6 million. Additionally, there are approximately 1,500 other PCLP loans in EDF's portfolio (including approximately 334 other non-performing PCLP loans with a potential reimbursement exposure of approximately \$29 million) on which losses will continue to emerge and develop and for which SBA will continue to bill EDF after the date of this Decision. Thus, EDF has failed to maintain a Loan Loss Reserve Fund as required by the PCLP Program.

3. EDF submitted reports to SBA that concealed the fact that EDF was failing to fund a Loan Loss Reserve Fund for hundreds of its PCLP loans

In early 2011, SBA discovered that hundreds of PCLP loans (both performing and non-performing) were missing from EDF's December 31, 2010 Quarterly Loan Loss Reserve Fund Report to SBA. None of the Quarterly Loan Loss Reserve Fund Reports submitted by EDF to SBA advise SBA that EDF was dropping loans from its reports and failing to fund a Loan Loss Reserve Fund for those loans. As discussed above, on April 26, 2011, SBA sent a letter to EDF asking EDF to explain the reporting discrepancy and for the missing loans, including 263 non-performing PCLP loans, and provide SBA with EDF's risk classification for the loan and the amount reserved for each loan. See Letter from Janet Tasker, Acting Director, SBA Office of Credit Risk Management to Frank Dinsmore, C.E.O. of EDF (April 26, 2011). In its response to SBA's request, EDF said that "there is no discrepancy," and failed to provide the requested information regarding the risk ratings and amount reserved. See Letter from Frank Dinsmore, EDF C.E.O. to Janet Tasker, Acting Director, SBA Office of Credit Risk Management (May 18, 2011).

SBA attempted to determine when the loans went missing from EDF's Quarterly Loan Loss Reserve Fund Reports to SBA. EDF's Quarterly Reports were not submitted in searchable electronic format, thus this was a time-consuming task. SBA was able to review EDF's Quarterly Loan Loss Reserve Fund Reports for June 30, 2009 and September 30, 2009, and determine that during that time period, EDF dropped a total of 107 PCLP loans from its Loan Loss Reserve Fund. Further, SBA was able to review EDF's quarterly reports for September 30,

2010 and December 31, 2010 and determine that during that time period, EDF dropped a total of 179 PCLP loans.

During the August, 2011 targeted review, the auditor looked at EDF's March 31, 2011 Quarterly Loan Loss Reserve Fund Report to SBA to determine which of the 117 loans in the auditor's sample appeared on the Quarterly Loan Loss Reserve Fund Report. *See* Audit Report at 7. The auditor determined that only six of the 117 loans appeared on the Quarterly Loan Loss Reserve Fund Report and that the reserve reported by EDF to SBA for those six loans was \$139,375. *Id.* The auditor noted that when EDF removes the loans from the Quarterly Loan Loss Reserve Fund Report, EDF stops reserving for such loans at that time and takes any related reserve off the financial statement. *Id.* Thus, 111 of the loans sampled by the auditor did not appear on the March 31, 2011 Quarterly Loan Loss Reserve Fund Report from EDF to SBA and consequently had no reserve.

The auditor analyzed when the 107 non-liquidation pilot loans in the sample dropped off EDF's Quarterly Loan Loss Reserve Fund Reports to SBA. *Id.* at Appendix C. The auditor's findings are summarized below:

Date of Last Appearance on Quarterly Loan Loss Reserve Fund Report to SBA	Number of Loans
12/31/08	7
3/31/09	2
6/30/09	22
9/30/09	2
12/31/09	1
3/31/10	11
6/30/10	10
9/30/10	33
12/31/10	5
3/31/11	1
6/30/11	6
Unable to Locate (non-PCLP)	7
TOTAL	107

Based on the auditor's review, it appears that EDF dropped loans from its Quarterly Reports to SBA over a period of years. With new loans being added and other loans being refinanced or paid off, the intentional but undisclosed removal of the subject loans from an overall report listing over one thousand loans would not have been readily apparent to SBA if not drawn to SBA's attention by EDF. However, in 2009 and thereafter, EDF did not reveal to SBA that it had commenced or was engaging in this undisclosed practice, and EDF revealed it only after enforcement efforts were undertaken by the Agency.

As discussed above, in connection with the August, 2011 targeted review, SBA made a request to EDF's Loan Loss Reserve Fund auditor, Perry-Smith, to deliver to SBA copies of Perry-Smith's work papers for its review of EDF's March 31, 2011 Quarterly Loan Loss Reserve Fund Report. *See* Letter from Eugene Stewman, Acting Director, SBA Office of Credit Risk Management, to Perry-Smith, LLP (September 2, 2011). Perry-Smith delivered the workpapers in two batches---one before the auditor interviewed Perry-Smith and a second one after the auditor interviewed Perry-Smith. The second set, delivered only after the auditor completed the interview of Perry-Smith and again requested all workpapers, provided a fuller picture of the extent of EDF's concealment of its manipulation of its Loan Loss Reserve Fund. Those workpapers demonstrated that EDF was risk rating and calculating the required reserve for *all* of its PCLP loans, but was not funding the reserve at the levels required by its Risk-Based Methodology and was not reporting this information to SBA. The workpapers supplied to SBA by Perry-Smith show that EDF calculated the required reserve for 316 PCLP loans that it had dropped from its reports to SBA, and that EDF determined that an additional \$9.4 million was required in EDF's Loan Loss Reserve Fund under EDF's Risk-Based Methodology to cover the dropped loans, for a total required reserve of \$10.4 million. EDF had failed to provide this material and significant information to SBA when asked directly to provide it in SBA's April 26, 2011 letter. Instead, SBA was able to obtain this information only after conducting the targeted review, interviewing representatives of Perry-Smith, and making several requests for this information. And then, the information was received only from Perry-Smith and not from EDF.

After reviewing the document from Perry-Smith's workpapers, SBA concluded that EDF was concealing information about the unfunded reserve requirement from SBA in the Quarterly Loan Loss Reserve Fund Reports. In fact, it appears that EDF was maintaining two sets of books---one set was a complete report on the loan grading and calculated reserve for all of its PCLP loans, and the second set was an incomplete and misleading report on the loan grading and calculated reserve for part of its PCLP loan portfolio that it presented to SBA. Had EDF fully funded its Loan Loss Reserve Fund with the required reserve amount of \$10.4 million that EDF had calculated, SBA would have had control of those funds by virtue of its security interest and the funds would not have been available to EDF for any other purpose. While EDF was engaged in this manipulation of its Loan Loss Reserve Fund, it was representing to SBA that "... the SBA should have total confidence in our [EDF's] ability to produce successful results and to safeguard public funds," and that "... [EDF] has reserves set up for future payments due ... [and] has the financial wherewithal to continue making these payments." *See* Letter from Frank Dinsmore, EDF C.E.O., to Karen Mills, SBA Administrator (July 13, 2009) and Letter from Frank Dinsmore, EDF C.E.O., to Grady Hedgespeth, Director, SBA's Office of Financial Assistance (June 10, 2010).

EDF had a regulatory obligation to file its Quarterly Loan Loss Reserve Fund Reports with SBA in a form that readily facilitated reconciliation of the amount actually maintained in EDF's Loan Loss Reserve Fund with the amount required to be maintained in EDF's Loan Loss Reserve Fund. *See* 13 C.F.R. § 120.847(f). By filing misleading reports that concealed from SBA the true amount required by EDF's Risk-Based Methodology to be maintained in EDF's Loan Loss Reserve Fund, EDF violated this regulatory reporting obligation. EDF also had a regulatory obligation to make additional contributions to its Loan Loss Reserve Fund to remedy any known deficiency. *See* 13 C.F.R. § 120.847(j). The document obtained from Perry-Smith demonstrates

that EDF knew that its Loan Loss Reserve Fund was deficient because EDF had calculated the true amount required to be funded under EDF's Risk-Based Methodology. By failing to remedy the known deficiency in its Loan Loss Reserve Fund, EDF violated its regulatory obligation to SBA.

Thus, EDF has failed to maintain a Loan Loss Reserve Fund in accordance with the requirements of the PCLP Program.

4. EDF has failed to comply with its statutory obligation to utilize an appropriate and effective process for analyzing the risk of loss associated with its PCLP loan portfolio and for grading each PCLP loan on the basis of the risk of loss associated with each loan

EDF's Risk-Based Methodology calls for at least annual reviews of loans and more frequent reviews if relevant information becomes available. *See* EDF Risk-Based Methodology at 13-14. The record establishes that EDF failed to conduct annual reviews, reclassify loans when new information became available, and appropriately adjust its Loan Loss Reserve Fund funding.

The auditor reviewed the 117 loans in the sample and determined that in most cases, the auditor did not see evidence of annual reviews by EDF, nor were loans appropriately downgraded when new information became available. *See* Audit Report at 1 and 5. The auditor determined that EDF failed to timely rate 101 out of 107 loans reviewed by the auditor. *See* Audit Report at Appendix C. Therefore, EDF timely rated only 5% of the loans reviewed by the auditor. *Id.* The auditor also applied EDF's Risk-Based Methodology to determine the appropriate current rating for each loan in the 117 loan sample. The auditor agreed with EDF's current risk rating on only 19 of 117 (16%) of the loans reviewed.⁵⁰ *Id.* Typically, the auditor's risk ratings were substantially more negative than EDF's risk ratings. *Id.* at 5. Because the risk factor Loan Loss Reserve Fund funding percentage increases as the loan rating downgrades, more negative ratings require additional Loan Loss Reserve Fund funding. The auditor concluded that because EDF did not re-evaluate its non-performing loans regularly, it did not adequately adjust funding and reporting in its financial statements. *Id.* at 7.

As recently as October 7, 2011, EDF's own auditor, Perry-Smith, criticized EDF for the same shortcomings identified by SBA's auditor---EDF's failure to timely review the PCLP loans in its portfolio. *See* Perry-Smith's October 7, 2011 report attached to EDF's September 30, 2011 Quarterly Loan Loss Reserve Fund Report to SBA. In that report, Perry-Smith observes:

For four of the fifteen loans reviewed, management had revised the loan classifications subsequent to our loan selection, but prior to our review. . . . Two of the four revised loans were downgraded to Loss, as the loans were in the process of liquidation. . . . Given that the loan classification for four of the fifteen loans that we selected for our review were revised after our selection, *it appears that management is not adjusting loan classifications in a timely manner.* It is crucial that all loans within the portfolio, not just

⁵⁰ Appendix C of the Audit report compares EDF's and the auditor's loan ratings.

those selected for our review, be reviewed on a consistent basis to ensure accurate and timely grading.

Id. at p. 5 (emphasis added). The record shows that Perry-Smith has consistently criticized EDF for failing to downgrade loans on a timely basis since at least December, 2009. *See* Perry-Smith Report on Credit Classification and Review of Loan Origination and Documentation Requirements, dated January 12, 2010, April 7, 2010, October 7, 2010, January 7, 2011, April 6, 2011 and July 8, 2011. EDF failed to alter this course of neglect and EDF continued to fail to timely review the PCLP loans in its portfolio for purposes of establishing accurate loan classifications.

Additionally, EDF's Risk-Based Methodology states that EDF's Board has approved the "overall Loan Loss Reserve Fund policy and system." *See* EDF Risk-Based Methodology at 13. Under EDF's Risk-Based Methodology, the CEO is to review the reserve, at least quarterly, to ensure appropriate funds have been set aside. *Id.* at 11. The Risk-Based Methodology provides: "Ultimately, the responsibility to ensure required funds are set aside resides with the CEO." *Id.* at 13. The auditor determined that the sufficiency of the Loan Loss Reserve Fund was negatively impacted by "[l]ack of senior management and board oversight in the application of the Risk-Based Methodology." *Id.* at 8. According to the auditor, EDF's Risk-Based Methodology is "neither a focus of management nor the board of directors of EDF." *See* Audit Report at 1.

EDF's Risk-Based Methodology also requires that "[s]uch amounts set aside in the Loan Loss Reserve Fund will be reviewed and confirmed by an outside CPA firm for appropriateness, at least quarterly." Risk-Based Methodology at 13. The auditor determined that EDF's Loan Loss Reserve Fund auditor, Perry-Smith, reviewed on a quarterly basis a sample of loans to determine whether EDF's classification of the loans was appropriate, but was not engaged to certify the adequacy of the Loan Loss Reserve Fund. *See* Audit Report at 8. Each quarter, EDF submitted to SBA a Perry-Smith "Report on Credit Classification and Review of Loan Origination and Documentation Requirements." *See* EDF's Quarterly Loan Loss Reserve Fund Reports (June 2004 – December 2011). The reports provide Perry-Smith's observations from a review of a small sample of EDF's PCLP loans for compliance with EDF's loan origination, loan documentation and credit classification policies. *Id.* The reports do not contain any review of or comments on the adequacy of the amounts set aside in EDF's Loan Loss Reserve Fund. *Id.* Thus, contrary to the requirements of EDF's Risk-Based Methodology, Perry-Smith was not reviewing and confirming the amounts set aside in the Loan Loss Reserve Fund for appropriateness.

EDF is required by statute to establish and utilize an appropriate and effective process for analyzing the risk of loss associated with its portfolio of PCLP loans and for grading each PCLP loan on the basis of the risk of loss associated with each loan. 15 U.S.C. § 697e(c)(7)(F)(ii). The record shows that EDF has failed to comply with this statutory requirement. Thus, EDF has failed to maintain a Loan Loss Reserve Fund as required by the PCLP program.

5. Analysis of EDF's Responses Regarding Failure to Establish and Maintain Loan Loss Reserve Fund as Required by PCLP Program

- a. EDF concedes that it must comply with the Alternative Loan Loss Reserve statute

Under the Alternative Loan Loss Reserve statute, EDF is required to have a Loan Loss Reserve Fund that is sufficient to protect SBA from the risk of loss. 15 U.S.C. § 697e(c)(7). In its May 18, 2011 Response, EDF concedes that it must comply with the Alternative Loan Loss Reserve statute, which requires that the amount of its reserve be sufficient to protect SBA from the risk of loss. *See* May 18, 2011 Response at 14 (II.C).

Nevertheless, EDF claims that it was left adrift because SBA did not promulgate regulations specifically for the temporary Alternative Loan Loss Reserve pilot program as required by the statute. *Id.* at 16 (II.E); *see also* EDF Resource Capital, Inc.'s Revised Risk-Based Methodology at 4 (undated). As cited throughout this Decision, SBA has numerous regulations governing the 504 Loan Program in general and the PCLP Program in particular, including a long-standing regulation addressing the Loan Loss Reserve Fund requirements of the PCLP Program, a subset of which is the temporary Alternative Loan Loss Reserve pilot program. *See* 13 C.F.R. § 120.847. SBA did publish a proposed rule for the Alternative Loan Loss Reserve pilot program and received comments from the public, but did not publish a final rule. *See* Business Loan; Premier Certified Lenders Program Alternative Loan Loss Reserve Pilot Program, 71 FR 30323 (May 26, 2006).

EDF freely chose to enter the Alternative Loan Loss Reserve program; promoted its own Risk-Based Methodology as the model for the program; and was neither misled nor prejudiced by the lack of regulations. For one thing, SBA holds EDF responsible solely for its evident failure to comply only with EDF's own Risk-Based Methodology (which in its format is consistent with industry standards) as well as the over-arching PCLP regulations generally governing PCLP Loan Loss Reserve Funds. SBA does not seek to hold EDF responsible for failing to comply with other rules or requirements never promulgated. Moreover, EDF was never required to use the alternative risk-based method for funding its PCLP Loan Loss Reserve Fund. It could have continued to use the standard 1% methodology from and after 2004 (which it had used for years prior to that date) and it could have returned to that methodology at any time after 2004 if it felt any lack of "guidance." Not only did it not do so, but at no time after 2004 (when it chose to take advantage of the alternative risk-based loss reserve pilot program) and before 2011 did it ever indicate it lacked guidance on the terms or application of the alternative risk-based loan loss reserve pilot

Further to the above, EDF argues that because SBA did not issue regulations as required by the Alternative Loan Loss Reserve statute, SBA cannot bring an enforcement action against EDF based on EDF's failure to comply with the requirements of the statute. *See* May 18, 2011 Response at p. 32. However, courts have upheld the enforcement of statutory requirements even when the statute requires an agency to issue regulations and the agency has failed to do so. In Pittway Corporation v. U.S., 102 F.3d 932 (7th Cir. 1996), the Court determined that a provision of the tax code requiring the imposition of a chemical excise tax was enforceable even though

the Internal Revenue Service had failed to issue the regulations required by the statute that had been passed fifteen years earlier. *Id.* at 935. The Court found that in the absence of regulations, the plain meaning of the legislation should be conclusive. *Id.* at 936. In Jefferson v. U.S., 546 F.3d 477 (7th Cir. 2008), the Seventh Circuit elaborated on its reasoning and stated that even if the statute is not clear on its face, in order to avoid circumventing the agency's lawful functions, the party against whom the statute is being enforced must show that it has been prejudiced by the agency's failure to follow the statutory mandate. *Id.* at 484. Further, if a statute is self-executing, an agency's failure to promulgate appropriate regulations to carry out the purposes of the statute does not preclude enforcement of the statute. *See Parker-Hannifin Corp. v. IRS*, 139 F.3d 1090, 1099 (6th Cir. 1998) ("The statute exists, and we must interpret it as best we can."); *see also Sundance Helicopters, Inc. v. U.S.*, 104 Fed.Cl. 1 (2012). Moreover, an agency's statutory interpretation is entitled to deference even if that interpretation is not embodied in a regulation. *See Western Pioneer, Inc. v. U.S.*, 709 F.2d 1331 (9th Cir. 1983).

The Alternative Loan Loss Reserve statute and its legislative history confirm that the statute is self-executing.⁵¹ *See* 15 USC § 697e(c)(7)(A); *see also* H.R. Rep. No. 108-153 at 17 (2003). SBA was directed by Congress to allow a PCLP CDC to participate in the Alternative Loan Loss Reserve pilot program if, inter alia, SBA determined that the PCLP CDC "has established and is utilizing an appropriate and effective process for analyzing the risk of loss associated with its portfolio of PCLP loans and for grading each PCLP loan made by the company on the basis of the risk of loss associated with such loan." 15 USC 697e(c)(7)(F)(ii). The plain meaning of the statute is that the PCLP CDCs were empowered to establish and utilize a risk-based process for analyzing and grading loans, and SBA was required to review the PCLP CDC-created process. SBA was not required by the statute to create the risk-based process by regulation as EDF claims. The creation of the risk-based process was left to the individual PCLP CDCs.

EDF knew that SBA regulations specific to the statutory pilot program did not exist as of the date EDF entered the temporary Alternative Loan Loss Reserve pilot program, and that the statutory time period by which SBA was to adopt relevant regulations had already passed. *See* Letter from Frank Dinsmore, EDF C.E.O., to Jim O'Neal, SBA District Director (September 3, 2004). Nevertheless, EDF enthusiastically embraced the Alternative Loan Loss Reserve program, and there is no evidence that EDF was disadvantaged by the lack of regulations. Contrary to EDF's assertion that it was left adrift by the lack of regulations, the evidence shows that EDF developed its Risk-Based Methodology a year ahead of enactment of the Alternative Loan Loss Reserve statute, announced to SBA that EDF was proceeding with implementation of its Alternative Loan Loss Reserve Fund on the statutory self-execution date, advised SBA that it had retained an independent auditor, Perry-Smith, to perform the review required by the statute, and acknowledged that SBA had not issued regulations. EDF presented its Risk-Based Methodology to SBA for review and SBA did not interpose any objection. *See* Letter from Charles W. Thomas, Director of SBA's Office of Program Development to Frank F. Dinsmore, EDF C.E.O. (December 14, 2005). When questioned by SBA about its participation in the Alternative Loan Loss Reserve program in late 2009 (five years after EDF started using an Alternative Loan Loss Reserve Fund), EDF argued that the statutory pilot program was still

⁵¹ In its submission to SBA, EDF inserts a block quote from the House Report on the Alternative Loan Loss Reserve statute, but omits the language that states that the statute is self-executing. *See* May 18, 2011 Response at 16.

available and stated its intention to lobby Congress to make the program permanent. *See* Letter from Frank Dinsmore, EDF C.E.O., to Bryan Hooper, Director, SBA Office of Credit Risk Management (September 11, 2009) and Letter from Frank Dinsmore, EDF C.E.O., to Susan Craw of SBA (November 30, 2009). In the November 30, 2009 letter, EDF acknowledges that lack of SBA regulations and expresses no reservations about that fact.

The record shows, and EDF admits, that EDF has continued to use its Risk-Based Methodology to assign ratings and calculate the required Loan Loss Reserve for all of the PCLP loans in its portfolio, despite the absence of SBA regulations. EDF simply decided not to share with SBA the ratings and Loan Loss Reserve calculations for 316 of EDF's defaulted PCLP loans with an outstanding balance of approximately \$194 million, because to do so would have demonstrated to SBA that EDF's Loan Loss Reserve Fund was seriously underfunded. The record shows that as of March 30, 2011, the amount of underfunding was, according to EDF's calculations, approximately \$9.4 million. EDF did not lack guidance from SBA. EDF knew better than anyone else how to use its Risk-Based Methodology and continued to follow it for risk rating loans. SBA is not disputing the validity of EDF's Risk-Based Methodology itself; SBA concedes that the terms and structure of the Methodology are industry standard. Instead, SBA is criticizing EDF's implementation of the Risk-Based Methodology. Had EDF fully funded the Loan Loss Reserve as EDF calculated in accordance with its own Risk-Based Methodology, SBA would have been substantially more protected from the now very real losses in EDF's portfolio.. Instead, SBA is facing mounting losses from EDF's unpaid loss-share obligations that are now at over \$15 million and could potentially soon grow to over \$40 million.

In any event, EDF does not explain how promulgation by SBA of additional regulations governing the use of a risk-based methodology to evaluate and fund a Loan Loss Reserve Fund would have prevented EDF from failing to adhere to its own detailed Risk-Based Methodology. Nor does EDF explain how promulgation by SBA of additional regulations governing the use of a risk-based methodology to evaluate and fund a Loan Loss Reserve Fund would have caused it to refrain from intentionally dropping hundreds of its riskiest loans from its Loan Loss Reserve Fund over a period of almost three years (in violation of its own Risk-Based Methodology); from filing a series of incomplete and misleading Quarterly Loan Loss Reserve Fund Reports with SBA that failed to account for the dropped loans; and from failing to properly fund its Loan Loss Reserve Fund with respect to the dropped loans. Moreover, SBA has a regulation that requires EDF to diligently monitor its Loan Loss Reserve Fund to ensure that it contains sufficient funds to cover its reimbursement obligation for its entire portfolio of PCLP loans (13 CFR § 120.847(j)), yet the \$9,220,860 deficiency in EDF's Loan Loss Reserve Fund to cover amounts billed as of the date of this Decision illustrates that even with regulatory guidance, EDF has chosen not to comply with its obligations.

None of the grounds for the instant enforcement proceeding is based upon an action by EDF for which regulations amplifying the statutory provisions relating to the temporary Alternative Loan Loss Reserve pilot program would have clarified for EDF what was acceptable and unacceptable behavior. Further, SBA is not seeking to enforce against EDF any additional duties over and above those in the statute and regulations and in EDF's own Risk-Based Methodology.

- b. EDF concedes that it has not complied with its Risk-Based Methodology and that it has dropped loans from its Quarterly Loan Loss Reserve Fund Report and its Loan Loss Reserve Fund

In its responses, EDF concedes that it has not complied with its Risk-Based Methodology and that it has dropped loans from its Quarterly Loan Loss Reserve Fund Reports to SBA and its Loan Loss Reserve Fund.

EDF claims that at some point in the past, it came to the conclusion that its Risk-Based Methodology was “misguided” and not worthy of application. *See* May 18, 2011 Response at 28-35 (IV). There are inconsistencies in EDF’s various filings as to when and why it came to this conclusion. On the one hand, EDF states that as economic conditions worsened and 504 loan delinquencies increased beginning around 2007 or 2008, EDF ceased to follow its Risk-Based Methodology. *Id.* On the other hand, EDF claims that it has continued to follow its Risk-Based Methodology by grading its PCLP loans using the same classifications it has always used, because EDF is required by statute to grade each PCLP loan on the basis of risk. *See* May 18, 2011 Response at 14 (II.C). EDF appears to be asserting that when times were good, EDF was satisfied with its Risk-Based Methodology, but when economic conditions changed for the worse and defaults occurred, resulting in EDF’s obligation to deposit funds, the Risk-Based Methodology was not satisfactory to EDF.

Similarly, there are inconsistencies in EDF’s explanation of when and why it dropped loans from its Quarterly Loan Loss Reserve Fund Reports and its Loan Loss Reserve Fund. In its May 18, 2011 Response, EDF says that starting in 2008, it *knowingly* dropped loans from its reports and reserve because “EDF’s growing experience with troubled loans in 2008 and 2009 confirmed to it that the EDF Methodology was ill-suited to serve the purpose for which it was designed . . . [a]ccordingly, during that period, EDF began modifying its application of the EDF Methodology to exclude from consideration loans in liquidation that did not satisfy the ‘SBA Formula’ [pertaining to when SBA will enter a protective bid and purchase the first lien interest on the project property]” *See* EDF’s May 18, 2011 Response at 32 (IV.C). However, this is not consistent with EDF’s December 14, 2011 Response. In Paragraph 57 of a declaration included with EDF’s December 14, 2011 Response, EDF’s COO states as follows:

When the subject was called to my attention during the TCBA “targeted review,” I ascertained that to the extent EDF did not include troubled loans on its quarterly Loan Loss Reserve Fund reports---a circumstance that did not occur prior to March 2009 and then not again until September 2009---*originally this was an unintended result of an internal modification of certain computer program codes*; beginning in late 2010, this was done as a result of EDF’s recognition that its Risk-Based Methodology was misguided, particularly given that SBA was abandoning certain troubled loans and interfering with EDF’s collection efforts on those loans.

See EDF’s December 14, 2011 Response, Second Declaration of Kim Ioanidis (emphasis added).

Ms. Ioanidis’ sworn testimony that any dropping of loans that occurred in 2009 was due to a computer error conflicts with a November 30, 2009 memorandum from EDF’s C.E.O., Frank

Dinsmore, that SBA found in the workpapers provided by Gallina in connection with the August, 2011 targeted review. That memorandum states that the dropping of loans in 2009 was intentional and not a computer error, as follows:

We have begun to seek legal counsel to confirm the CDC will not be held responsible for a percentage of the loss, if SBA elects not to defend on a property, thereby keeping the CDC from maximizing recoveries and minimizing the loss. At this point we are working with the premise that if SBA elects not to defend on a project---we will not be held liable for our percentage of the loss. Thus, in order to maintain a loan loss reserve that reflects these outcomes---we have eliminated loans that we will be pursuing recovery on, or working with the borrower to maintain their operations, in an effort to minimize SBA's losses and ultimately that of the CDC as well.

See Memorandum Re: Loan Loss Reserve from Frank Dinsmore, EDF C.E.O., to Gallina LLP (November 30, 2009) (Dinsmore Memorandum).

SBA reviewed EDF's Quarterly Loan Loss Reserve Fund Reports for June 30, 2009 and September 30, 2009, and determined that during that time period, EDF dropped a total of 107 PCLP loans from its Loan Loss Reserve Fund. Further, SBA reviewed EDF's quarterly reports for September 30, 2010 and December 31, 2010 and determined that during that time period, EDF dropped a total of 179 PCLP loans. Additionally, Ms. Ioanidis' statement that the dropping of loans only occurred in two batches before late 2010 conflicts with the auditor's determination from a review of EDF's reports that EDF was dropping loans from its reports on an ongoing basis each quarter. *See* Audit Report at 7.

EDF attempts to explain away its earlier admission that it intentionally misrepresented the state of its Loan Loss Reserve Fund in the Quarterly Loan Loss Reserve Fund Reports to SBA, by claiming that the concealment was due to computer errors that later became corporate policy. *See* EDF's December 14, 2011 Response, Second Declaration of Kim Ioanidis, para. 57. (Notably, nowhere does EDF suggest that it ever brought these alleged "computer errors" to SBA's attention at the time.) However, the Dinsmore Memorandum shows that EDF was dropping loans intentionally in order to avoid its PCLP reimbursement obligations to SBA. Completely apart from the inconsistencies in EDF's explanations, EDF concedes that it is not following its Risk-Based Methodology and that it has dropped loans from its Quarterly Loan Loss Reserve Fund Reports to SBA and from its Loan Loss Reserve Fund. *See* May 18, 2011 Response at 14 (II.C).

- c. SBA did not acquiesce in EDF's concealment of the dropped loans in EDF's Quarterly Loan Loss Reserve Fund Reports to SBA and EDF's failure to fund a reserve for those loans

EDF asserts on page 32 of its May 18, 2011 Response that SBA acquiesced in EDF's concealment of the dropped loans in EDF's Quarterly Loan Loss Reserve Fund Reports to SBA and EDF's failure to fund a reserve for those loans because SBA did not object or comment on the incomplete and misleading reports. *Id.* at 32 (IV.C). EDF appears to be suggesting that SBA should have been expected to realize that EDF was misleading SBA by concealing that EDF

dropped the loans from its Quarterly Reports and reserve, and that such presumed realization can be interpreted as SBA's implied consent to EDF's avoidance of its obligation to properly report on and fund its Loan Loss Reserve Fund.

It is well-settled that the Government may not be estopped on the same terms as any other litigant. *See Heckler v. Community Health Services of Crawford County, Inc.*, 104 S.Ct. 2218, 2224 (1984). The record shows that EDF filed misleading reports that concealed its failure to properly report on and fund its Loan Loss Reserve Fund, and now attempts to place the blame on SBA for not uncovering the misrepresentation. But negligence on the part of a party in failing to discover the falsity of a statement is no defense when the misrepresentation was intentional rather than negligent. *See Hartong v. Partake, Inc.*, 266 Cal. App. 2d 942, 964 (Cal. App. 1968), *citing Seeger v. Odell*, 115 P.2d 977 (Cal. 1941).

SBA rejects EDF's contention that SBA acquiesced in EDF's failure to apply its own Risk-Based Methodology by failing to discover EDF's intentional concealment at an earlier date.

- d. EDF concedes that it has not funded its Loan Loss Reserve Fund as required by its Risk-Based Methodology

In its responses, EDF concedes that it has not funded its Loan Loss Reserve Fund as required by its Risk-Based Methodology, although it claims it continues to grade its loans in accordance with its Risk-Based Methodology because it is required to do so by statute. *See* May 18, 2011 Response at 14 (II.C). (As set forth above, however, the evidence establishes that EDF is not timely or accurately grading the PCLP loans in its portfolio, or accurately reporting to SBA on the grades of the PCLP loans in its portfolio.) In any event, EDF asserts that its statutory obligation to grade its loans on the basis of risk is separate from its statutory obligation to fund a reserve in an amount that is sufficient to protect SBA from the risk of loss. *Id.* In direct contravention to this position, EDF maintains two sets of books in which it records the risk ratings of all of its PCLP loans and in which it calculates the full funding of its Loan Loss Reserve Fund as required under its Risk-Based Methodology. *See* EDF Loan Rating Report dated March 30, 2011 retrieved from Perry-Smith workpapers.

EDF contends that the rating of a loan does not address whether SBA faces a risk of loss on a loan because whether there is a loss and the amount of any such loss can only be determined in the future, not predicted in advance, and more fundamentally, a loan that is under collection or liquidation may someday ultimately pay all principal and interest in full. *Id.* at 28-29 (IV.B). By asserting that whether there will be a loss on a loan can only be determined in the future and that a loan rating does not reflect that there will in fact be a loss on the loan, EDF attempts to completely eviscerate the very concept of a risk-based Loan Loss Reserve Fund. EDF's argument confuses risk of loss with actual loss. Under EDF's reasoning, no financial institution could be required to maintain loan loss reserves.

The purpose of the reserve amount required by the statute is to ensure that there are sufficient funds available, in reserve, for EDF to pay its 15% PCLP reimbursement obligation to SBA should EDF fail to obtain 100% repayment on a defaulted 504 Loan after exhaustion of reasonable collection efforts. *See* Cong. Rec. S14229 (1994). The reserve provides SBA with

security for the repayment of EDF's PCLP reimbursement obligations to SBA, and EDF is required by statute to provide SBA with a security interest in the reserve. *Id.* This statutory purpose is reflected in SBA's regulation that requires EDF to diligently monitor its Loan Loss Reserve Fund to ensure that it contains sufficient funds to cover its 15% PCLP reimbursement obligation for its entire portfolio of PCLP loans, and within 30 days of the date it becomes aware of a deficiency, make additional contributions to the Loan Loss Reserve Fund to remedy the deficiency. *See* 13 C.F.R. § 120.847(j). Currently, EDF's Loan Loss Reserve Fund is deficient by millions of dollars just with respect to the 15% PCLP reimbursement obligations on 111 loans that have already been billed by SBA, let alone the millions of dollars in additional reimbursement obligations ready to be billed from the auditor's sample of 117 loans, and the reimbursement obligations on the approximately 1,500 additional PCLP loans in EDF's portfolio, hundreds of which are non-performing.

EDF's Risk-Based Methodology was (in structure and format, at least) designed by EDF to do exactly what the applicable law required---provide a reserve in an amount sufficient to protect SBA from the risk of loss (which risk across the portfolio would be regularly re-evaluated and updated). However, EDF concedes that it has failed to comply with its Risk-Based Methodology and adequately fund its Loan Loss Reserve Fund as required by its Risk-Based Methodology. *See* May 18, 2011 Response at 14 (II.C). Thus EDF has failed to comply with its statutory obligation to have a reserve that contains an amount sufficient to protect SBA from the risk of loss.

- e. EDF's claim that EDF has protected SBA from the risk of loss by aggressive workout and liquidation actions on EDF's PCLP loans is devoid of merit

After conceding that it has failed to comply with its Risk-Based Methodology, dropped loans from its Quarterly Loan Loss Reserve Fund Reports to SBA and failed to fund its Loan Loss Reserve Fund in compliance with its Risk-Based Methodology, EDF argues that it has nevertheless complied with its statutory obligation to have a reserve in an amount sufficient to protect SBA from the risk of loss. *See* May 18, 2011 Response at 39 (IV). EDF asserts that regardless of the amount in its reserve, EDF has protected SBA from the risk of loss through aggressive and successful efforts to restore delinquent loans to performing status and/or to maximize collections on defaulted loans. *Id.* This assertion fails to address the statutory requirement that EDF have a reserve in an amount sufficient to protect SBA from the risk of loss. As a PCLP CDC, EDF has an independent legal obligation to take action to restore delinquent loans to performing status and/or to maximize collections on defaulted loans, in addition to funding a Loan Loss Reserve Fund. *See* 13 C.F.R. §§ 120.826, 120.848 and 120.975. EDF cannot comply with its statutory duty to have a Loan Loss Reserve Fund in an amount sufficient to protect SBA from the risk of loss by doing nothing more than carrying out EDF's required collection duties on behalf of SBA.

Moreover, the record makes clear that EDF's collection efforts have not avoided losses on the 124 loans for which EDF has exhausted its collection efforts and invoices have been sent by SBA to EDF. SBA had over \$75 million in losses on those loans, and has billed EDF a total of approximately \$11.4 million for EDF's 15% PCLP loss-share reimbursement obligation on those

loans. See PCLP Reimbursement Obligation Invoices Chart, *supra*. EDF has failed to pay all of those invoices, and EDF's Loan Loss Reserve Fund currently has a deficiency of approximately \$9.4 million on just those loans. SBA has charged off an additional 39 PCLP loans, on which it has had over \$24 million in losses; and will soon be billing EDF for approximately \$3.6 million in additional 15% PCLP loss-share reimbursements, bringing the deficiency over and above EDF's existing Loan Loss Reserve Fund balance to approximately \$13 million.

More to the point, as of September 30, 2012, EDF had a PCLP loan portfolio consisting of approximately 1,500 other PCLP loans which had not been charged off, with a total outstanding balance of approximately \$700 million. As of September 30, 2012, there were approximately 334 other non-performing PCLP loans (defined as Past Due, Deferred, Delinquent, In Catch Up, and Purchased Not Charged Off) in EDF's portfolio, with a total outstanding balance of approximately \$198 million. The total share of losses that EDF would be obligated to pay SBA on these non-performing PCLP loans if all became losses would be approximately \$29 million (15% of \$198 million). This is in addition to the approximately \$11.4 million for which SBA has billed EDF on loans that have been charged off, and the \$3.6 million that is ready to be billed on other charged off loans. As set forth in the chart below, SBA's records indicate that EDF's total net recoveries to date since 2000 on all non-performing PCLP loans in its portfolio are approximately \$15 million.

EDF Purchases and Recoveries since 2000 (paid or collected through 10/31/2012)		
FY	Purchases	Recoveries
2001	\$ 238,861.72	\$ 97,273.99
2002	\$ 98,808.60	\$ 814.62
2004	\$ 123,390.73	\$ 126,777.05
2007	\$ 2,319,221.87	\$ 382,868.77
2008	\$ 14,350,391.62	\$ 226,674.19
2009	\$ 48,988,730.34	\$ (232,957.02)
2010	\$ 99,708,935.14	\$ 5,808,240.53
2011	\$ 48,350,704.99	\$ 5,370,176.17
2012	\$ 41,483,366.15	\$ 3,547,452.50
2013	\$ 996,577.25	\$ 300.00
Total	\$ 256,658,988.41	\$ 15,327,620.80

EDF's collection efforts, no matter how robust, will not change the fact that there are likely to be large losses on EDF's portfolio. EDF will be responsible for paying to SBA its share of those losses, and EDF has demonstrated that it cannot (and will not) pay its share to SBA.

In its December 14, 2011 Response, EDF claimed that with respect to the loans in the auditor's sample, EDF has recovered \$4.4 million and projects to recover an additional \$29 million, thus EDF asserts that it has protected SBA from the risk of loss on these loans. See December 14, 2011 Response at 63 (IX.B.4). While it is the case that EDF is statutorily obligated to protect SBA from the risk of loss, and EDF has attempted to avoid this requirement by claiming that it must protect SBA only from actual loss, EDF's own numbers show that its argument fails. EDF

acknowledges that the loans in the auditor's sample have an outstanding balance of at least \$102 million. *See* December 14, 2011 Response, Declaration of Joey Larsen, Exhibit 11. Assuming for the purpose of argument only that EDF's projected total recovery amount of \$29 million is correct, this would still leave an actual loss to SBA of approximately \$72 million on just the loans in the sample. EDF's 15% reimbursement obligation to SBA on EDF's own projected actual loss figures would be approximately \$10 million (15% of \$72 million). With only \$1.9 million in EDF's Loan Loss Reserve Fund account and a projected amount due to SBA based on EDF's own figures of \$10 million, EDF's reserve is clearly not in compliance with the statutory requirement that it be in an amount sufficient to protect SBA from the risk of loss even accepting EDF's own arguments.

Further, in its report, the auditor criticized the timeliness and adequacy of EDF's collection practices. *See* Audit Report at 5. EDF argues that the auditor's findings regarding the untimeliness and inadequacy of EDF's collection practices are wrong because the loans in the sample are bad loans, and thus many will not have good results. *See* December 14, 2011 Response at 50 (IX.B.1). EDF contends that the auditor's determination regarding the adequacy of EDF's collection practices on the loan sample cannot be projected to the remaining hundreds of non-performing loans in EDF's portfolio. *Id.* EDF claims that because the loans reviewed by the auditor were the worst of EDF's non-performing PLCP loans, the results were predictably not good. *Id.* However, if EDF is claiming to be protecting SBA from the risk of loss through its aggressive collections practices, EDF cannot be heard to complain about "bad" loans. The loans in the sample represent actual and potential losses and very significant ones---- approximately \$5.2 million billed by SBA, approximately \$2.1 million ready to be billed by SBA and approximately \$12 million required in the Loan Loss Reserve Fund for the loans in the sample. The fact that other loans may generate fewer additional losses is good news, but does not change the actual losses and likely losses on the loans in the sample.

EDF also points to the liquidation pilot program as an example of the "creative" liquidation strategies employed by EDF that should be a model for the CDC industry and that allegedly protect SBA from the risk of loss. *Id.* at 80 (XII.B). However, EDF's performance under the liquidation pilot shows that instead of protecting SBA from the risk of loss, EDF has magnified SBA's actual loss. SBA is now a further at least (at least and almost certainly more) \$8.9 million underwater on the liquidation pilot loans than it was in 2009. *See* Pilot Liquidation Chart, *supra*. This is in addition to the over \$7 million that the 504 borrowers continue to owe SBA on the underlying 504 loans for the pilot projects. *Id.* EDF has failed to turn over to SBA millions of dollars in proceeds from the sale of SBA's collateral, despite demand, and has failed to use or has misused a significant amount of funds advanced by SBA to EDF. *Id.* The liquidation pilot more than doubled SBA's losses on those loans and did not prove to be a successful collections or recovery tool. Rather than demonstrating the "creativity" of EDF's collection efforts, the liquidation pilot has instead resulted in additional losses to SBA because of EDF's failure to comply with its obligations. In view of the above, EDF has failed to protect SBA from the risk of loss on the liquidation pilot loans.

EDF also argues that it has complied with its statutory obligation to fund a reserve in an amount sufficient to protect SBA from the risk of loss because EDF plans to collect enough on EDF's 300 plus defaulted loans that do not meet the SBA formula for entry of a protective bid to cover

EDF's maximum possible 15% reimbursement obligation.⁵² See May 18, 2011 Response at 84 (XIII). EDF claims that it owns the collections generated or to be generated on those loans. *Id.* at 84 (XIII). EDF states that based on the total outstanding balance of those defaulted loans, the maximum possible 15% reimbursement obligation that EDF will owe SBA is \$32 million. *Id.* EDF asserts that because it projects that it will collect \$90 million on those loans, it has protected SBA from the risk of loss without any further funding of the Loan Loss Reserve Fund. *Id.* at 84-85 (XIII). As discussed in section IV.B.2.d. below, EDF does not own the collections on these loans. For each defaulted loan, EDF's collections on that loan reduce the total loss on that particular loan, thereby reducing *pro rata* EDF's ultimate 15% reimbursement obligation to SBA. See PCLP Loan Guaranty Agreements at para. 10. But it is only after EDF pays SBA on EDF's 15% reimbursement obligation that EDF will own a 15% share of the loan. *Id.* at para. 11. Any *future* collections on that loan will then be split *pro rata*---15% to EDF and 85% to SBA. *Id.* Because EDF has paid the 15% reimbursement obligation invoices on only six PCLP Loans to date, the amount of future collections owned by EDF is likely to be minimal.

For the foregoing reasons, SBA rejects EDF's assertion that it has complied with the statutory requirement to have a reserve sufficient to protect SBA from the risk of loss because of EDF's workout and liquidation actions.

- f. EDF has not protected SBA from the risk of loss by terminating PCLP lending and through declining PCLP loan portfolio delinquency rates

EDF also asserts that instead of properly funding its Loan Loss Reserve Fund, it has protected SBA from the risk of loss by terminating PCLP lending and through declining PCLP loan portfolio delinquency rates. See May 18, 2011 Response at 39-41 (V.I). SBA rejects these assertions.

It is in fact the case that EDF has made very few, if any PCLP loans since 2009. EDF claims that it made the decision to stop making PCLP loans to protect SBA from the risk of loss. *Id.* at 40-41 (V.I). It is not clear how the decision to stop making additional PCLP loans protects SBA from the risk of loss on EDF's existing portfolio of over 1,500 PCLP loans. The decision to terminate PCLP lending appears to have been made to protect EDF from incurring any additional 15% reimbursement obligations on new loans.⁵³

SBA agrees that declining PCLP portfolio delinquency rates would reduce SBA's risk of loss. However, EDF has little control over this.

⁵² EDF conceded that as of May 18, 2011, there were 46 non-performing loans that did meet the SBA formula for entry of a protective bid, thus on those loans, EDF is not claiming ownership of any "unanticipated recoveries" on those loans. See May 18, 2011 Response at 81 (XII.C)

⁵³ EDF has not stopped making loans. It is submitting its new loans through ALP or Regular CDC. SBA reviews the credit and approves the new loans. See *supra* sect. II.A.3.

6. SBA's Final Decision on Ground A – 13 CFR § 120.1400(f)(2) – Failure to Establish or Maintain a Loan Loss Reserve Fund as Required by the PCLP Program

The record shows that EDF's Loan Loss Reserve Fund is insufficient by millions of dollars under EDF's Risk Based Methodology requirements. Additionally, EDF submitted reports to SBA that concealed the fact that EDF was failing to fund a Loan Loss Reserve Fund for hundreds of its PCLP loans. EDF has failed to comply with its statutory obligation to utilize an appropriate and effective process for analyzing the risk of loss associated with its PCLP loan portfolio and for grading each PCLP loan on the basis of the risk of loss associated with each loan.

In its objections, EDF has conceded that it must comply with the Alternative Loan Loss Reserve statute. EDF also concedes that it has dropped loans from its Quarterly Loan Loss Reserve Fund Report and its Loan Loss Reserve Fund. SBA did not acquiesce in EDF's concealment of the dropped loans nor did SBA acquiesce in EDF's failure to fund a reserve for the dropped loans. EDF concedes that it has not funded its Loan Loss Reserve Fund as required by its Risk-Based Methodology. EDF's claim that EDF has protected SBA from the risk of loss by aggressive workout and liquidation actions on EDF's PCLP loans is devoid of merit.

For the foregoing reasons, it is SBA's final decision that EDF has failed to establish or maintain (including failing to properly evaluate, risk rate, manage, fund and fully and accurately report on) a Loan Loss Reserve Fund as required by the PCLP Program.

B. EDF has failed to Comply Materially with SBA's Loan Program Requirements to Pay Invoiced Obligations in a Timely Manner as Required by 15 U.S.C. § 697e(b)(2)(C) and/or 13 C.F.R. § 120.847(h)(2). Thus, SBA has sufficient grounds for the Enforcement Action pursuant to 13 C.F.R. § 120.1400(c)(2).

In Section II of SBA's Notice, SBA charged EDF with the failure to comply materially with SBA's Loan Program Requirements to Pay Invoiced Obligations in a timely manner as required by 15 U.S.C. § 697e(b)(2)(C) and/or 13 C.F.R. § 120.847(h)(2). The record shows that this charge is sustained.

1. EDF owes SBA \$11.4 million in invoiced PCLP 15% reimbursement obligations that EDF has failed and refused to pay

As of the date of this Decision, SBA has invoiced EDF for a total of \$11.4 million in PCLP 15% reimbursement obligations that EDF has failed to pay as required by 15 U.S.C. § 697e(b)(2)(C) and 13 C.F.R. § 120.847(h)(2).⁵⁴ See PCLP Reimbursement Obligation Invoices Chart, *supra*. EDF's Loan Loss Reserve Fund, which currently contains approximately \$1.9 million, is supposed to secure EDF's payment obligations to SBA on these invoices. However, even if SBA were to apply all of the funds in the Loan Loss Reserve Fund accounts to the outstanding

⁵⁴ An appeal is pending on \$600,000 of that amount and the appeal has been denied. See Section IV.B.2.e. below.

invoices, EDF would still owe SBA \$9.4 million in unpaid invoices, let alone the \$3.6 million in 15% PCLP reimbursement obligations on the 39 additional charged off PCLP loans that will be invoiced by SBA.

2. Analysis of EDF's Responses Regarding Failure to Pay Invoiced Obligations

- a. EDF acknowledges its obligations to SBA, but it has refused to pay these obligations

In EDF's May 18, 2011 Response, EDF does not deny that it is obligated to repay its 15% reimbursement obligations. EDF concedes that it has entered into six PCLP Loan Guarantee Agreements with SBA and further admits that under those agreements, EDF is required to comply with SBA's Loan Program Requirements. *See* Ioanidis Declaration, Exhibits 5-10; *see also* EDF's May 18, 2011 Response at 20 (III.A). EDF also recognizes that PCLP CDCs participating in the Alternative Loan Loss Reserve pilot program are required to reimburse SBA for 15% of SBA's losses. *See* EDF's May 18, 2011 Response at 14-15 (II.C). Indeed, in late 2009 and early 2010, EDF paid SBA on 4 PCLP 15% reimbursement obligation invoices totaling \$239,632. *See supra*. Despite all of EDF's concessions regarding its obligations to SBA under the program in which EDF chose to participate, when called upon to honor its 15% PCLP reimbursement obligations after May, 2010 and continuing to the present, EDF has failed and refused to pay SBA.⁵⁵

⁵⁵ By letter dated June 13, 2012, EDF's counsel asserted that EDF is not obligated to pay the 15% PCLP reimbursement obligation invoices because SBA has not suffered a loss on the defaulted PCLP loans. *See* Letter dated June 13, 2012 from David P. Callet and Jerry Stouck of Greenberg Traurig LLP to Eric Benderson of SBA. This issue was not raised in a timely manner, but SBA will nonetheless address it here. EDF asserts that SBA has no loss or a small loss on the PCLP loans because SBA is only losing the subsidy cost of each loan, rather than losing the entire amount that remains unpaid by the borrower. The short answer to this contention is that the applicable laws, regulations, and SOPs create a clear obligation on EDF's part to pay the amounts SBA says that it owes. The Federal Credit Reform Act (FCRA), 2 U.S.C. § 661a, changed the budgetary measurement of cost for Federal credit programs from the amount of cash flowing into or out of the Treasury to the long-term cost to the Government. Only the unreimbursed costs of making or guaranteeing new loans (the subsidy cost, on a present value basis, and administrative expenses, on a cash basis) are included in the budget. Specifically, the cost of a loan guarantee is the net present value, at the time when the guaranteed loan is disbursed by the lender, of the following estimated cash flows: (1) payments by the Government to cover defaults and delinquencies, interest subsidies and other requirements; and (2) payments to the Government, including origination and other fees, penalties and recoveries. Agencies are required to reestimate the subsidy cost throughout the life of each loan cohort to account for the differences between the original assumptions of cash flow and actual cash flow. These reestimates represent additional costs or savings to the Government. Reestimates that indicate an increase in subsidy cost are financed by permanent indefinite borrowing authority. All Federal credit agencies, including SBA, are required to use a model approved by the Office of Management and Budget (OMB) to determine the subsidy cost of each credit program. The model must rely on, among other things, statutory and regulatory program requirements, assumptions regarding the program characteristics and historical cash flow data. The 504 Loan Program credit subsidy model includes cash flows to the SBA deriving from the 15% PCLP reimbursement obligation requirement for each PCLP CDC. EDF's argument that because SBA did not receive a subsidy for the 504 Loan Program until FY 2012, SBA had no losses for 504 loans before that date is not compatible with FCRA. FCRA is concerned with the cost of loan programs, not losses on particular loans. While SBA may not have received subsidy appropriations for the 504 Loan Program until FY 2012, since the cash flows for the 504 Loan Program were less than modeled in

- b. SBA has not breached the covenant of good faith and fair dealing and the alleged duty of cooperation

Section 5(b) of the Small Business Act (15 U.S.C. § 634(b)) gives SBA wide discretion to deal with defaulted loans:

(b) In the performance of, and with respect to, the functions, powers, and duties vested in him by this Act the Administrator may---

. . .

(2) under regulations prescribed by him, assign or sell at public or private sale, or otherwise dispose of for cash or credit, in his discretion and upon such terms and conditions and for such consideration as the Administrator shall determine to be reasonable, any evidence of debt, contract, claim, personal property, or security assigned to or held by him in connection with the payment of loans granted under this Act, and to collect or compromise all obligations assigned to or held by him and all legal or equitable rights accruing to him in connection with the payment of such loans until such time as such obligations may be referred to the Attorney General for suit or collection;

(3) deal with, complete, renovate, improve, modernize, insure, or rent, or sell for cash or credit upon such terms and conditions and for such consideration as the Administrator shall determine to be reasonable, any real property conveyed to or otherwise acquired by him in connection with the payment of loans granted under this Act;

(4) pursue to final collection, by way of compromise or otherwise, all claims against third parties assigned to the Administrator in connection with loans made by him. This shall include authority to obtain deficiency judgments or otherwise in the case of mortgages assigned to the Administrator. . . . The power to convey and to execute in the name of the Administrator deeds of conveyance, deeds of release, assignments and satisfactions of mortgages, and any other written instrument relating to real property or any interest therein acquired by the Administrator pursuant to the provisions of this Act may be exercised by the Administrator or by any officer or agent appointed by him without the execution of any express delegation of power or power of attorney. Nothing in this section shall be construed to prevent the Administrator from delegating such power by order of by power of attorney, in his discretion, to any officer or agent he may appoint;

. . .

prior years, the 504 Loan Program had upward reestimates of \$1.5 billion for FY 2009, \$1.6 billion for FY 2010, and \$1.2 billion for FY 2011. In other words, for FY 2009 through FY 2011, the 504 Loan Program cost the Government \$4.3 billion more than estimated in the model. These reestimates reflect the indefinite borrowing authority needed to make whole the 504 Loan Program subsidy costs.

(7) in addition to any powers, functions, privileges and immunities otherwise vested in him, take any and all actions (including the procurement of the services of attorneys by contract in any office where an attorney or attorneys are not or cannot be economically employed full time to render such services) when he determines such actions are necessary or desirable in making , servicing, compromising, modifying, liquidating, or otherwise dealing with or realizing on loans made under the provisions of this Act

Id.

Section 308(f) of the Small Business Investment Act (15 USC § 687(f)) makes Section 5(b) of the Small Business Act applicable to the liquidation of 504 loans as follows:

(f) In the performance of, and with respect to the functions, powers, and duties vested by this Act, the Administrator and the Administration shall (in addition to any authority otherwise vested by this Act) have the functions, powers, and duties set forth in the Small Business Act

EDF's 15% PCLP reimbursement obligation is a consequence of EDF's election to participate in the PCLP program and specifically the Alternative Loan Loss Reserve pilot program. *See* 15 U.S.C. § 697e(c)(7). EDF is required to pay the reimbursement obligation to SBA when all reasonable collection efforts have been exhausted on a PCLP loan. *See* 13 C.F.R. § 120.847(h); *see also* EDF's Risk-Based Methodology at 14. The reimbursement obligation is not contingent on anything else.

In its May 18, 2011 Response, EDF claims that SBA owes a duty to assist its contractual partner, EDF, in loan collections and that SBA has breached the covenant of good faith and fair dealing and its duty of cooperation through SBA's "irrational" formula for determining when to buy out the Senior Third Party Lender's first lien on defaulted PCLP loans. *See* May 18, 2011 Response at 42-44 (V.II). EDF also asserts that SBA acknowledged its duty of cooperation and the irrationality of its liquidation formula by lending EDF \$12 million under the liquidation pilot program. *Id.* at 50 (VIII). SBA rejects EDF's assertions.

SBA disagrees with EDF's claim that SBA has a fiduciary duty of cooperation that requires SBA to advance funds for the purchase of a first lien thereby increasing SBA's exposure to 90% of the 504 project cost in order to protect EDF's 6% (i.e., 15% of 40%) of the 504 project cost. The cases cited by EDF in support of this argument are inapposite. In fact, because of EDF's position as a delegated authority lender performing liquidation activities on behalf of SBA, the duty flows the other way--EDF must liquidate the loans in a commercially reasonable, prudent and cost-effective manner and remit the proceeds of such liquidation to SBA. *See* 13 C.F.R. §§ 120.848 and 120.975; *see also* SBA SOP 50 51 3, Chapter 6.

EDF declares that SBA's formula for determining when to purchase a Senior Third Party Lender's first lien interest in collateral is irrational, arbitrary and capricious and deprives EDF of the most promising and effective collection action. *See* May 18, 2011 Response at 50 (VII).

EDF advances this argument despite the fact that the SBA formula was fully set forth in SBA's governing SOPs as early as December 1, 1997 (SOP 50 51 2, Chapter 21) and EDF, bound to abide by SBA's SOPs through regulation (13 C.F.R. §§ 120.180, 120.826(a), 120.846(a), 120.848(a) and 120.1400(a)), also specifically affirmed and reaffirmed its obligation to comply with SBA's SOPs, as promulgated and amended from time to time, in each of the PCLP Loan Guarantee Agreements it signed from 1997 to 2009. SOP 50 51 2, Chapter 21, clearly states SBA policy and position: "Purchase of a prior lien requires an additional expenditure of funds and added liquidation risks. Therefore, the non-purchase alternatives are preferred liquidation procedures."

As discussed above, SBA is the noteholder on each 504 loan. As the noteholder, SBA has all of the general authority that any creditor has to liquidate a defaulted loan, including the discretion to determine when to purchase any competing (or senior) liens on the collateral. SBA retains its general and statutory authority to determine when to purchase the first lien on defaulted 504 loans unless SBA delegates that authority. SBA has not delegated that authority. In 2000, Congress expressed its determination that SBA should not delegate that authority by amending Section 510 of the Small Business Investment Act (15 U.S.C. § 697g) to provide that CDCs with delegated authority (such as PCLP delegated authority) must obtain prior written approval from SBA before committing the SBA to the purchase of any other indebtedness secured by the property securing a defaulted 504 loan. *See* 15 U.S.C. § 697g(c)(1)(A).

EDF asserts that "it is well recognized that the best strategy for maximizing recovery on the 504 loan is for the PCL to take control of the real estate collateral securing both the first and second loans, either by protective bid at the foreclosure sale of the first mortgage or through pre-foreclosure negotiation with the first mortgagee." *See* May 18, 2010 Response at 45 (VII). But this observation arises solely from an uncorroborated statement in the Declaration of EDF's own Chief Portfolio Officer. *See* Larsen Declaration at para. 10. No other support is provided by EDF for this assertion. In all real estate investing, there are three issues: how much money is placed at risk, how long it is placed at risk, and what information is available about the degree of risk. EDF seems to argue that SBA should place double the amount at risk and leave it at risk for as long as EDF feels is necessary, no matter the risks of non-repayment or the carrying costs along the way, or the level of equity remaining in the property. The formula that SBA used for decisions about whether or not to buy out the first lien in the event of a default was long-standing, had been used in transactions involving EDF, and is intentionally conservative to regulate whether taxpayers take on additional risk when a small business borrower is not making payments on both the first and second mortgages on a 504 project. *See e.g.* SOP 50 51 2, ch. 21. SBA pointed out to EDF that EDF was free to employ EDF's own funds to buy out the interest of the Senior Third Party Lender when SBA determined not to do so with public funds, but SBA is unaware of any instance in which EDF employed its own funds for this purpose. *See* Letter from Grady Hedgespeth, Director, SBA Office of Financial Assistance, to Frank F. Dinsmore, EDF C.E.O. (August 25, 2010).

EDF asserts that SBA has breached the implied covenant of good faith and fair dealing through its "irrational" formula. *See* May 18, 2011 Response at 50 (VIII). SBA disagrees with EDF's claim. Under California law, the covenant of good faith and fair dealing cannot be used to vary the express terms of an agreement. *See* Carma Developers (California), Inc. v. Marathon

Development California, Inc., 2 Cal.4th 342, 374 (1992) (citations omitted). As the Centex Corp. case cited by EDF states, “[t]he covenant [of good faith and fair dealing] imposes obligations on both contracting parties that include the duty not to interfere with the other party’s performance and not to act so as to destroy the *reasonable expectations* of the other party regarding the fruits of the contract.” See Centex Corp. v. U.S., 395 F.3d 1283, 1305 (2005) (emphasis added). EDF’s only reasonable expectation was that SBA would act in accordance with the Loan Program Requirements to which EDF bound itself under the regulations of the PCLP Program and the PCLP Loan Guarantee Agreements EDF executed. It is not reasonable for EDF to expect that SBA would essentially double SBA’s exposure on defaulted loans regardless of the value of the 504 project property, particularly at a time of great volatility and uncertainty in the California real estate market.

In this context, EDF also appears to be reasserting the mitigation argument that was rejected by SBA in its August, 2010 final decision denying EDF’s appeal of the first batch of unpaid 15% PCLP reimbursement invoices. In its earlier appeal, EDF argued that, by determining not to expend additional federal funds to buy out a Senior Third Party Lender’s first lien interest on collateral also serving to secure a second lien in favor of SBA on a defaulted 504 Loan, SBA was failing to mitigate the Agency’s losses and thereby releasing EDF from any further responsibility on its part to honor its 15% reimbursement obligation to SBA. The case cited by EDF in its May 18, 2011 Response, Robinson v. United States, 305 F.3d 1330 (Fed. Cir. 2002), does not substantiate EDF’s mitigation argument. Certainly, *Restatement (Second) of Contracts*, § 350 makes clear that an injured party cannot recover damages that could have been avoided by reasonable efforts not presenting undue risk, and the case cited by EDF echoes this truism. However, both the Robinson case and the *Restatement (Second) of Contracts* establish that for the doctrine of mitigation to apply there must be an outstanding contractual breach from which damages are flowing. EDF is not conceding that it breached its PCLP Loan Guarantee Agreements with SBA, and that SBA is therefore required to mitigate losses resulting from EDF’s breach. Instead, EDF is misapplying the mitigation doctrine to argue that SBA’s decision not to purchase the first lien interest somehow excused EDF from its obligation to perform its contractual and regulatory duties. In effect, EDF is turning the doctrine of mitigation on its head, asserting that an alleged failure to mitigate gives rise to an excusable breach. But there can be no obligation to mitigate losses resulting from a breach if no breach has yet occurred. Although SBA may be interested in mitigating its losses resulting from borrower’s breach of its loan obligations, there is no duty to mitigate with respect to EDF because it is not EDF’s breach.

EDF also asserts that SBA acknowledged its alleged duty of cooperation and the irrationality of its liquidation formula by lending EDF \$12 million under the liquidation pilot program. See May 18, 2011 Response at 50 (VIII). Contrary to EDF’s assertion, the liquidation pilot was a test (requested by EDF) to determine whether EDF could achieve additional recoveries, not an acknowledgment by SBA of any deficiencies or duties. See May 18, 2011 Response, Ioanidis Declaration, Exhibit 33. In fact, the liquidation pilot exacerbated SBA’s losses because EDF has failed to comply with its obligations.

- c. SBA's limitation of the liquidation pilot did not constitute abandonment of SBA's PCLP Loans to EDF

In its May 18, 2011 Response, EDF claims that when SBA made the decision to limit the liquidation pilot to \$12 million in advances on 10 loans, SBA by that action determined that every other defaulted 504 Loan that did not meet SBA's protective bid formula had no value. *See* May 18, 2011 Response at 49 (VII). This claim is without merit. SBA's decision not to enter a protective bid if the proposed additional funding did not meet SBA's formula was not a determination that SBA's existing 504 loan had no value. Rather it was a common-sense determination that the property no longer had sufficient market value to warrant the expenditure of significant additional funds by SBA. Even after foreclosure and loss of the property as collateral, SBA would still own its 504 loan and would still look to other sources (such as personal guarantees or other collateral) for additional collections and recovery to reduce the final amount of unpaid debt.

EDF goes on to assert that by failing to pursue a protective bid, SBA released EDF from any further responsibility for liquidating the 504 Loan and SBA actually abandoned all government interest in the loan. *Id.* at 53 (IX). EDF asserts that SBA's alleged abandonment endowed EDF with the right to keep all loan recoveries for itself and that EDF is the rightful owner of the loan recoveries it has generated on behalf of SBA. *Id.* at 54 (IX). EDF fails to provide any applicable authority in support of its abandonment argument. EDF cites only one case in connection with its argument of abandonment – Nippon Shosen Kaisha, K.K. v. United States, 238 F. Supp. 55 (N.D. Cal. 1964). That case involved the clear intent of a private insurance company to abandon the cargo of a damaged steamship. As noted by the court in that case, “[a]bandonment is the intentional relinquishment of property.” *Id.* at 58 (XI). The case provides no support for EDF's contentions regarding SBA.

Clearly, SBA did not abandon any of its rights in any of the 504 Loans merely by following the SOP provision regarding the entry of a protective bid. SBA did not abandon its interest in its subordinate liens on the real estate collateral, and it certainly did not abandon its interest in potential recoveries from the guarantors of the loans or other collateral. While the SOP in question – SOP 50 51 2, Chapter 21, and, since November 15, 2010, SOP 50 51 3, Chapter 10 – sets forth the conditions under which a prior lien should and should not be purchased by SBA, the SOP directs that other reasonable means of recovery through liquidation are at all times to be pursued by the CDC. The SOP nowhere indicates that in the absence of a protective bid other avenues of liquidation, such as workouts or pursuit of guarantors should be jettisoned. And SOP 50 51 3 provides that “[a]fter any Third Party Lender or other senior lienholder's foreclosure sale where the property was not acquired to protect the equity available for the SBA Loan, the Liquidation Officer [defined by the SOP to include the CDC performing the liquidation function] must ascertain whether there are excess foreclosure sale funds available for distribution to junior lienholders and take the necessary and appropriate action to obtain the funds available for application to the SBA Loan balance.” *See* SOP 50 51 3, Chapter 10, paragraph G(1). These are not words directing abandonment. Indeed, nowhere in any of the documentation provided by EDF is there any evidence suggesting that in deciding not to put further government funds at risk by purchasing a prior lien interest, SBA was intentionally abandoning its ownership interest in the 504 Loans and specifically in liquidation proceeds. EDF itself repeatedly admits that SBA

always continues to seek further recovery on defaulted loans even if the primary collateral (i.e. the real estate) is lost through foreclosure by the Senior Third Party Lender. *See e.g.* December 14, 2011 Response at 46 (IX.A). Moreover, EDF repeatedly references its own such collection efforts on SBA's behalf. *See e.g.* December 14, 2011 Response at 18 (II).

d. EDF cannot use SBA's liquidation recoveries to pay EDF's obligations to SBA

EDF claims that because SBA abandoned the 504 Loans on which it did not authorize the entry of a protective bid, a claim that SBA has rejected, any liquidation recoveries EDF obtained subsequent to SBA's alleged abandonment resulted only from EDF's own "creative and aggressive" efforts.⁵⁶ *See* May 18, 2011 Response at 79-81 (XII.A-C). EDF asserts that as a result it owns these "unexpected recoveries," and further argues that to the extent it turns over any such recoveries to SBA, these funds should be used to pay EDF's 15% reimbursement obligation to SBA. *Id.* at 53-54 (X). EDF claims that it has paid the \$11.4 million in outstanding invoices because it has collected over \$10 million on loans that SBA has allegedly "abandoned" and those collections should be credited to the amounts EDF owes to SBA. SBA rejects EDF's assertions. *Id.* at 83 (XII.E).

As discussed above, SBA has not abandoned the 504 Loans on which SBA decides not to fund the entry of a protective bid. SBA continues to own 100% of these 504 Loans. *See* PCLP Loan Guaranty Agreement, at Paragraph 11. Any liquidation recoveries generated on these 504 Loans belong to SBA and EDF holds these funds in trust for SBA. *See* 13 C.F.R. § 120.975(a). All liquidation recoveries are required to be remitted to SBA. *See* SBA SOP 50 51 3, ch. 25, para. F(5). SBA is required by the Federal Credit Reform Act to place all recoveries obtained on defaulted 504 Loans into SBA's 504 financing account, which is used by SBA to support the 504 Loan Program. *See* 15 U.S.C. § 697(g); *see also* 2 U.S.C. § 661a(5)(A) and (7).

EDF argues that it has an ownership interest in the all of the recoveries on a loan *before* it has paid its 15% reimbursement obligation and that because it has an ownership interest, EDF can use the loan recoveries to pay its 15% reimbursement obligation on that loan as well as any other PCLP loan on which it may owe a reimbursement obligation to SBA. *See* May 18, 2011 Response at 53-54 (IX). To the extent that EDF is suggesting that any liquidation proceeds it collects on behalf of SBA can be applied to cover EDF's 15% PCLP reimbursement obligations, EDF is proposing to fulfill its obligations to SBA by using monies that belong to SBA and that EDF holds in trust for SBA. In other words, EDF is attempting to convert SBA's funds to EDF's own use to the detriment of the entire 504 Loan Program. EDF's assertion is without merit.

⁵⁶ EDF contends that in pursuing its collection efforts on defaulted 504 Loans subsequent to a determination by SBA not to purchase the first lien interest, EDF was required "to devote time and resources to the effort, including the expenditure of funds to cover collection expenses." *See* Larsen Declaration, ¶ 21, attached to EDF's May 18, 2011 Response. What EDF fails to note, is that pursuant to SOP 50 51 3, SBA reimburses EDF for its reasonable out-of-pocket liquidation costs and expenses and, in fact, EDF can deduct such expenses from any recoveries on the loan. *See* SBA SOP 50 51 3, ch. 19, para. h D(3). at 133. EDF also claims that it is entitled to be paid a compensation fee on top of its recoverable expenses pursuant to 120.542(c). *See* EDF's May 18, 2011 Response at 54 (IX). However, EDF has no independent legal entitlement to this fee and SBA has not had any budgetary authority to pay this fee to any CDC for several years.

At most, any loan recoveries that EDF collects on a loan can be used to reduce the total amount of SBA's loss on that particular loan, thereby reducing EDF's 15% share of the loss on the loan, *pro rata*. In the six PCLP Agreements it signed while a participant in the PCLP program, EDF repeatedly acknowledged that it does not have any ownership interest in a defaulted PCLP loan until it makes full payment to SBA of EDF's share of the loss on the loan. *See* PCLP Loan Guaranty Agreement, Para. 11. EDF has no ownership interest in a defaulted PCLP Loan until it completes its collection actions, turns over all collections to SBA and pays its 15% reimbursement obligation to SBA. At that point only will EDF have a 15% ownership interest in any *future recoveries* on the loan (and that interest will then be limited to its 15% *pro rata* share on any future recoveries). Because EDF has paid the 15% reimbursement obligation invoices on only six PCLP Loans to date, the amount of future collections owned by EDF is likely to be minimal.

- e. SBA's Treasury referrals have not interfered with EDF's collection efforts on behalf of SBA, thus EDF's appeal of the 3Q 2011 invoices is denied

By letter dated June 3, 2011, EDF appealed, pursuant to 13 C.F.R. § 120.847, seven invoices issued by SBA in May, 2011 totaling over \$600,000. *See* Letter from Jerry Stouck and David Callet of Greenberg Traurig, to Grady Hedgespeth, Director, SBA's Office of Financial Assistance, and Leslie Niswander, Deputy Center Director, SBA's Commercial Loan Servicing Center (June 3, 2011). In its appeal letter, EDF claims that (1) EDF has already paid SBA sufficient amounts to cover these invoices for the reasons stated in EDF's May 18, 2011 Response and (2) SBA's "premature" referral of defaulted 504 Loans to the Department of Treasury Offset Program (TOP) for collection interferes with EDF's collection efforts and such interference discharges EDF's reimbursement obligation to SBA. *Id.* at 2. In its December 14, 2011 Response, EDF elaborates on its second argument and states that SBA's "premature" referral to TOP breaches the covenant of good faith and fair dealing and SBA's alleged duty of cooperation. *See* December 14, 2011 Response at 46 (IX.A).

As support for its "premature" referral argument, EDF cites a letter for a 504 loan that is not one of the invoiced PCLP loans being appealed by EDF. *See* Letter from SBA to Hafoka Electric (November 8, 2009). EDF has provided no evidence that such a letter was sent on the invoiced PCLP loans. Furthermore, in the Hafoka matter, SBA did not make an actual referral to Treasury, it just notified the obligors that a referral would be made.

EDF proffers no evidence hinting of how any such action by SBA interferes with collection efforts by EDF. SBA is required by law to refer loans to Treasury. *See* Debt Collection Improvement Act, 31 U.S.C. § 3716(c); *see also* 31 U.S.C. § 3720A. Further, any monies collected by the Treasury would serve to reduce SBA's loss, and, thus, reduce the 15% reimbursement obligation amount EDF would owe to SBA, just as if EDF itself had recovered such funds. *See* SBA SOP 50 51 3, ch. 20, para. F. Additionally, if EDF paid its 15% PCLP reimbursement obligation on a loan after it was referred to Treasury and Treasury successfully

collected some amount, EDF would be entitled to a 15% share of that collection.⁵⁷ Quite simply, EDF has failed to show how referrals to Treasury harm EDF's collection efforts.

SBA has also rejected the other bases for EDF's appeal in the discussion above. For all of the foregoing reasons, EDF's appeal has been denied. See Memorandum from Grady Hedgespeth, Director, SBA Office of Financial Assistance, to Brent M. Ciurlino, Director, Office of Credit Risk Management (December 12, 2012).

3. SBA's Final Decision on Ground B – 13 CFR § 120.1400(c)(2) – Failure to Comply Materially with SBA's Loan Program Requirement to Pay Invoiced Obligations in a Timely Manner as Required by 15 U.S.C. § 697e(b)(2)(C) and/or 13 CFR § 120.847(h)(2)

The record shows that EDF owes SBA \$11.4 million in invoiced PCLP 15% reimbursement obligations that EDF has failed and refused to pay. In its objections, EDF acknowledges its obligations to SBA, but it refuses to pay these obligations. SBA has not breached the covenant of good faith and fair dealing and the alleged duty of cooperation. SBA's limitation of the liquidation pilot did not constitute abandonment of SBA's PCLP loans to EDF. EDF cannot use SBA's liquidation recoveries to pay EDF's obligations to SBA. SBA's Treasury referrals have not interfered with EDF's collection efforts on behalf of SBA.

For the foregoing reasons, it is SBA's final decision that EDF has failed to pay invoiced obligations in a timely manner as required by 15 U.S.C. § 697e(b)(2)(C) and/or 13 CFR 120.847(h)(2) and has thus failed to comply materially with SBA's Loan Program Requirements.

C. EDF has failed to Comply Materially with SBA's Loan Program Requirement to Maintain the Financial Ability to Operate as Required by 13 C.F.R. § 120.825. Thus, SBA has sufficient grounds for the Enforcement Action pursuant to 13 C.F.R. § 120.1400(c)(2)

In Section II of SBA's Notice, SBA charged EDF with the failure to comply materially with SBA's Loan Program Requirement to Maintain the Financial Ability to Operate as required by 13 C.F.R. § 120.825. The record shows that this charge is sustained.

⁵⁷ EDF understands this concept because its counsel asserted in a letter dated June 13, 2012 that SBA is not giving EDF any credit for amounts collected by Treasury after EDF receives its 15% PCLP reimbursement obligation invoices from SBA. See Letter dated June 13, 2012 from David P. Callet and Jerry Stouck of Greenberg Traurig LLP to Eric Benderson of SBA. Paragraph 11 of EDF's PCLP Agreement with SBA states as follows: "Upon full payment by CDC to SBA of CDC's share of any loss on a PCLP loan, SBA will issue to CDC a certificate of interest evidencing the percentage of the loan in which CDC has an interest. Thereafter, all security interest and rights, all reasonable expenses incurred by SBA or CDC which are not recoverable from the Borrower, and all sums which SBA or CDC recover from any source will be shared by SBA and CDC according to their respective interests in the loan." Under the PCLP Agreement, if EDF were to pay its outstanding invoices for the PCLP reimbursement obligations, SBA would share *pro rata* with EDF any Treasury recoveries on those loans. However, EDF has paid SBA on only 6 PCLP reimbursement invoices sent by SBA to EDF. Four of the PCLP loans for which the invoices were paid have been referred to Treasury, but as of June 15, 2012, Treasury has made no recoveries on those loans.

1. EDF is insolvent

During the August, 2011 targeted review, SBA's auditor reviewed the current financial condition of EDF with a focus on current assets and liabilities. As set forth in the Audit Report dated October 28, 2011, the auditor found that EDF is insolvent. *See* Audit Report at 10. The auditor determined that EDF's liabilities exceed the fair and realizable value of its assets and EDF is unable to pay its debts as they become due. *Id.* The auditor also stated that "EDF's ability to repay its obligations which include an estimated \$22,484,847 to SBA and \$1,465,038 to others is doubtful (not likely to happen) given total current assets of \$11,869,421 which are roughly half of current liabilities." *Id.* at 1.

The \$22 million that SBA's auditor determined is currently owed by EDF to SBA includes \$5.1 million in 15% PCLP reimbursement obligation invoices that SBA had sent to EDF as of the date of the Audit report (October 28, 2011), an additional \$8.3 million in 15% PCLP reimbursement obligations that the auditor determined were ready to be billed by SBA to EDF as a result of the auditor's review of EDF's loan files, and the \$8.9 million in liquidation pilot obligations for which SBA had made written demand on EDF as of the date of the Audit report and that remained unpaid. *See* November 14, 2011 Supplement at 6-7.

As discussed below, after reviewing EDF's December 14, 2011 Response, the auditor lowered the amount of PCLP reimbursement obligations by \$952,000. SBA has also determined that \$95,169 of the \$8.3 million is attributable to a non-PCLP loan, thus the non-PCLP amount should be subtracted out as well. Additionally, subsequent to the date of the Audit report, SBA has billed EDF for an additional \$6.1 million in PCLP reimbursement obligations, including approximately \$5.2 million in obligations on loans in the auditor's sample. SBA is also preparing to bill EDF for an additional approximately \$3.6 million in PCLP reimbursement obligations on 39 charged off PCLP loans, including approximately \$2.1 million in obligations on PCLP loans in the auditor's sample.

2. EDF does not have the financial ability to operate as required by SBA's regulations

13 C.F.R. § 120.825 requires that a CDC must maintain the financial ability to operate. The regulation defines the financial ability to operate as follows: "A CDC must be able to sustain its operations continuously, with reliable sources of funds (such as income from services rendered and contributions from government or other sponsors)." *See* 13 C.F.R. § 120.825. The financial ability to operate is a core requirement that must be met by a PCLP CDC.

The auditor found that "EDF will [not] be able to sustain its current operations continuously in the future." *See* Audit Report at 10. More specifically, the auditor noted the following:

Our understanding is that EDF has been reducing operating expenses to conserve cash; its credit lines are close to exhausted. Advances made to affiliated firms are considered uncollectable. It is not believed EDF has nor has access to sufficient funding to cover the \$10 million plus shortfall of assets available to pay its liabilities. Such funding might include additional borrowing and selling fixed assets which are valued at about

\$1,000,000 – neither of which appears realistic. Lenders/investors will most likely be disinclined to make money available after reviewing EDF's books.

Id. at p. 11.

Thus, EDF has failed to maintain the financial ability to operate as required by SBA's regulations.

3. Analysis of EDF's Responses Regarding Failure to Maintain Financial Ability to Operate

- a. EDF owes the \$5.1 million in unpaid PCLP 15% reimbursement obligation invoices listed on the balance sheet in the Audit report

In its December 14, 2011 Response, EDF addresses its financial ability to operate by attacking the SBA obligations listed on the EDF balance sheet in the Audit report. *See* December 14, 2011 Response at 44-50 (IX.A). EDF claims that it does not owe the \$5.1 million⁵⁸ in unpaid 15% PCLP reimbursement obligation invoices for the reasons set forth in EDF's May 18, 2011 Response and because SBA has also breached the covenant of good faith and fair dealing and its duty of cooperation by prematurely referring delinquent loans to the Department of Treasury as set forth in EDF's June 3, 2011 appeal letter. *Id.* at 45-46 (IX.A). For the reasons discussed in section IV.B.2.e. above, SBA finds EDF's assertions to be without merit.

EDF also argues that the findings of the Audit Report are in error because they are based, in part, on alleged obligations of EDF to SBA that EDF contests. *See* December 14, 2011 Response at 45-47 (IX.A). According to EDF, disputed liabilities should not be included in current liabilities, and the auditor had no authority to determine the outcome of disputes between the parties over whether these liabilities exist. *Id.* 48. However, GAAP accounting standards require that current liabilities include estimated or accrued amounts that are expected to be required to cover expenditures within the year for known obligations the amount of which can be determined only approximately. *See* ASC 210-10-45-6. Further, if the amounts of periodic payments of an obligation are, by contract, measured by current transactions, the portion of the total obligation to be included as a current liability shall be that representing the amount accrued at the balance sheet date. *See* ASC 210-10-45-11. In other words, obligations that have been billed as of the balance sheet date as well as those obligations estimated to be billed within one year of the balance sheet date are considered current liabilities. SBA has concluded that it was entirely reasonable for the auditor to include in its consideration debts that EDF disputes. After thorough consideration of all evidence before it, including the extensive submissions of EDF in opposition to SBA's Notice, SBA concludes that EDF does owe the debts referenced by the auditor, and therefore the auditor's finding that EDF is insolvent is well-grounded.

⁵⁸ As discussed above, this number has now increased to \$11.4 million through subsequent invoicing by SBA.

- b. The \$8.3 million (lowered to \$7.3 million) in 15% reimbursement obligations calculated by the auditor as a result of its file review are current liabilities

In its December 14, 2011 Response, EDF contends that the additional \$8.3 million in 15% PCLP reimbursement obligations that the auditor determined were ready to be billed by SBA to EDF as a result of the auditor's review of EDF's loans are not current liabilities because SBA has not yet billed EDF for this amount and, in some cases, is not entitled to bill EDF for the calculated amounts. *See* December 14, 2011 Response at 47 (IX.A).

EDF claims that:

[O]ver 70% of TCBA's "loan write ups" incorrectly include the assertion that a wrap up report "[s]hould have been completed within 90 days of foreclosure" on the collateral supporting the loan. . . . SBA has no such regulatory requirement. Rather SBA SOP 50 51 3, Chapter 20, entitled "Wrap-up Procedures" states at Section E(1) "Wrap-up Reports – When required" "For each SBA Loan classified in liquidation status, a Wrap-up Report . . . should be submitted . . . within 90 days of completing all reasonable and cost-effective efforts." (Emphasis added). . . . "reasonable and cost-effective efforts" were ongoing on each of those loans.

Id. at 56 (IX.B.2). EDF's Chief Portfolio Officer, Joey Larsen, also asserts in her Second Declaration that the auditor reached erroneous conclusions with respect to some of the loans it reviewed. *See* December 14, 2011 Response, Second Larsen Declaration, para. 31.

The auditor has advised SBA that it employed the phrase "within 90 days of foreclosure" in many instances specifically because the auditor determined that in those cases foreclosure was the event representing the conclusion of all reasonable and cost-effective liquidation efforts. Nevertheless, after reviewing EDF's December 14, 2011 Response, the auditor agreed with EDF that a wrap up report was not yet due on 10 of 72 loans. *See* Email from David Bufton of Bazilio Cobb Associates f/k/a Thompson, Cobb, Bazilio & Associates, to Paul Kirwin, SBA Financial Analyst, SBA Office of Credit Risk Management (January 6, 2012). Based on this finding, the auditor lowered its calculation of the 15% PCLP reimbursement obligation amount currently owed by EDF to SBA but not yet billed by approximately \$952,000. *Id.* SBA has also determined that \$95,169 of the \$8.3 million is attributable to a non-PCLP loan and should be subtracted out of the total. Thus, the corrected amount ready to be billed as determined by the auditor is \$7.3 million. This revised figure makes no difference in the auditor's determination that EDF is insolvent. *Id.*

Subsequent to the date of the Audit report, SBA has billed EDF for an additional \$5.2 million in obligations on PCLP loans in the auditor's sample. SBA has also charged off another 14 PCLP loans in the auditor's sample and is preparing to bill EDF for approximately \$2.1 million in 15% PCLP reimbursement obligations on those loans. Thus, since the date of the Audit report, \$7.3 million in 15% PCLP reimbursement obligations has accrued through invoicing or charge off of PCLP loans in the auditor's sample.

c. The \$8.9 million in liquidation pilot advances are current liabilities

EDF does not dispute that it is obligated to repay SBA for the \$8.9 million in liquidation pilot loan advances. However, EDF argues in its December 14, 2011 Response, that the Audit Report incorrectly lists the \$8.9 million obligation under current liabilities because the parties never agreed on an absolute date for repayment of the advances. *See* December 14, 2011 Response at 47 (IX.A). SBA concludes that EDF and SBA did in fact agree to an absolute due date for repayment of the pilot loan advances and such repayment was due by EDF upon the sale of the property or two years from the date of the advance, *whichever occurs first*. *See* Liquidation Pilot Assignments of Deed of Trust and Promissory Note.

To support EDF's assertion, EDF points only to paragraph 48 of the December 14, 2011 Declaration of Kim Ioanidis. However, the December 14, 2011 Ioanidis Declaration does not say that the parties never agreed on an absolute date for repayment of the advances or that the \$8.9 million is not a current liability. Instead, in her Declaration, Ms. Ioanidis states merely that it is her understanding that SBA would consider *extensions* of the two-year deadline for repayment of the advances and that it would be unreasonable for SBA to force premature sales of the pilot loan properties. *See* December 14, 2011 Response, Second Declaration of Kim Ioanidis, para. 48. The liquidation pilot loan agreements were fully integrated, written agreements---an after-the-fact declaration of alleged intent, understanding or oral promise cannot be used to vary the terms of an integrated written instrument. *See, Brawthen v. H&R Block, Inc.*, 28 Cal.App.3d 131, 136 (1972) (citations omitted).

The signed documents evidencing the pilot loan transactions show that EDF and SBA agreed to an absolute due date for repayment of the pilot loan advances. For each of the pilot loan advances, EDF submitted to SBA a letter signed by its CEO, Frank Dinsmore, outlining the terms of the pilot transaction for the loan. *See* Liquidation Pilot Loan Agreements. The letters each follow the same format, reciting the pilot loan advance amount requested by EDF and the specific due date for repayment of the advance to SBA. SBA in turn noted its approval in writing on the EDF letters outlining the terms.⁵⁹ In order to effectuate the pilot loan advance transaction for each loan, SBA assigned to EDF the note and collateral documents for the underlying 504 loan. *See* Liquidation Pilot Assignments of Deed of Trust and Promissory Note. The Assignment of Deed of Trust and Promissory Note executed by SBA and delivered to EDF for each of the pilot loan advance transactions, clearly states that repayment of the pilot loan advance is due by EDF upon the sale of the property or two years from the date of the advance, *whichever occurs first*.

EDF's claim that the pilot loan advances are not current liabilities also cannot be reconciled with EDF's own documentation. The audited 2010 Annual Financial Statements submitted by EDF to SBA list the pilot loan advances as current liabilities on EDF's balance sheet as of September 30, 2010. *See* EDF Resource Capital, Inc., 2010 Financial Statements. Additionally, EDF recently submitted its 2011 Financial Statements to SBA. These financial statements also list the pilot

⁵⁹ SBA agreement is represented by an Administrative Action stamp on the signature page of each letter.

loan advances as current liabilities.⁶⁰ See EDF Resource Capital, Inc., 2011 Financial Statements. For EDF to assert that these liabilities are not current liabilities defies explanation.

EDF acknowledges in Exhibit 39 to the December 14, 2011 Ioanidis Declaration that the two-year due dates on each of the pilot loan advances fell between March 5, 2011 and August 31, 2011. See Second Declaration of Kim Ioanidis, para. 39. EDF also acknowledges in Exhibit 39 that it has repaid to SBA just three of the ten advances. *Id.* As Exhibit 39 shows, the amount of unpaid advances due by EDF to SBA as of August 31, 2011 totaled \$8.9 million. *Id.* As discussed above, SBA has made written demand on EDF for repayment of the \$8.9 million that is currently due and owing to SBA on the remaining seven advances. Further, by letters dated November 10, 2011, SBA rejected EDF's claim that there was flexibility in the repayment due date for the seven remaining advances and advised EDF that if EDF failed to pay to SBA all amounts due that SBA may avail itself of all remedies available to SBA under applicable law. See Letter from Joel Stiner, Center Director, Commercial Loan Servicing Center, to Frank Dinsmore, EDF C.E.O. (November 10, 2011); see also Letter from Leslie Niswander, Deputy Center Director, SBA Commercial Loan Servicing Center, to Frank Dinsmore, EDF C.E.O. (November 10, 2011). Despite written demand, EDF has failed and refused to pay SBA the \$8.9 million in pilot loan advances currently due and owing on the remaining seven pilot loan advances. EDF is currently holding approximately \$8.2 million in sale proceeds that it has refused to turn over to SBA, despite written demand.

SBA rejects EDF's assertion that the liquidation pilot program advances in the amount of \$8.9 million are not current liabilities.

- d. The financial ability to operate is a basic requirement that must be met by a PCLP CDC

In its December 14, 2011 Response, EDF argues that when the \$5.1 million in unpaid invoices, \$8.3 million (lowered to \$7.3 million) in 15% reimbursement obligations calculated by the auditor and \$8.9 million in liquidation pilot advances are removed from EDF's balance sheet, EDF has a positive net worth of \$10 million.⁶¹ See December 14, 2011 Response at 48 (IX.A). For the reasons stated above in sections IV.C.3.b. and IV.C.3.c., SBA rejects this contention.

EDF acknowledges that “. . . EDF cannot pay in the short term what it does not have.” *Id.* at 14 (II). EDF then goes on to assert, “To say that this justifies putting EDF out of business, as SBA proposes, is akin to putting a delinquent mortgage holder in debtor's prison. Owing money, assuming that could be established, is no reason to put EDF out of business, particularly since EDF does have the ability to pay its rightful debts over time.” *Id.* But according to the Loan Program Requirements binding upon EDF, financial ability to operate is a basic requirement that must be met by a PCLP CDC. See 13 C.F.R. § 120.825. EDF cannot be heard to argue that it would be inappropriate to prohibit EDF from acting as a CDC when it does not meet the

⁶⁰ The 2011 Financial Statements are not in compliance with the requirements of 13 C.F.R § 120.826(c) because the auditor did not issue an opinion.

⁶¹ EDF's own audited financial statements submitted to SBA show a much smaller net worth amount of approximately \$4 million for 2009 and 2010. See EDF Audited Financial Statements (2009 and 2010).

regulatory requirements required of such a participant in the 504 Loan program. Further, EDF has provided no evidence, other than its own sanguine hopes, that it will be able to satisfy its sizable debts in the foreseeable future.

Finally, EDF asserts that it has the financial ability to operate because it has been operating in a robust manner during the pendency of the enforcement proceeding. *See* December 14, 2011 Response at 48 (IX.A). EDF's argument is entirely unconvincing. SBA is by far EDF's largest creditor. *See* EDF Financial Statements (2010). As noted, SBA finds that EDF currently owes SBA in excess of \$20 million, with potentially substantial additional losses still to come as the non-performing PCLP loans in EDF's portfolio move through the liquidation process. It is SBA's conclusion that EDF has remained in operation by retaining funds that it owes to SBA and/or was required to use to fund EDF's Loan Loss Reserve Fund, and instead expended such funds for its own purposes. In short, SBA finds that EDF would have been unable to continue to operate its business if it had properly honored its obligations to SBA under the Loan Program Requirements with which it agreed to abide, paid SBA all funds due and owing to the Agency and properly funded EDF's Loan Loss Reserve Fund.

4. SBA's Final Decision on Ground C – 13 CFR § 120.1400(c)(2) – Failure to Comply Materially with SBA's Loan Program Requirement to Maintain the Financial Ability to Operate as Required by 13 CFR § 120.825

The record shows that EDF is insolvent. EDF does not have the financial ability to operate as required by SBA's regulations. SBA has considered EDF's objections and determined that EDF owes the unpaid PCLP 15% reimbursement obligations. Further, the 15% PCLP reimbursement obligations calculated by the auditor as ready to be billed by SBA to EDF are current liabilities. Additionally, the liquidation pilot advances are current liabilities.

For the foregoing reasons, it is SBA's final decision that EDF has failed to maintain the financial ability to operate as required by 13 C.F.R. § 120.825 and has thus failed to comply materially with SBA's Loan Program Requirements.

V. ANALYSIS OF EDF'S ADDITIONAL OBJECTIONS

A. EDF has not been denied due process

In its May 18, 2011 Response, EDF contends that it has been denied due process by the instant administrative proceeding. *See* May 18, 2011 Response at 87 (XV.A). EDF's claim is without merit.

The procedural history of this enforcement proceeding is described in detail in Section III above. EDF claims that SBA did not adequately clarify the Agency's reasons for the proposed enforcement action as requested by EDF in its March 18, 2011 letter, and that SBA did not provide EDF with adequate time to respond to the Agency's allegations because SBA did not adequately respond to EDF's request for clarification. *Id.* Yet, even a cursory review of EDF's May 18, 2011 Response clearly demonstrates that EDF had no doubts as to the grounds of the

proposed enforcement action and that EDF's counsel set forth numerous arguments responsive to SBA's Notice, as clarified.

EDF further claims that in the absence of the right to discovery and cross-examination it is being deprived due process. *Id.* at 87. However, SBA has, at all times, followed the procedure specifically set forth in the regulations governing enforcement actions against CDCs (13 C.F.R. §120.1600(a)), procedures that EDF has repeatedly accepted by its participation in the PCLP Program.⁶² 13 C.F.R. §120.1400(a) plainly provides that "By making SBA ... 504 loans, SBA Lenders automatically agree to the terms, conditions, and remedies in Loan Program Requirements, as promulgated or issued from time to time and as if fully set forth in the SBA Form 750, Loan Guaranty Agreement or other applicable participation, guaranty, or supplemental agreement." *See* 13 C.F.R. § 120.1400(a).

Additionally, EDF was given a full and complete opportunity to respond to the Audit Report, and vigorously did so, through counsel, on December 14, 2011. There can be no question that EDF has received ample opportunity to present its objections to the proposed enforcement action within the context of administrative procedures to which EDF has agreed to be subject.

Moreover, the very sincerity of EDF's due process objection is called into question by additional assertions it has made in its December 14, 2011 Response. In that submission EDF criticizes SBA for not responding during this proceeding to EDF's various objections. As voiced by EDF, "Significantly, SBA has never provided any substantive response to the positions articulated in detail in EDF's Response fully seven months ago. Evidently, SBA is unable to provide any substantive response" (December 14, 2011 Response at 26 (V)); and "... the SBA has never defended or explained [its legal positions]" (December 14, 2011 Response at 43 (IX)). Further, EDF asserts in its Supplemental Response that "Significantly, although SBA has been pursuing its proposed enforcement action against EDF for more than a year ..., during that entire period, SBA has not placed any operational restrictions on EDF..." (December 14, 2011 Response at 12 (II)) and "... SBA [since October 2009] ... has repeatedly renewed EDF's qualification to participate in the PCLP program, as well as its qualification to participate in the ALP. ... Either EDF is, or is not, qualified to continue making 504 loans and to participate in the 504 program as a PCLP and ALP lender. SBA cannot have it both ways." *See* December 14, 2011 Response at 16-17 (II).

Yet, it is precisely SBA's actions in not addressing the merits relevant to this enforcement proceeding until all the evidence has been submitted and fully considered, and in not in any way imposing limitations upon EDF's participation in the 504 Loan program until a final agency determination has been reached, that demonstrate the Agency's dutiful adherence to the principles of due process. EDF cannot be heard to argue, on the one hand, that it has been denied due process in not being afforded sufficient time to set forth its position, and that the Agency has pre-decided the matter, but yet, on the other hand, that the procedure is demonstrably flawed

⁶² Because EDF is not an "SBA Supervised Lender" (defined by SBA's regulations as a 7(a) Lender that is either a Small Business Lending Company or a Non-Federally Regulated Lender), the procedures of 13 CFR § 120.1600(b) do not apply to EDF. 7(a) Lenders participate in SBA's other flagship small business lending program, the 7(a) Loan Program.

because SBA did not sanction EDF prior to the Agency's deliberate consideration of the voluminous evidence and argument EDF has submitted in objection to the proposed enforcement action. EDF's assertions are unsupported and without merit.

SBA finds that the various assertions by EDF that it has been denied due process by the conduct of the instant administrative proceeding are without merit, and that EDF has, in fact, been accorded a full and fair opportunity to submit its objection to the proposed enforcement action at issue.

B. EDF's assertions regarding Janet Tasker's recusal are moot and are without merit

EDF also claims that a certain SBA official, Janet Tasker, former Acting Director of the Office of Credit Risk Management, had allegedly exhibited hostility toward EDF suggestive of prejudgment of the Agency's case against EDF. *See* May 18, 2011 Response at 87 (XV.A). Further, EDF states that Ms. Tasker must be recused from this matter. *Id.* at 101 (XVI.C). While EDF has provided no convincing evidence of prejudice or pre-decision on the part of Ms. Tasker, it is nonetheless the case that Ms. Tasker has not served as Acting Director of OCRM since approximately May, 2011, has had no involvement in the pending proceeding since that time, and has retired from employment with the Agency. Thus, EDF's recusal request is moot.

EDF bases its allegations related to recusal, moot though they now are, on alleged actions taken by Ms. Tasker during a November 4, 2010 meeting between EDF and SBA officials, targeted reviews of EDF that were conducted in the December, 2010 and announced in April, 2011, and letters sent by Ms. Tasker to EDF related to such targeted reviews. *See* EDF's May 18, 2011 Response at 57, 58, 59, 60, 96, 97, 98, 102, and 104; *see also* Ioanidis Declaration at Exh. 49. After a careful and thorough review and investigation of EDF's allegations, SBA has determined that Ms. Tasker's actions were taken in her capacity as Acting Director of OCRM, pursuant to SBA authority to oversee CDCs, and did not exhibit bias, predisposition, or any other improper or inappropriate motive. Accordingly, SBA concludes that EDF's request for recusal is both moot and without merit and is, therefore, denied.

C. EDF's general arguments regarding fairness and equal protection are without merit

SBA has reviewed EDF's general arguments regarding fairness set forth in the December 14, 2011 Response. The majority of EDF's allegations concern requests for settlement discussions or settlement discussions that the parties agreed would be confidential. SBA will not consider these arguments because SBA and EDF agreed that the settlement discussions would be confidential. Moreover, Federal Rule of Evidence 408 prohibits offering evidence relating to settlement discussions at trial.

EDF also claims that SBA selectively and arbitrarily prosecuted EDF; and that this is a serious violation of constitutional equal protection principles affecting EDF as a class of one. *See* December 14, 2011 Response at 15 (II). EDF's equal protection argument is without merit. SBA is required to demonstrate that it has a strong rational basis for proceeding with the subject

enforcement action against EDF. *See FCC v. Beach Communications, Inc.*, 508 U.S. 307, 313-314 (1993) (citations omitted) (“Where there are ‘plausible reasons’ for [government] action, ‘our inquiry is at an end.’”); *id.* at 313 (“[I]f there is *any* reasonably conceivable state of facts that could provide a rational basis for the classification” the rational basis test is met.) (emphasis added); *Perry v. Brown*, 671 F.3d 1052 (9th Cir. 2012) (quoting *Beach Communications*, 508 U.S. at 320) (“The assumptions underlying these rationales may be erroneous, but the very fact that they are ‘arguable’ is sufficient, on rational-basis review, to ‘immuniz[e]’ the [government’s] choice from constitutional challenge.”); *American Bus Ass’n v. Rogoff*, 649 F.3d 734 (D.C. Cir. 2011) (quotations omitted) (“But rational-basis review ‘is not a license for courts to judge the wisdom, fairness, or logic of [governmental] choices.’”). The within Decision, and the facts and analysis set forth herein, demonstrate that basis.

Furthermore, EDF has failed to show that SBA’s rational basis is pretext for “an impermissible motive.” *Squaw Valley Development Co. v. Goldberg*, 375 F.3d 936, 944, overruled on other grounds, *Action Apt. Ass’n v. Santa Monica Rent Control Bd.*, 509 F.3d 1020, 1025 (9th Cir. 2007) (quotations omitted) (Where an equal protection claim is based on “selective enforcement of valid laws,” a plaintiff can show that the defendants’ rational basis for selectively enforcing the law is a pretext for “an impermissible motive.”) In *Squaw*, the Court found triable issues of fact regarding one of the defendant’s motives based on, among other things, his genuine animosity toward the plaintiffs and his inability to recall any instance when plaintiffs did not comply with the water quality standards. *See Squaw*, 375 F.3d at 946-47. Unlike the finding in *Squaw*, SBA has articulated numerous instances of EDF’s failure to comply with SBA Loan Program requirements and, as discussed in Section V.B., SBA determined that the former Acting Director of OCRM did not exhibit bias, predisposition, or any other improper or inappropriate motive. As to another defendant, *Squaw* granted summary judgment because plaintiffs had no evidence to show that his decisions were based on personal animosity or that the problem arose from anything other than a disagreement over regulatory methods. *See Squaw*, 375 F.3d at 947-48. Similarly, EDF’s equal protection argument arises from its disagreement with the regulatory process required by SBA regulations rather than a denial of EDF’s inability to pay. *See also Rubinovitz v. Rogato*, 60 F.3d 906, 911-912 (1st Cir. 1995) (illustrating the extreme “malicious orchestrated campaign” needed to surmount the constitutional threshold of an equal protection claim); *see also Bekele v. Ford*, Slip Copy, 2011 WL 4368566 (N.D.Cal. 2011) (denying defendants’ motion to dismiss because there are “sufficient factual allegations to draw a reasonable inference that defendants intentionally treated [plaintiff] differently than other ‘bigger players’ similarly situated and that there was no rational basis for the difference in treatment, and indeed, that the only basis for the discrimination was corruption at City Hall, or so it is alleged.”). Thus, EDF’s equal protection argument must fail.

D. The auditor was qualified to make the findings it has made and it is an independent reviewer

In its December 14, 2011 Response, EDF attempts to discredit the findings of the Audit Report by asserting that (1) 13 CFR §120.1600(a)(1)(ii) does not provide SBA with the authority to hire a dedicated review team, direct that team’s conduct of the review, and then rely on the review team’s report as supposedly independent information obtained from a third party; (2) the review team was not independent; and (3) the reviewers are not qualified, and do not have the requisite

expertise, to arrive at their findings. *See* December 14, 2011 Response at 65 (IX.A). None of these assertions has merit.

Nothing in the regulatory provision cited by EDF prohibits the retention by SBA of a contractor to conduct a targeted review of a CDC as SBA may direct, or the consideration of, and, ultimately, reliance by, SBA on the findings arrived at by such contractor. 13 CFR §120.1010 provides that, “An SBA Lender . . . must allow SBA’s authorized representatives . . . during normal business hours, access to its files to review, inspect, and copy all records and documents, relating to SBA guaranteed loans or as requested for SBA oversight.” *See* 13 C.F.R. § 120.1010. Paragraph 13 of the June 12, 2009 PCLP Loan Guaranty Agreement between SBA and EDF establishing the terms and conditions of EDF’s participation in the PCLP Program, specifically sets forth that EDF “grants SBA’s authorized representatives, during normal business hours, access to its files to review, inspect and copy all records and documents relating to PCLP loans.” Additionally, SBA regulations provide that SBA may conduct on-site reviews of a CDC’s loan operations and may conduct such other on-site reviews and examinations as needed and determined by SBA in its discretion. *See* 13 C.F.R. § 120.1050.

Further, nowhere does EDF assert that SBA in any way directed its contractor to reach pre-determined findings or conclusions, or that the Agency in any way interfered with the auditor’s efforts to develop and set forth its findings. The fact that SBA specified the services it requested the auditor to undertake, and retained overall authority over the conduct of the targeted review conducted by the auditor on behalf of SBA, in no way establishes or implies that the auditor’s professional independence was in any way compromised. And EDF presents not a single fact demonstrating otherwise.

Finally, SBA has fully and carefully reviewed the expertise and experience of the various employees of the auditor who were involved in the targeted review of EDF at issue, and has concluded that the team of individuals employed by the auditor to undertake and complete the subject targeted review were more than adequately experienced with financial accounting, SBA’s 504 Loan program, and commercially accepted practices relating to the appropriate maintenance of loan loss reserve funds to arrive at expert findings relating to EDF’s financial condition; EDF’s actions with respect to, and the adequacy of, the loan loss reserve fund at issue; and the other findings reflected in the Audit Report.

VI. CONCLUSION

It is SBA’s final decision to permanently revoke EDF’s 504 program authority and to permanently transfer EDF’s 504 loan portfolio based on the grounds set forth in SBA’s Notice of Proposed Enforcement Action to EDF as follows:

1. EDF has failed to establish or maintain a Loan Loss Reserve Fund as required by the PCLP Program. Thus, SBA has sufficient grounds for the enforcement action pursuant to 13 C.F.R. § 120.1400(f)(2).
2. EDF has failed to comply materially with SBA’s Loan Program Requirement to pay invoiced obligations in a timely manner as required by 15 U.S.C. §

697e(b)(2)(C) and/or 13 C.F.R. § 120.847(h)(2). Thus, SBA has sufficient grounds for the enforcement action pursuant to 13 C.F.R. § 120.1400(c)(2).

3. EDF has failed to comply materially with SBA's Loan Program Requirement to maintain the financial ability to operate as required by 13 C.F.R. § 120.825. Thus, SBA has sufficient grounds for the enforcement action pursuant to 13 C.F.R. § 120.1400(c)(2).

It is SBA's determination that the foregoing grounds, either individually or in the aggregate, are sufficient to support the final decision. SBA's Notice of Proposed Enforcement Action to EDF set forth two additional grounds. Because those two additional grounds overlap with the grounds for SBA's final decision, SBA sees no reason to address the two additional grounds.

In view of the foregoing, from and after the date hereof, EDF shall no longer have the authority to participate as a CDC in the 504 Loan program. The revocation of EDF's 504 program authority precludes EDF from continuing to close and service its 504 Loan portfolio and process pending 504 Loan applications. Revocation of EDF's 504 program authority therefore requires transfer of its 504 Loan portfolio and its pending 504 Loan applications and all rights associated therewith, including all related processing, closing and servicing functions and the right to receive processing, closing, servicing and late fees, to an entity or entities authorized by SBA to perform such functions in accordance with applicable law. The power to order such a transfer as an incident to an enforcement action is expressly reserved to the Agency by regulation. *See* 13 C.F.R. § 120.1500(e)(1).

In making this final decision, SBA has been guided by the following principles: (1) protection of the integrity of the SBA 504 Loan program and the protection of taxpayers from a lending partner (EDF) who has failed to comply with applicable law, regulations and SBA Loan Program Requirements; (2) SBA's evaluation of the impact of the identified grounds and the proposed actions on the identified risk to the SBA 504 Loan portfolio of EDF; and (3) the lack of ability and willingness of management and/or Board of Directors of EDF to accomplish immediate action to mitigate the serious issues identified herein dictates more severe enforcement action. A formal enforcement action is warranted because the record demonstrates, *inter alia*, that there are significant problems in EDF's systems or controls, deceptive action, substantial law violation, serious compliance problems, and serious reporting failures. Although EDF may have contributed in the past to SBA's mission through a demonstrated commitment to credit gap lending and meeting the needs of underserved markets, it has become apparent that in recent years EDF conducted itself in a manner that significantly increased the risk of the SBA 504 Loan program. EDF may have been affected by local economic conditions during recent years. However, those circumstances neither justify nor excuse EDF's actions as disclosed by the record. Accordingly, the nature, extent and severity of EDF's breaches and violations, including the dollar magnitude of the risk, EDF's insolvency, the unwillingness of EDF's management and board to correct identified problems, and program integrity considerations, all warrant the permanent revocation of EDF's 504 program authority and require the permanent transfer of EDF's SBA 504 Loan portfolio.

VII. NOTICE OF APPEAL RIGHTS

Pursuant to 13 C.F.R. § 120.1600(a)(5), EDF may appeal this Decision only in the appropriate federal district court.

Dated at Washington, D.C. this 17th day of December, 2012.

_____/s/_____
Brent M. Ciurlino
Director
Office of Credit Risk Management