



January 22, 2007

To the Members of the Board of Directors:

The federal indictment of a senior officer at BLX for loan fraud and his admission of the fraud compel me, once again, to call upon the Allied Capital Board of Directors to act for the benefit of the company and its shareholders. Specifically, the Board should exercise its duty of care by removing the present management team that has presided over the metastasizing fraud at BLX and Allied and by quickly moving to take remedial steps to end the dishonest culture perpetuated by current management.

To the numerous particular examples of fraud that the Board has already seen, and willfully ignored, you can now add the indictment of a senior BLX executive and the confirmation that more than \$76 million in loans were fraudulently originated in a single BLX office.

Unfortunately, the fraud is not isolated or limited to a single person or office. You have received and ignored evidence that the fraud extends to numerous other BLX offices around the United States, contrary to what Allied management is telling investors, rating agencies and research analysts. There is evidence that BLX has engaged in similar fraudulent lending in Alabama, Arizona, Arkansas, Colorado, Georgia, Illinois, Louisiana, Maryland, Mississippi, Missouri, New Jersey, New York, Pennsylvania, South Carolina, Tennessee, Texas, and Virginia. Allied's culture of fraud has and continues to divert hundreds of millions of dollars from the SBA's loan program and other government programs. It appears that BLX is the largest SBA fraud in history. And Allied's potential liability for a pattern of fraud goes well beyond Allied's public announcements, as you know.

The Board's Cursory Dismissal Of My Prior Letters To The Board

On two prior occasions, I wrote directly to you about the continuing misconduct of Allied's management and specifically identified the fraudulent issuance of government loans as an urgent issue for the Board's attention. Almost two years ago, in my March 11, 2005 letter, I wrote you the following:

Allied has falsely maintained and increased its valuation of BLX through a scheme dependent on the commission of systematic fraud against the Small Business Administration and, as a result, against the taxpaying citizens of the United States. I have learned that BLX has maintained its loan origination volume only by knowingly approving loan applications that fail to comply with SBA regulations. These applications, among other things, have fraudulently inflated property and collateral values, failed to verify equity injections, contained impermissible property splits and property flips, and other violations of SBA rules that were concealed from the agency. Additionally, many of these loans were the subject of improper loan brokering arrangements.

Your response was cursory and dismissive, stating merely that the information you had received from Allied's management and outside counsel, for which you provided no detail, "has not supported [my] accusations of misconduct." To avoid focusing on the factual merits, your letter attempted to deflect these serious, substantiated issues by suggesting that they should be disregarded because I had, consistent with my research, taken a short position in Allied stock. Indeed, the only noticeable action taken by Allied after my letter was the swift and suspicious elimination of the summary financial disclosure of BLX's performance from Allied's SEC filings.

I am now writing an open letter to you because Allied's pattern of fraud continues and because your responses to my prior private letters demonstrate that the Board refuses to confront the hard cold facts and has opted, instead, to impugn my motives, and management has publicly mischaracterized the specific instances of fraud which I have brought to your attention.

The Harrington Indictment Confirms Misconduct

On December 14, 2006, a grand jury in the Eastern District of Michigan indicted Patrick Harrington, a former Executive Vice President of BLX and head of its Detroit office, for originating more than \$76 million in fraudulent loans. The indictment charges that Harrington often originated these loans through loan brokers, and did so by falsifying information concerning the buyers' financial status, work experience, the true owner of the property, and the value of the property. He is also being indicted for witness tampering and making false statements to a grand jury in 2005 among other things.

Fraudulent loan origination through loan brokers and falsification of information is the exact conduct that I described to you in my March 11, 2005 letter which you summarily dismissed. Furthermore, as explained below, it is evident that Allied knew or should have known long ago about these issues and similar fraud occurring elsewhere at BLX.

Prior Red Flags Informing the Board and Allied Management of Ongoing Fraud at BLX

In its previous responses to my letters, the Audit Committee of Allied's Board sloughed off its responsibility by shifting the burden to me to provide additional "specific" relevant information. As recent events have plainly shown, you should not have required any additional information; the information I had already provided was specific and could have been confirmed if even a basic, independent investigation had been performed. Indeed, over the past several years, you have received from me and from others mounting evidence that BLX has engaged in widespread loan origination fraud – fraud that extends far beyond the scope of the Harrington Indictment. Yet, you have repeatedly ignored this evidence of continuing misconduct by BLX's and Allied's management. A few examples follow:

1. **1999-2003: Allied transfers disqualified SBA loans off-balance sheet to BLX but agrees to take the loans back pursuant to an undisclosed oral agreement.** In 1999, the SBA audited a number of loans originated by Allied Capital Express, Allied's pre-BLX small business lending arm, and disqualified those loans from its guarantee



program. Joan Sweeney, your current COO, was directly responsible for Allied Capital Express.¹ The disqualified loans included loans originated by the now-shut-down Detroit office. Allied did not disclose the negative findings of the audit to the public or reflect the adverse impact on its financial statements. Instead, when Allied formed BLX, Allied swept the problem under the rug by shifting the loans from Allied's balance sheet to BLX's, which Allied did not consolidate. The effect was to "park" the disqualified loans at BLX.

In connection with the transfer of these disqualified loans to BLX, Allied orally agreed with BLX to bear the ultimate cost of this obligation. Allied made no provision on its financial statements to reflect this liability and did not publicly disclose this agreement. Ultimately in 2003, Allied unwound the parking arrangement and took back more than \$9 million of the disqualified loans. The SBA was reimbursed more than \$5 million for related guarantee payments. As I described in my March 11, 2005 letter, when Ms. Sweeney was asked during Allied's fourth quarter 2002 conference call about SBA investigations only weeks after she personally executed the loan transfer agreement that unwound the parking arrangement, she denied, contrary to the evidence, any knowledge on that call.

2. **2001: Allied's attorneys learn of Harrington's misconduct in a deposition of a loan recipient.** During a deposition in a civil lawsuit brought by Allied's former small business lending unit, Allied Capital SBLC Corp., in the Eastern District of Michigan,² Allied's own attorneys obtained the following sworn testimony from one recipient of loans from the Detroit office: (1) her loans from Allied were originated and supervised by Mr. Harrington, head of the Detroit office; (2) because she had previously borrowed the SBA maximum of \$1 million, Allied suggested she form a new corporation and use her brother to sign the loan documents; (3) after her two SBA loans defaulted, Allied instructed her to set up a new company in her 20-year-old daughter's name to borrow additional money; and (4) she ultimately obtained the loan in the name of a different brother who lived in California, and signed her brother's name on the loan documents at the direction and in the presence of Allied personnel. This should have been clear evidence to Allied that Harrington was engaged in misconduct.
3. **1999-2006: Matthew McGee, a felon convicted of securities fraud and a BLX Executive Vice President who headed the Richmond, Virginia Office, directed the fraudulent origination of shrimp boat loans in the Gulf region.** Greenlight recently served a federal lawsuit on BLX, its wholly-owned subsidiary Business Loan Center (BLC) and several individuals with claims arising under the federal False Claims Act relating to tens of millions of dollars of fraudulent SBA 7(a) shrimp boat

¹ Allied Capital Form N-14 filed with the SEC on December 11, 2000, page 93. When the loans became a public issue, despite her direct responsibility, Ms. Sweeney blamed the originations on "a prior management team" in the New York Times on April 27, 2004.

² Allied Capital SBLC Corp. v. Debaeke Properties L.L.C., et al., Civil Action Nos. 00-74574 and 00-74649.



loans extended through the General Purpose Lender Program.³ The complaint seeks treble damages and other remedies. These loans are particularly noteworthy because BLX's Richmond, Virginia office generated many if not all of them. Mr. McGee, head of this office, plead guilty in 1996 to a criminal violation of the federal securities laws, was incarcerated and was separately barred by the SEC from ever working with any investment company (such as Allied).

BLC subsequently obtained permission from the SBA, but not the SEC, to employ Mr. McGee, in a limited capacity where he would not be included in BLC's financial affairs or have credit approval or responsibility.⁴ Mr. McGee subsequently participated in or supervised: (a) the preparation of documents for credit approval, (b) guiding loans through the credit committee, (c) submitting fraudulent loan applications containing false information to the SBA, (d) obtaining SBA guarantees, (e) closing fraudulent loans and (f) disbursing loan funds. When Allied management was questioned about Mr. McGee's employment and role in 2002, they defended his status and conduct.

4. **2002: SBA audit of BLX loan in Georgia uncovers lender violations of SBA policies and procedures.**⁵ In 1998, BLC issued a loan to Kalindi LLC in connection with the purchase and renovation of a Warner Robbins, Georgia motel. After Kalindi defaulted on its loan, BLC issued a second loan, which went to a related company, Magnet Properties, LLC to pay off the defaulted loan and buy the hotel from Kalindi.

In 2002, the SBA Office of the Inspector General audited these two loans and discovered that the loans violated numerous SBA policies and procedures. Among other things, BLC failed to supervise distribution of loan proceeds, did not verify a required \$410,000 equity injection, and violated change of ownership and refinancing criteria thereby transferring BLC's loss to the SBA. The SBA audit determined that these deficiencies were "egregious acts and warrant SBA action to seek civil fraud remedies against the lender," and "the lender's failure to follow prudent lending practices and materially comply with SBA requirements undermined the integrity of the Section 7(a) business loan program." The audit recommended consideration of suspension of BLC's preferred lender program status in the Georgia District Office and civil enforcement remedies under the False Claims Act.

5. **2004: Allied management announces that the SEC and the Department of Justice are investigating Allied's valuation practices and Business Loan Express.** These are two separate investigations, being conducted out of the United States Attorney's Office for the District of Columbia and the SEC in Washington D.C. These investigations of potential criminal violations and violations of the securities laws,

³ United States ex rel James R. Brickman and Greenlight Capital v. Business Loan Express, et al., 05-CV-3147 (JEC). This complaint does not include loans under the Preferred Lending Program (PLP).

⁴ Based on the written correspondence between BLC and the SBA seeking permission to employ Mr. McGee, it appears BLC did not disclose to the SBA Mr. McGee's lifetime SEC ban, which bars him from associating with any broker, dealer, municipal securities dealer, investment adviser or investment company.

⁵ Available at <http://www.sba.gov/ig/2-35.pdf>.



respectively, are in addition to the criminal investigation by the U.S. Attorney's Office in Michigan.

6. **2005: My letter informs the Board of the scale and depth of fraud at BLX.** As noted above, my March 11, 2005 letter described exactly the kind of fraudulent loan origination found by the United States Attorney's Office to exist in BLX's Detroit office, found by the Department of Agriculture in Arkansas, and occurring in BLX's shrimp boat loans in the Gulf region.
7. **2005: Allied becomes aware that the United States Attorney's investigation into fraudulent loan origination at BLX is ongoing.** As set forth in the Harrington Indictment, Mr. Harrington testified before a grand jury in 2005 in connection with an ongoing United States Attorney's investigation into BLX's fraudulent loan originations. Thus, Allied should have known in 2005 through the grand jury investigation of allegations of serious criminal wrongdoing at BLX.
8. **2005: United States Department of Agriculture recommends debaring BLX from the Business & Industry Guaranteed Loan Program.** The Office of the Inspector General at the USDA found that BLX misrepresented property values and other information to the government in connection with a small business loan guaranteed by a division of the USDA. The audit of a BLX loan to an oil and gasoline distributor in Arkansas published in September 2005 found that "the lender misrepresented information to RBS [Rural Business-Cooperative Service], did not comply with key provisions of the guaranteed loan, and used loan funds for unauthorized purposes." Among other things, BLX misrepresented the value of the collateral property and the operational status of the property, and hid the existence of environmental violations. The audit recommended that RBS debar the lender and its subsidiaries from the B&I Guaranteed Loan Program.⁶ Debarment from the program results in automatic debarment from the SBA lending programs pursuant to a government-wide debarment policy.⁷

In short, you have stayed remarkably silent in the face of mounting evidence that BLX's business is a portfolio of fraud. Failure to disclose material information relating to ongoing fraud poorly serves Allied, its shareholders, and the taxpayers whose dollars have supported BLX.

Additionally, it appears that after many years, Allied is finally preparing to write down or even write off its investment in BLX. It also appears that Allied management is positioning itself for an "ostrich defense" by claiming that they had no reason to believe that Allied's investment in BLX should previously have been written down. This is ludicrous since Allied has exercised complete control over BLX and Allied's top management, including CEO

⁶ Available at <http://www.usda.gov/oig/webdocs/34099-07-TE.pdf>. The Rural Business-Cooperative Service ("RBS"), an agency within the Department of Agriculture's "Rural Development mission area," guaranteed 80% of the loan as part of the "Business & Industry Guaranteed Loan Program." Though the report does not identify the lender, the USDA has confirmed that it is BLX.

⁷ Executive Order 12549, 51 F.R. 6370, February 18, 1986 and 13 CFR 145.



William Walton, COO Joan Sweeney, and Managing Director Christina DelDonna, were the majority of managers of BLC.⁸ As the above facts demonstrate, Allied management knew about the fraud at BLX for a very long time and allowed it to continue.

Separate and apart from the fraud at BLX, Allied's valuation of BLX has lacked any reasonable basis for many years.

The Continuing Misrepresentations of Allied Management in Response to Recent Events

In my prior letters, I noted that Allied management has typically employed two tactics in response to criticism: (1) misrepresentations; and (2) *ad hominem* attacks against the critic. Allied's most recent response to the Harrington Indictment is more of the same.

In response to the Harrington Indictment, Allied management has misled research analysts, rating agencies and other market observers by portraying Mr. Harrington's fraud as bad behavior by a single employee in a single office. Allied also claimed that it only recently learned of the investigation and Mr. Harrington's malfeasance and acted quickly and decisively by closing the office, dismissing Mr. Harrington and fully disclosing the events promptly in its November 2006 10-Q. Finally, Allied claimed that its exposure is limited to its \$285 million investment in BLX.

None of this is true.

Allied's Claim That It Only Recently Learned of the Fraud is Not Credible

Allied has had direct knowledge of Mr. Harrington's fraudulent conduct for years. Allied's claim of prompt disclosure is belied by Mr. Harrington's perjury charge, which indicates that the United States Attorney's investigation began at least in 2005, a fact of which Allied was well aware – and did not disclose. It is simply not credible that Allied and BLX could not detect the fraudulent behavior in 2001 when Allied's attorneys heard sworn testimony of Mr. Harrington's misconduct or at least in 2005 when the companies' attention was being pointed directly at those loans by the U.S. Attorney's Office.

Though Allied had already closed the Detroit office and dismissed Mr. Harrington, it deliberately decided not to mention either material event in its Form 10-Q,⁹ quarterly earnings release or in its lengthy presentation on its conference call. Although those significant events were not worthy of Mr. Walton's attention, apparently I was. Mr. Walton used the

⁸ According to BLC state filings, Mr. Walton and Ms. Sweeney stepped down as managers of BLC in January 2006. We find the timing of this change suspicious.

⁹ The limited disclosure made in the third quarter 2006 Form 10-Q was buried and inadequate. The disclosure of the Office of the Inspector General of the SBA and the Department of Justice investigations was not made in the normal place for significant legal developments, where the other government investigations were disclosed. Instead, the disclosure was buried on page 82 under a section called "Change in Unrealized Appreciation or Depreciation" under the subsection "Business Loan Express, LLC." When management was asked to elaborate on the significance of these new disclosures, rather than offer that fraud had been found and that Allied had taken corrective measures by dismissing Harrington and closing the Detroit office, management declined to comment.



opportunity to engage in yet another round of *ad hominem* attacks against me, stating that I was merely “an individual with a motive to depress Allied Capital’s stock” and that he “wish[es] that Mr. Einhorn would give up his quest for a big payday.” You as a Board member owe a duty to Allied’s shareholders to fully investigate the substance of my message – that there is fraud in your company – not condone attacks on the messenger who delivers the incriminating evidence.

Allied’s Claim That the Fraud Involves Only One BLX Office and One Employee Is False

Allied’s claim that the fraud involves only a single BLX office and a single BLX employee is also demonstrably false. According to a sworn affidavit by a Senior Special Agent with the SBA, Mr. Harrington “has admitted that between approximately 2000 and July 2006, he, *and other BLX employees* working at his direction, originated and issued approximately 96 SBA-guaranteed loans knowing...[that they were] falsely and fraudulently documented.”¹⁰ Indeed, if in fact the loan origination fraud was limited to a single BLX employee, why would Allied have found it necessary to close the entire Detroit office?

Most importantly, we have found evidence that BLX has engaged in fraud in many other states. In addition to the frauds cited above from Arkansas, Georgia, and the fraudulent shrimp boat loans (mostly in the Gulf States), we have identified improper loans in Arizona, Colorado, Illinois, Maryland, Missouri, New Jersey, New York, Pennsylvania, South Carolina, Tennessee, Texas, and Virginia.

This widespread fraud has gorged BLX and artificially inflated Allied’s earnings with undeserved revenues, but gouged the SBA and other government agencies at the expense of United States taxpayers. According to publicly available SBA records obtained under the Freedom of Information Act, BLX originated \$1.05 billion of loans during the calendar years 1999-2001.¹¹ BLX has caused the SBA to make guarantee payments on an astounding 23% of those loans. As 44% of these loans remain outstanding, the final reimbursement rate will be even worse. The SBA has made guarantee payments on over **\$370 million of loans issued since 1999.**

Additionally, publicly available information obtained through the Freedom of Information Act shows that the USDA has paid out on 42% of the guaranteed portions of BLX’s loans outstanding under USDA guaranteed lending programs at a cost to the government of \$41 million. These facts are well known to BLX and Allied management.

Given the astronomical guaranteed purchase rate and demonstrable evidence of fraud, it is likely that a large percentage of these payments have been made on fraudulent loans. Because

¹⁰ Emphasis added.

¹¹ We chose the 1999-2001 period because sufficient time has passed for us to be able to definitively analyze the performance of these loans. Not surprisingly, loans in more recent years are less seasoned, but also appear to be tracking to excessive losses. The SBA has already paid guarantees on 15%, 9% and 4% of loans issued in 2002, 2003 and 2004, respectively.



there remains a large portfolio of loans outstanding, the taxpayer exposure to future guarantee obligations for fraudulently originated loans is enormous, potentially in the hundreds of millions of dollars.

Allied's Claim That It Faces Relatively Limited Exposure From BLX's Fraud Understates the Risks

Allied has claimed that it faces only a relatively small exposure because BLX is only a \$284.9 million investment, and only one of Allied's approximately 140 portfolio companies. Allied conveniently omits that BLX is Allied's largest investment, and – in contrast to its other investments – is 95% owned by Allied (with the remaining 5% owned by insiders). This is a far different circumstance from providing a mezzanine loan to a company owned by a third party, a description that fits most of Allied's investment portfolio. Given Allied's control over BLX, any finding that it has actively participated in the fraud could lead to legal liability far beyond its direct investment in BLX.

In addition, Allied's potential exposure plainly exceeds its \$284.9 million valuation of BLX:

- Allied has guaranteed the first 50% of loss on BLX's credit line, a guarantee worth \$188 million;
- Allied has guaranteed letters of credit supporting BLX's securitizations worth \$29 million;
- BLX's banks may sue Allied directly for knowing about the extent of the fraud at the time the banks issued the lines of credit;
- BLX has collected hundreds of millions in guarantees on defaulted loans from the SBA. The SBA has indicated it will seek restitution for fraudulent payments. The government may also seek treble damages and other penalties through the False Claims Act;
- BLX currently maintains a \$2.7 billion portfolio of loans, many if not most of which are similarly guaranteed by the SBA. BLX's historical loss patterns indicate that an alarmingly high percentage of these loans will default, triggering the SBA's guarantee payment obligation. To the extent that any of these loans were fraudulently originated, the SBA may look for BLX/Allied to absorb the loss;
- The SBA data also shows that approximately 75% of the loans for which the SBA made guarantee payments between 1999 and 2005 still have outstanding balances. These loans are effectively in liquidation and are neither charged-off nor resolved. Although it should be relatively simple to promptly liquidate such straightforward small business loans, it often takes BLX several years to complete this process, if the process is completed at all. Delaying the resolution of the loans allows BLX to defer losses on its own books, continue to collect servicing fees, and skew the statistics used by the SBA in its analysis of lenders. We believe that should the SBA determine that



BLX is not properly servicing loans in liquidation,¹² the SBA would have to assume control of the servicing to protect the taxpayer, thereby depriving BLX of its most significant asset. The SBA may also seek reimbursement for previous servicing fees to the extent they have been earned improperly;¹³

- Allied's inadequate disclosures could result in liability to its shareholders for potential violations of federal securities laws. Since 2002, Allied has raised more than \$900 million in equity, including \$200 million since the end of the second quarter of 2006;
- The government could pursue further civil or criminal actions and seek fines and penalties. Indeed, this apparent corrupt, fraudulent enterprise could expose Allied and/or BLX to criminal RICO liability in which the government could seek forfeiture of assets, including all the BLX property involved in the conduct and fines of twice the gross profits or other proceeds. Civil liability under RICO could also lead to, among other things, treble damages.

Allied's Claim That BLX is Financially Strong is Belied by Its Weak Balance Sheet, Growing Debt and Falling Profits

In its January 15, 2007 press release, Allied indicates BLX is in a strong financial position with \$190 million of equity and "a substantial cash flow stream from its residual interests and servicing assets." In particular, Allied notes, "If scheduled loan payments were to be received as stated in the loan agreements with no future losses or prepayments, BLX would receive future cash flows of over \$1 billion over time." Obviously, it is not realistic to make these assumptions. This statement appears to be a misleading attempt to give investors an unrealistic impression of BLX's value.

The truth is that BLX is in a precarious financial position and has limited financial resources. Over BLX's life it has been a steady user of cash. When Allied provided summary financial disclosure of BLX in the Form 10-Q in the second quarter of 2002, BLX had borrowed \$96 million on its credit line. Even with the benefit of the residual interest cash flow, four-and-a-half years later that figure has steadily grown to \$322 million.

Allied has taken numerous steps to prop-up BLX including converting its debt investment into equity and increasing its equity investment. Even prior to this latest crisis, BLX's operations had deteriorated, as demonstrated by the steady reduction in income Allied receives from BLX. Tellingly, Allied did not disclose BLX's EBITM,¹⁴ which used to be the key metric Allied highlighted when describing BLX's performance. Allied has cited higher loan prepayments and scaled back originations in its most recent filings to explain the

¹² 13 CFR 120.453 requires use of generally accepted commercial banking standards employed by prudent lenders.

¹³ The unusual period it takes BLX to resolve defaulted loans may explain why Allied claims that BLX suffers losses in its loan portfolio of only 1-2%. The delays defer the recognition of losses and charge-offs, artificially lowering BLX's reported loss rate and skewing SBA statistics.

¹⁴ Earnings Before Interest, Taxes and Management Fees.



deterioration.¹⁵ Putting aside the obvious valuation questions from the growing debt and falling income, it is unlikely that BLX can make significant restitution without further financial support from Allied.

As I have stated to you in my prior letters, I continue to have concerns about your company entirely apart from BLX. We have both statistical and anecdotal evidence that Allied has similarly overvalued other investments in its portfolio and engaged in performance smoothing and other improper behavior. As for the recent illegal accessing of my phone records and those of other Allied critics, we note your carefully worded and now familiar denial that you have “found no evidence” to support my accusation that management or its agents improperly accessed telephone records. We believe that the government has been investigating whether Allied or its agents accessed those records and whether the acts were related to our criticism of Allied.

* * * *

I cannot fathom how the Board has ignored such a wide-scale and continuing fraud by BLX and Allied. A serious investigation would have confirmed what we told you years ago. Yet each new revelation about the fraud – whether from the Department of Justice, other government agencies, analysts, or the investigative media – is met with escalating denials from Allied’s management and deafening silence from the Board.

This must end. It is time to get serious about cleaning up the dishonesty within Allied. Allied has spent tens of millions of dollars of shareholder money defending current management. Instead of further defending them, your duty to Allied and its shareholders mandates that you dismiss responsible management and conduct a full, complete investigation into all of the issues currently facing Allied, including BLX’s loan origination fraud, Allied’s misleading valuation of BLX, Allied’s misleading valuation of other investments, and its continued efforts to mislead the public about these issues. Your continuing silence and inaction does a serious disservice to Allied, its shareholders, the capital markets and taxpayers.

Yours,



David Einhorn

¹⁵ Allied Capital Form 10-Q for the quarter ended June 30, 2006, page 80.

