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August 18, 2015

Pepper Submits Comments on SBA's Model Form of Agreement of Limited Partnership

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In June, the U.S. Small Business Administration (SBA) issued a notice in the *Federal Register* soliciting comments on a proposed revision of the SBA's Model Form of Agreement of Limited Partnership for an SBIC Issuing Debentures Only, Version 3.0.

On August 10, 2015, the leaders of Pepper's Small Business Investment Company (SBIC) Practice, Michael B. Staebler and Christopher A. Rossi, submitted the firm's comments.

Review the submission beginning on the next page.

Pepper Hamilton LLP's SBIC Practice has represented more than 235 successfully licensed SBICs and has experience representing private equity funds in connection with their formation, operations and investment activities. Our practice is uniquely qualified to provide comments based on the firm's experience and conversations held with members of the SBIC community.

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August 10, 2015

Javier Saade
Associate Administrator, Office of Investment & Innovation
U.S. Small Business Administration
409 3rd Street, S.W., Suite 6300
Washington, DC 20416

Re: Comments to Revised SBA Model Form of Agreement of Limited Partnership for an SBIC Issuing Debentures Only, Version 3.0; Docket ID No. SBA-2015-0010

Dear Mr. Saade:

We are sending this letter to you in response to the notice (the "Notice") published by the U.S. Small Business Administration ("SBA") in the Federal Register on June 26, 2015, Vol. 80, No. 123, pp. 36881-36882, soliciting comments on a proposed revision of SBA's Model Form of Agreement of Limited Partnership for an SBIC Issuing Debentures Only, Version 3.0 (the "Proposed Model"). We are responding in our capacity as a law firm that has, since 1994, represented more than 235 successfully licensed SBICs and extensive experience representing private equity funds in connection with their formation, operations and investment activities. We are, consequently, quite familiar with provisions in limited partnership agreements that are currently considered customary by fund sponsors and investors in those funds. In addition, we also represent limited partners (such as funds of funds) in connection with their investments in private equity funds. Therefore, we are aware of the dialogues between fund sponsors and investors of all types (including individuals, family offices, banks, public and private pension plans and other institutional investors) with respect to terms negotiated in private equity fund limited partnership agreements.

We appreciate SBA's effort to update its existing model limited partnership agreement (currently Version 2.0, dated October 21, 2010 (the "Existing Model")) with the Proposed Model. There have been extensive updates – both to the provisions which are in bold-faced Arial font type (these provisions are sometimes referred to in this letter as the "mandatory provisions") and to the provisions which are not in bold-faced Arial font type (these provisions are sometimes referred to in this letter as "optional provisions") – to the Existing Model. As SBA states in its introductory notes to the Proposed Model, SBA publishes a form of limited partnership agreement to serve as a working model to which an SBIC's fund managers and limited partners can refer as an outline for basic provisions customarily found in limited partnership agreements of private equity funds, while at the same time including certain language SBA requires to implement specific requirements of the Small Business Investment Act of 1958, as amended and the rules and regulations promulgated thereunder (the "SBIC Act"). The mandatory provisions are those which SBA believes are required to implement specific provisions of the SBIC Act or are necessary to help ensure the repayment of Debenture Leverage. The optional provisions represent SBA's suggested wording to serve as a guide for additional provisions that are often addressed in limited partnership agreements for private equity funds.

In our view, many of the suggested changes in the Proposed Model, particularly those contained in the additional and updated optional provisions reflect positive updates to bring the SBA's model limited partnership agreement more in line with customary norms. However, the Proposed Model also contains terms (both in the mandatory and optional provisions) that extend significantly beyond market norms or even take positions which are contrary to well established legal principles and customary practices in the marketplace.[1] We believe these provisions will put SBICs at a significant disadvantage in the market as they arm potential investors with "negotiated" positions that appear to be deemed approved or required by SBA, serve as a disincentive to well qualified fund managers who might otherwise seek SBIC licenses, and ultimately defeat the policy and purpose of the SBIC Act to support and promote investment in U.S. small businesses in a manner designed to insure the maximum participation of private financing sources.[2]

In addition, many of the new provisions are unrelated to SBA's position as a creditor or regulator of SBICs. While off-putting to potential participants in the program they also will result (as they already do) in increased delay and complexity in the licensing process. The perceived need by SBA's staff to review and then comment upon or negotiate deviations from these optional provisions proposed by SBIC license applicants and their investors consumes considerable time in the licensing process.

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[1] On May 15, 2014 a working group of lawyers from this Firm, Semmes Bowen and Semmes, Edwards Wildman (who are now with Jenner & Block) and Foley Hoag submitted to SBA a draft form of model limited partnership agreement (the "Four Firm LPA"). The Four Firm LPA was prepared to begin an active dialogue among SBA and various SBIC constituencies to update SBA's Existing Model. Consistent with the spirit and purpose of SBA publishing a model limited partnership agreement for SBIC's, the Four Firm LPA was designed to provide a variety of alternatives for SBIC fund managers and limited partners to consider when addressing various subject matter customarily seen in private fund limited partnership agreements. Many of these alternatives were styled within bracketed text and structured to reveal considerations for a balancing of interests*, as the fund managers and limited partners may themselves consider appropriate for their needs*. Indeed, some of the provisions contained within brackets included concepts that could be seen as "fund manager friendly" or "limited partner friendly." Although it appears that SBA accepted many of the "neutral" provisions proposed in Four Firm LPA (*e.g.*, updates to the capital account allocation mechanisms), it also appears that SBA has, unfortunately, "cherry-picked" among the various alternative provisions suggested and styled within brackets, particularly those which "favor" limited partners, and has in many instances inappropriately expanded those provisions beyond market norms without offering the countervailing considerations. Further, SBA removed the brackets from the text; thereby leaving the impression that the language is required or favored by SBA. We think it is a mistake for SBA to publish a model limited partnership agreement that clearly is weighted in favor of "LPA friendly" provisions, rather than balanced provisions. We do not think it advisable for SBA to interject itself in the marketplace in this manner.

[2] See Section 102 of the SBIC Act (15 U.S.C. §661).

We believe all constituencies to Debenture SBICs greatly benefit when they are free to negotiate their limited partnership agreements to incorporate business understandings that reflect current market conditions and terms and conditions (as they may evolve over time) that align the interest of an SBIC's managers with those of the SBIC's investors, all while recognizing and preserving SBA's interest to ensure compliance with the SBIC Act and that all Debenture Leverage is repaid. In this regard, the final form of SBA's model limited partnership agreement should reflect the differences between the Debenture SBIC program and the terminated Participating Securities program because, unlike the terminated Participating Securities program in which SBA was a preferred limited partner in an SBIC, SBA is a lender under the Debenture program.

SBA should also recognize the significant differences between SBICs and their larger counterparts and competitors in the marketplace. The Proposed Model incorporates (and in our view even extends beyond) various positions advocated by the Institutional Limited Partners Association ("ILPA"), an association of very large institutional investors that typically invest only in the largest of private equity funds. Although ILPA has had success in moderating fund terms more in favor of limited partners, sponsors of larger private funds are still able to negotiate terms that are more favorable to them, and limited partners in such funds are generally presented with a "take it or leave" it approach when it comes to negotiating terms. The limited partners in SBIC funds, on the other hand, are typically able to (and, in our experience, often do) negotiate stronger investor protections than the limited partners in larger funds. Therefore, SBA should not be advocating or suggesting, either through specific contract language or in footnotes, any position on terms (whether more favorable to the SBIC's managers relative to its limited partners or *vice versa*) that do not contradict a requirement under the SBIC Act or are not necessary to ensure that Debenture Leverage gets repaid. Freedom to contract, to the extent not inconsistent with the SBIC Act, should be the overall guiding principle in SBA's preparation and publication of its final form of model limited partnership agreement.

Accordingly, the focus of our comments in this letter will be on various of the mandatory provisions in the Proposed Model because, in our experience, SBA has historically permitted SBIC's fund sponsors and limited partners to include specifically negotiated provisions which are in addition to, or different from, the optional provisions contained in the Existing Model so long as they did not contradict the SBIC Act or the mandatory language contained in the Existing Model. However, our review of the Proposed Model (and recent experience in advising our clients through SBA's legal document review portion of the SBIC licensing process) suggests that SBA is seeking to implement policy and regulatory interpretation changes through proposed modifications not only to the mandatory provisions but also to certain of the optional provisions. We, therefore, are concerned that these optional provisions are intended to and will become, in practice, *de facto* mandatory provisions, as our experience indicates frequently occurs. We are also concerned that the provisions which appear to implement recent SBA policy and regulatory interpretation changes will have an adverse effect on the Debenture program by putting SBICs at a disadvantage in the marketplace. Therefore, this letter also contains our comments to those optional provisions contained in the Proposed Model which we believe are moving beyond providing mere guidance and are instead signaling a change in policy direction or regulatory interpretation by SBA that will be disadvantageous to SBICs and impair the policy and purpose of the Debenture program under the SBIC Act by deterring well qualified fund managers from seeking SBIC licenses. Our comments also include technical suggested wording changes to make the document more consistent internally and with the SBIC Act.[3] Capitalized terms used but not otherwise defined in this letter have the respective meanings ascribed to such terms in the SBIC Act or the Proposed Model, as applicable. For ease of reference, our comments to the Proposed Model are generally presented in the order in which the concepts about which are commenting appear in the Proposed Model.

SECTION 1.01 – DEFINITIONS

Below are our comments to certain of the definitions contained in the Proposed Model. Most of these comments are technical in nature.

1. "*Assumed Leverage*" – The definition of "Assumed Leverage" is a mandatory provision in the Proposed Model. The new language in the definition of Assumed Leverage caps the amount of Assumed Leverage at two (2) times the SBIC's Regulatory Capital. Although 13 CFR §107.1150, provides that SBA will generally limit Leverage commitments to 200% of an SBIC's Regulatory Capital, §107.1150 also contemplates the possibility that SBA may approve Leverage commitments in excess of 200% (and up to 300%) of an SBIC's Regulatory Capital under certain circumstances so long as the maximum amount of Leverage commitments to any single SBIC does not exceed $150 million. Thus, the new language does not conform with, and indeed contradicts, §107.1150 because it removes the possibility that an SBIC could obtain a Leverage commitment for up to 300% of its Regulatory Capital so long as its total Leverage commitments does not exceed $150 million.. Under the Existing Model, an SBIC's Management Fee Base would be permitted to include Assumed Leverage in excess of 200% of its Regulatory Capital without an amendment to its limited partnership agreement. However, by including the new cap language, that SBIC would need to obtain an amendment to its limited partnership agreement to do so. It seems such a step is unnecessary given the existing regulatory constraints. Therefore, we believe that the definition of "Assumed Leverage" contained in the Existing Model is sufficient and that the inclusion of the new "not to exceed two (2) times" cap contained in the Proposed Model should be eliminated. The reference to "not exceed two (2) times the Partnership's Regulatory Capital" in footnote 36 of the Proposed Model should be deleted for the same reasons.

2. "*Banking Acts*" – The definition of "Banking Acts" is an optional provision that now includes the USA Patriot Act as one of several listed laws falling within the concept of "Banking Acts." We do not understand the reason for such inclusion and suggest that it be removed.

[3] We would like to note that our failure to comment upon any specific provision or language in the Proposed Model is not intended to be viewed by SBA or others as an acquiescence by this Firm or any of our clients that (1) such language is appropriate or the best way to address the subject matter of such provision or language or (2) additional subject matter not addressed by the Proposed Model should not be included in an SBIC's limited partnership agreement.

3. "*Covered Party*" – The definition of "Covered Party" in the Proposed Model (a new mandatory provision which replaces the definition of "Designated Party" in the Existing Model) is a concept used in relation to the standard of care and indemnification provisions contained in Sections 3.09 and 3.10 of the Proposed Model. We provide more detailed comments to those two sections below. This definition includes in clause (v) a list of persons "who serve at the request of the General Partner on behalf of the Partnership as an officer, director, employee, agent or member of any other entity, including, without limitation, a Portfolio Company." The inclusion of such persons within the category of persons entitled to the benefit of the exculpation and indemnification provisions of Section 3.09 and Section 3.10 is a welcome update to the extent that an SBIC would like to extend the protection of those provisions to such individuals. However, we do not believe that the extension of these provisions to such persons should be mandatory. In addition, given that these persons will be serving as fiduciaries to the entity to which they have been requested to serve, we believe that they should be subject to the standard of care set forth in Section 3.09(b) rather than Section 3.09(a) to the extent they are extended the benefit of the exculpation provisions of Section 3.09. Therefore, we suggest that clause (v) be removed from the definition of "Covered Party" and that Section 3.09(b) be revised to include a reference to such persons to the extent the SBIC desires to extend the provisions of Section 3.09(b) to such persons as follows:

> "(b) Standard of Care for Other Parties. Neither any Limited Partner, any member of any Partnership committee or board[(including the Advisory Board)] who is not an Affiliate of the General Partner, nor any Person who is not an Affiliate of the General Partner and who serves at the request of the General Partner on behalf of the Partnership as an officer, director, employee, agent or member of any other entity, including without limitation, any Portfolio Company, will be liable to the Partnership or any Partner as a result of any decision made in good faith by such Limited Partner, such committee or board member or such Person, in its capacity as such."

4. We suggest that a definition of "Depreciation" be added to the Proposed Model because the term "Depreciation" is used in the definitions of "Gross Asset Value" and "Net Profits," but Depreciation is not a defined term in the Proposed Model. We suggest the following definition:

> "Depreciation" means, for each Fiscal Year or other period, an amount equal to the depreciation, amortization, or other cost recovery deduction allowable for federal income tax purposes with respect to an asset for such year or other period, except that if the Gross Asset Value of an asset differs from its adjusted basis for federal income tax purposes at the beginning of such year or other period, Depreciation shall be an amount which bears the same ratio to such beginning Gross Asset Value as the federal income tax depreciation, amortization, or other cost recovery deduction for such year or other period bears to such beginning adjusted tax basis. In the event that the federal income tax depreciation, amortization, or other cost recovery deduction is zero, Depreciation shall be determined with reference to such beginning Gross Asset Value using any reasonable method, except to the extent the Code Section 704(c) "remedial allocation" method has been elected with respect to the underlying Partnership property in which case

Depreciation with respect to such property shall be calculated in a manner consistent with Treasury Regulations §1.704-3(d)."

5. "*Gross Asset Value*" – Clause (a) in the definition of Gross Asset Value contains a parenthetical providing "with any unrealized appreciation…not reflected in such valuation deemed realized…" We do not think this parenthetical should be in clause (a) because clause (a) contemplates situations where property is being contributed and is first getting booked by the SBIC. Thus, there is no reason to say "deemed realized" in clause (a) here. We also note that clauses (a) and (d) require valuation to be based on or determined in accordance with Section 3.08, but clause (b) says "as determined by the General Partner in accordance with this Agreement." We believe that all three clauses should refer to the value "as determined pursuant to Section 3.08."

6. "*Indemnifiable Costs*" – The definition of "Indemnifiable Costs" (a mandatory provision) should include threatened claims, actions, suits, proceedings or investigations. Such inclusion would be consistent with market norms and the expectations of fund managers and limited partners.

7. "*Investment Period*" and "*Commencement Date*" – The definition of "Investment Period" is a new defined term in the Proposed Model. The first sentence of the definition is a mandatory provision (even though this term does not appear in any other mandatory provision elsewhere in the Proposed Model) and the second sentence is an optional provision. The mandatory portion of the term "Investment Period" requires that the "Investment Period"[4] start on the "Commencement Date." The "Commencement Date" is a new defined term (and a mandatory provision) defined as the date on which the first capital contribution is made to the SBIC. Although the addition of these two defined terms provides appropriate guidance for the provisions contained in the Proposed Model that utilize these concepts, we believe they should be optional provisions and not mandatory provisions. We frequently encounter SBICs where the fund managers and limited partners want to delay the beginning of the investment period until the SBIC receives its license, which often is months after the initial capital contribution. It also is very common in the private fund world for the investment period to begin at the end of the fundraising period (which is very important to the later investors). SBIC's and their investors should be free to design the structure of the SBIC's investment period to start at a later date if they so desire. For example, such flexibility is highly desirable in the case of SBIC applicants that have a significant number of bank investors who are now no longer permitted under the Volker Rule to invest in private funds other than SBICs and funds that make "public welfare investments." To solve the "chicken and egg" situation created by the SBIC Act and SBA's licensing procedures which require an SBIC applicant to have paid-in capital of at least $2.5

[4] In the private equity fund context, the term "investment period" generally refers to the period during which the fund is permitted to make investments in companies in which the fund has not previously made an investment.

million before it can obtain an SBIC license,[5] many bank investors fund their initial capital contributions in escrow pending receipt of the SBIC license. In such situations, the applicant and its limited partners do not want the investment period to begin until the fund is licensed to operate as an SBIC.[6]

8. "*Majority in Interest of Limited Partners*" – The definition of "Majority in Interest of the Limited Partners" (a new optional provision) contains language which excludes the capital contributions of "Associates and Affiliates of the General Partner" from the determination of the voting threshold needed to reach the requisite majority. As an initial matter, we do not believe that SBA should include such language in its model limited partnership agreement (even as an optional provision). Although it is true that limited partners sometimes seek and successfully negotiate this type of language in limited partnership agreements, many times such language is limited to approvals sought on specified matters under the limited partnership agreement that directly impact the general partner or management company or relate to certain types of transactions, particularly those that may involve the general partner, the management company or any of their respective affiliates. This is particularly true in situations where the fund managers and other affiliates of the general partner are significant limited partners in an SBIC. To the extent such language is included in the final model limited partnership agreement published by SBA, the use of the term "Associates" in reference to the General Partner is not appropriate and should be eliminated because the term "Associates," as defined in the SBIC Act,[7] is defined with reference to a "Licensee" (*i.e.*, the SBIC) *not* the General Partner or any other person. Thus, there is no legal basis for SBA or an SBIC to apply the multi-dimensional and complex concepts embodied within the definition of "Associate" to a General Partner. The foregoing comments also apply to the definition of "________ Percent (__%) in Interest of the Limited Partners" contained in Section 1.01 of the Proposed Model.

9. "*Management Fee Rate*" – The definition of "Management Fee Rate" (an optional provision) includes footnote 13 which encourages Limited Partners to engage in negotiations with SBIC applicants and suggests alternative terms to use within the definition of "Management Fee Base." As a threshold matter, SBIC fund managers and limited partners should be free to negotiate their own management fee structures, including with respect to the management fee rate, the base upon which the rate is to be applied, the period during which management fee is to be paid and related matters. Moreover, we do not believe it is appropriate for the final model limited partnership agreement published by SBA to advocate or suggest any position on terms (whether more favorable to the SBIC's managers relative to its limited partners or *vice versa*).

[5] 13 CFR §107.210(a) requires that an SBIC applicant have at least $2.5 million in Leverageable Capital as a condition to its receipt of an SBIC license. SBA requires that this $2.5 million be paid to the applicant before SBA's Agency Licensing Committee meets to consider the applicant's application for approval.

[6] As an aside, we note that in these situations, the "Management Fee Initial Period" typically does not start until the fund is licensed as an SBIC.

[7] See 13 CFR §107.50.

Many fund managers charge their SBICs management fees that are lower than the maximum amount permitted by SBA TechNote 7A. While footnote 13 may seem an innocuous suggestion by SBA, it is at conflict with SBA's new proposed language in Section 3.07(a), which seeks to allocate new costs to the Investment Adviser/Manager and mandate new offsets against the management fee. These new costs and mandates will, for the reasons we later articulate, likely result in pressure for fund managers to seek an increase in management fees. Therefore, footnote 13 should be limited to the cross-reference to Section 3.05 and the second sentence which states that the rate set forth in brackets is the maximum rate permitted by SBA. Footnote 33 in the Proposed Model should be eliminated for the same reasons.

10. "*Net Profit*" – The penultimate sentence of definition of "Net Profit" should refer to 5.04(f). We believe that the reference to Section 8.03 in that sentence should be deleted.

11. "*Organization Expenses*" – The definition of "Organization Expenses" is a new mandatory provision which provides the impression SBA is taking a policy position that SBIC's will not be permitted to pay placement agent fees incurred in connection with an SBIC's fundraising activities. We welcome the inclusion of the concept of "Organization Expenses" in the Proposed Model, although we believe it should be an optional provision, not a mandatory provision. Although we understand that ILPA has articulated a position that placement agent fees should be paid by the fund managers (and many fund managers agree to bear such fees), we believe that SBIC's and their investors should be free to negotiate the parameters which allocate who bears the expenses associated with placement agent fees and the final model limited partnership agreement published by SBA should eliminate the reference to placement agent fees. Many small investment funds, such as SBICs, pay for placement fees. We believe that the genesis of ILPA's position was large, often public employee, pension funds that wanted to limit the use of politically connected "advisers" or investment bankers to provide warm introductions to their funds. Small SBICs have found it helpful to use licensed investment bankers in a few instances. This new SBA policy would provide a barrier to do so and should not be implemented.

12. "*Principal*" – The definition of "Principal" is a new optional provision which is drafted in a manner that lists specified individuals as "principals" but does not provide flexibility to address situations when an individual no longer serves as a principal or new individuals are added as principals.[8] If an individual is no longer a Principal, then provisions of the SBIC's limited partnership agreement that apply to the Principals as such should no longer apply to that individual.[9] Similarly, if the SBIC would like to add a new Principal, it should be able to do so

[8] In SBA regulatory practice, the term "Principal" is used to refer to those individuals who engage in the management of an SBIC, and customarily includes directors, officers or managers of the SBIC's General Partner who will have a vote in investment decisions. See SBA Form 2181, 2182 and 2183 Application Instructions, page 8.

[9] See, for example, Section 3.04(c) of the Proposed Model (prohibiting a Principal from acting as a general partner or principal or in a similar management capacity for an entity with investment objectives substantially

(provided, of course, SBA has approved such individual to serve as a principal) without the need to obtain an amendment to its limited partnership agreement to do so. Being mindful of all of this, we therefore, propose that the definition of "Principal" be revised to read as follows:

> " "Principal" means [_________], [_________] and [________], in each case, so long as such individual is [a manager of or serves in a similar capacity for] the [General Partner] [Investment Adviser/Manager], and any other individual who the [General Partner] [and a Majority in Interest of the Limited Partners] designate as a Principal, so long as that individual is [a manager of or serves in a similar capacity for] the [General Partner] [Investment Adviser/Manager], in each of the foregoing cases, subject to approval of SBA."

Note that the bracketed language in the proposed definition is intended to convey that a Principal could have different titles and roles within the General Partner's or Investment Adviser/Manager's organization.

13. "*Target Account*" – We believe that the cross reference at the end should be to Section 7.01(b) and not to "7.01(b)[indicate clause] through 7.01(b)[indicate clause]" because the Target Account concept is intended to capture the entire distribution waterfall in Section 7.01(b).

ARTICLE 3 - MANAGEMENT

1. *Section 3.03(b)(iv)* – Section 3.03(b)(iv) is a proposed new mandatory provision which mandates that the agreement delegating any part of the General Partner's authority to an Investment Adviser/Manager include a provision requiring the Investment Adviser/Manager to comply with 13 CFR §107.691 to the extent that the Investment Adviser/Manager maintains any books, records other documents or material subject to examination by SBA. We note that the requirements of 13 CFR §107.691 only apply to the SBIC and, through 13 CFR §107.160(b)(2), to the SBIC's General Partner. We understand and agree with the need for SBA to have access to all books and records that may be maintained by the Investment Adviser/Manager to the extent the Investment Adviser/Manager maintains them. However, SBA does not have regulatory authority over the Investment Adviser/Manager. Thus, we propose revising the provision to read as follows:

> "(iv) to the extent the Investment Adviser/Manager maintains any books, records and other pertinent documents and materials subject to examination by SBA under the SBIC Act, the Investment Adviser/Manager will make such books, records and other pertinent documents and materials available to the Partnership and the General Partner so as to enable the Partnership and the General Partner to comply with their obligations under 13 CFR §107.691."

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similar to the Partnership unless certain conditions are satisfied). If the definition of Principal does not contain flexibility to address an individual who no longer serves as a Principal, then such individuals would be precluded from managing another investment fund. This is not the intended outcome of Section 3.04(c).

2. *Section 3.05(a)* – Section 3.05(a) is a provision which is partially mandatory and partially optional. The mandatory portion of Section 3.05(a) states, "[a]s Management Compensation for services rendered to the Partnership, beginning on the Commencement Date and ending on the termination of the Partnership, the Partnership will pay an annual management fee computed on a daily basis equal to . . . [remaining language of Section 3.05(a) which is optional]." In our view, Section 3.05(a) should be an optional provision in its entirety so that SBIC's and their investors are free to design the period during which the SBIC is required to pay management fees in a manner that best suits their needs. Indeed, the first sentence of footnote 35 in the Proposed Model states as such and we support the inclusion of that sentence in footnote 35. As previously mentioned, many SBIC's and their investors negotiate terms that begin the payment of management fees at some point after the Commencement Date so long as the payment of management fees begins no later than the date required by TechNote 7A. TechNote 7A requires that the initial management period begin on the first to occur of: (1) the date on which the SBIC's application for an SBIC license has been approved; (2) the date on which the SBIC makes its first portfolio investment; and (3) the date on which the SBIC first charged or accrues any Management Compensation based upon Assumed Leverage. We also note that the mandatory language in Section 3.05(a) of the Proposed Model that requires the SBIC to pay Management Compensation "beginning on the Commencement Date" contradicts SBA's TechNote 7A which sets forth when the "Management Fee Initial Period" must begin. In short, the date on which the payment of Management Compensation must begin should be an optional provision left to the negotiation of the parties, subject to the constraints of TechNote 7A.

We also observe that footnote 35 of the Proposed Model states that "The Limited Partners may negotiate a lower rate than the maximum rate provided in the Management Fee definition, including among other things, whether the Partnership accrues or pays any Management Compensation prior to the receipt of an SBIC license." For reasons previously discussed, it is inappropriate for the final model limited partnership agreement published by SBA to advocate or suggest any position on terms (whether more favorable to the SBIC's managers relative to its limited partners or vice versa). Thus, this sentence should be deleted.

Footnote 35 also states, "SBA will not approve Management Compensation formulas that are inequitable to SBA or the Partnership" and continues by citing as an example situations where "any Limited Partner is charged a lower rate than the rate set in this Agreement" and requires in such situations, that "the Management Fee Rate charged on Assumed Leverage must be the blended rate being charged on all Commitments." In our view, this is an unwarranted change in SBA policy. As a threshold matter, it is difficult to understand how payment of any Management Compensation by an SBIC can be "inequitable" to SBA because SBA does not pay any management fee. The fact that "Assumed Leverage" may be included in an SBIC's Management Fee Base during the SBIC's Management Fee Initial Period does not alter this fact. SBA is a creditor of the SBIC, not a limited partner. As such, none of the Management Compensation is paid by, or is otherwise allocable to, SBA. Moreover, market dynamics sometimes require that an SBIC offer a reduced management fee rate as an incentive to early/anchor investors whose capital commitment is necessary to create the SBIC and/or is significantly larger than that of other investors. Such incentives can be particularly important to emerging/first time SBIC fund managers. In our experience, the possibility of these reduced management fee rate incentives are disclosed to the other limited partners, who are then free to decide whether or not they still want to invest in the SBIC. SBA should not interfere in these market dynamics. Thus, these provisions in footnote 35 should be deleted.

The last sentence of footnote 35 also contains a statement to the effect that SBA will not permit SBIC's utilizing a drop-down structure to pay a higher management fee at the SBIC level than the fee paid by the parent fund. It is difficult to understand why SBA has incorporated this sentence in the Proposed Model and it is unclear what problem SBA is seeking to solve with this statement. It is unclear whether SBA is seeking to implement a policy suggesting that the total dollar amount of an SBIC's Management Compensation cannot be more than the total dollar amount of the management fee paid by the fund. If so, then SBA should not implement that policy because some drop-down structures result as much of 75% of capital commitments to the parent fund being, in turn, committed by the parent fund to the drop-down SBIC.[10] As SBA knows, all limited partners in the parent fund are required to become "Class B Limited Partners" in the drop-down SBIC.[11] Thus, the limited partners of the parent fund are aware of the terms and conditions of the drop-down SBIC's limited partnership agreement, including those relating to the calculation and payment of Management Compensation by the drop-down SBIC. In our experience with structuring drop-down SBIC's, the parent fund's limited partners have already negotiated a management fee and when the drop-down SBIC is formed, the parent fund limited partnership agreement is amended to provide that the total management fee paid by the limited partners does not exceed the amount that would have been paid by them had there only been a single SBIC fund rather than a parent fund and drop-down SBIC. If SBA is seeking to implement a policy that requires the management fee rate for the parent fund and the drop-down SBIC to be the same, then we object to that policy because the limited partners, not SBA, are paying the management fees. SBA has already implemented a policy in TechNote 7A which sets forth the maximum Management Compensation an SBIC is permitted to pay. The fact that an SBIC is or is not a drop-down SBIC is irrelevant to the determination of whether or not the SBIC should be permitted to pay the maximum amount of Management Compensation if the limited partners have agreed to do so. At the end of the day, SBA is not paying any management fees. Rather, management fees are being paid solely by the limited partners, who are free to negotiate with the fund managers the appropriate level of management fee. Finally, it is inappropriate for SBA to adopt and implement any policy changes in a footnote to the model limited partnership agreement.

[10]SBA policy requires that the parent fund of a drop-down SBIC retain at least 25% of the capital commitments made to the parent fund for its own use.

[11]SBA requires that the parent fund limited partners become "Class B Limited Partners" in the drop-down SBIC in order to "back-up" the capital commitment of the parent fund in the event that the parent fund does not pay its entire capital commitment to the drop-down SBIC. In a typical drop-down SBIC structure, all economic benefits associated with the drop-down SBIC flow solely to the parent fund and then to the partners of the parent fund.

3. *Section 3.06(c)* – Section 3.06(c) is an optional provision[12] which implements TechNote 7A's requirement that all fees described under 13 CFR §107.860 and fees earned by SBIC Associates under 13 CFR §107.900 inure to benefit the SBIC and, hence, either be paid directly to the SBIC or used to offset Management Compensation paid by the SBIC. In our experience, a 100% offset is not customary for private equity funds. Rather, the amount of the offset is and should be a subject of negotiation between the fund sponsor and its limited partners. Our experience indicates that the offset for lower middle market private equity funds (the portion of the market in which most, if not virtually all, SBICs invest) ranges from 50% to 80%, depending upon the circumstances. SBICs are disadvantaged in their negotiations with investors because of current SBA requirements. Accordingly, we recommend that SBA allow the market to determine the extent of the management fee offset.

We note that the language in Section 3.06(c) of the Proposed Model requires offset to Management Compensation for financing fees, management services fees, director fees and transaction fees received by *"Associates" of the General Partner or the Investment Adviser/Manager*. As previously observed, the use of the term "Associates" in reference to the General Partner or the Investment Adviser throughout Section 3.06(c) is not appropriate and should be eliminated because the term "Associates," as defined in the SBIC Act, is defined with reference to a "Licensee" (i.e., the SBIC) *not* the General Partner, the Investment Adviser/Manager or any other person. Thus, there is no legal basis for SBA or an SBIC to apply the multi-dimensional and complex concepts embodied within the definition of "Associate" to a General Partner or the Investment Adviser/Manager. If SBA would like to utilize the term "Associates" within the language of Section 3.06(c), then the term should be used with reference to the SBIC and not to the General Partner or the Investment Adviser/Manager.[13]

4. *Section 3.07(a) and Section 3.07(b)* – Section 3.07(a) is an optional provision which addresses the scope of expenses that are to be paid by the entity receiving the Management Compensation.[14] Section 3.07(b) is an optional provision which addresses the scope of expenses that are to be paid by the SBIC. In our view, certain of SBA's proposed modifications to the Existing Model in these two sections (as well as our understanding of actions taken and proposed to be taken by SBA through its examination of SBICs) strongly suggest that that SBA is seeking

[12]We note that, while the language in Section 3.06(c) is itself styled as an optional provision, SBA has taken the position in note (6) to TechNote 7A that all fees of the kind described in Section 3.06(c) received by Associates of the SBIC must be offset against the Management Compensation. Thus, while SBICs will be required to include a provision in their limited partnership agreements providing for such an offset, they are free to tailor the language to suit their needs so long as the substance of TechNote 7A is reflected.

[13]We note that, under the definition of "Associates" contained in 13 CFR §107.50, each of the General Partner and the Investment/Adviser Manager and entities Controlling, Controlled by or under common Control with, the General Partner and the Investment Adviser/Manager would be captured by applying the term "Associate" with reference to the SBIC.

[14]For purposes of our comments and consistent with our experience, we assume that the Investment Adviser/Manager is the entity to receive the Management Compensation.

to implement policy and regulatory interpretation changes through these proposed modifications and that Section 3.07(a) and Section 3.07(b) are intended to and will become, in practice, *de facto* mandatory provisions. We believe that these proposed modifications have no basis in, and are indeed contrary to, the SBIC Act. We are very concerned that the proposed modifications, if implemented, will be disadvantageous to SBIC and will have an adverse effect on the Debenture program and the policy and purpose of the Debenture program under the SBIC Act.

Specifically, Section 3.07(a)(ii)(F) of the Proposed Model now requires the Investment Adviser/Manager to pay all "accounting fees and costs and expenses associated with the preparation of the SBIC's annual and interim financial statements, portfolio financing reports and capital certificates." Not only is this new requirement contrary to widely held and accepted industry practice,[15] but it is also contrary to 13 CFR §107.520 and SBA's prior interpretations and regulatory practices. Based upon the position in which this new language is placed, it is apparent that SBA has now suddenly taken the view, contrary to its long standing historical practices and interpretations, that these accounting fees, costs and expenses are "bookkeeping" expenses, which are included within the definition of "Management Expenses" required to be paid by the Investment Adviser/Manager by 13 CFR §107.520(a)(6). If SBA is now taking this view, then it reflects a fundamental misunderstanding of the differences between "bookkeeping" and "accounting" and is contrary to 13 CFR §107.520(b), which specifically excludes from the definition of "Management Expenses" "services provided by specialized outside consultants, outside lawyers and independent public accountants if they perform services not generally performed by a venture capital company."

"Bookkeeping" focuses on data entry, the recording of transactions and the maintenance (*i.e.*, the "keeping") of books and records. It is a very mechanical and technical process that does not require much in the way of exercising judgment. "Accounting," on the other hand, involves the classification, summarization, reporting, analysis and interpretation of the data recorded and the preparation of financial statements and reports which incorporate this data. These statements and reports are then used by managers to assess and make decisions regarding a firm's financial condition and performance. Accounting is subjective rather than technical and requires specialized education and knowledge (typically at least a bachelor's degree) because it involves a significant exercise of judgment. Although bookkeeping is an integral part of a firm's overall financial reporting system (and accountants are generally charged with assisting firms in the establishment of their bookkeeping systems), bookkeeping is only one component of the system. Thus, accounting is much broader than bookkeeping. The SBIC Act recognizes this distinction and treats the fees, costs and expenses associated with "bookkeeping" and the remaining accounting aspects of the financial reporting system - 13 CFR §107.520(a)(6)

[15] Throughout the years during which we have represented SBICs in connection with their formation, licensing and operating activities, we cannot recall any instance where limited partners took a position that accounting fees, costs and expenses associated with the audit and preparation of the SBIC's financial statements should not be borne by the SBIC. The same is true in our representation of non-SBIC fund clients. Indeed, to our knowledge, not even ILPA has taken the position that accounting costs, fees and expenses should not be borne by the private fund.

recognizes that the fees, costs and expenses incurred for bookkeeping services are "Management Expenses" while §107.520(b) recognizes that the fees, costs and expenses incurred for the specialized services from outside consultants and independent public accounting firms are not Management Expenses and, therefore, properly chargeable to the SBIC.

SBA's newly found position and interpretation may result from observations during its regulatory exams that some SBIC fund managers are not appropriately separating fees and expenses associated with the provision of "bookkeeping" services (which are properly required to be paid by the Investment Adviser/Manager as "Management Expenses under 13 CFR §107.520(a)(6)) from other fees and expenses associated with the provision of the accounting and regulatory compliance services of the type that are provided by specialized outside consultants and properly treated as SBIC expenses in accordance with 13 CFR §107.520(b). If that is the case, then the solution is not for SBA to take a policy position that is contrary to the SBIC Act, but to address those situations on a case-by-case basis. In our experience, many SBIC fund managers do properly allocate and separately account for expenses paid to outside vendors that are to be borne and paid by Investment Adviser/Manager as "Management Expenses" from those expenses to be borne and paid by the SBIC.[16]

The vendors which provide the services relating to the preparation of an SBIC's annual and interim financial statements (including on SBA Form 468), portfolio financing reports, capital certificates and other documents and reports required to be prepared by the SBIC Act and an SBIC's limited partnership agreement are outside consultants, lawyers and independent public accounting firms with specialized experience in the subject matter areas for which they provide services. SBIC's retain these specialized outside consultants because regulatory and accounting compliance matters, including under the SBIC Act, are quite complex. It is for this reason that the SBIC Act recognizes that the fees, costs expenses incurred in connection with these services are specifically excluded from the definition of "Management Expenses" under 13 CFR §107.520(b) and are properly borne by the SBIC *should the SBIC's fund managers and limited partners so agree.* These outside consultants include third party fund administrators who have highly specialized knowledge of SBA's complex regulatory framework and offer an efficient solution to SBIC fund managers (and in particular to managers of first time or smaller SBIC funds) to handle these types of specialized services. Although some SBIC fund managers have decided it is more cost effective and efficient to hire in-house persons having the specialized knowledge and expertise necessary to handle the preparation of financial statements and other documents and reports required to be prepared and filed under the SBIC Act and other applicable laws and other regulatory matters, it cannot reasonably be stated that the preparation of annual and quarterly financial reports (including on SBA Form 468) and other documents and

[16] We note that an increasing number of our SBIC fund manager clients are required to register as investment adviser under the Investment Advisers Act of 1940. Thus, they have been subject to regulatory examination by the U.S. Securities and Exchange Commission (the "SEC"). We have not heard of any instances where the SEC has concluded that the allocation to the SBIC of the fees, costs and expenses paid to these specialized consultants is improper.

reports required to be prepared by the SBIC Act are of the type _generally performed by a venture capital company_.

The most effective and efficient way to determine the best allocation of expenses between the Investment Adviser/Manager and the SBIC is to permit the SBIC's fund managers and limited partners to negotiate that allocation, subject only to the constraints of 13 CFR §107.520. In this regard, not only is SBA's position that the Investment Adviser/Manager is required to pay all fees, costs and expenses for accounting and SBIC regulatory compliance matters contrary to 13 CFR §107.520 for the previously described reasons, it is also likely to result in SBIC's paying a greater amount of management fees. SBIC fund managers and limited partners do not negotiate the SBIC's management fees in a vacuum apart from the expense allocation provisions. Rather, these provisions are considered together. Indeed, many SBICs pay management fees in amounts which are less than the maximum amount of management fee permitted under TechNote 7A with the full understanding and expectation between the SBIC's fund managers and limited partners that the costs and expenses associated with the services of specialized outside consultants, outside lawyers and independent accounting firms will be borne by the SBIC and detailed as such in Section 3.07(b). Most SBIC limited partners would prefer to have the fund managers focus their time and resources on seeking and making high quality investments and helping portfolio companies grow rather than hiring an inside person to prepare the detailed financial statements and other regulatory reports. SBA should not interfere with those decisions through a mandate in the final model form of limited partnership agreement published by SBA that fees and expenses properly allocable to and paid by the SBIC under 13 CFR §107.520(b) be allocated and paid by the Investment Adviser/Manager. Rather, it should leave such decisions to the business judgment of, and negotiations between, an SBIC's fund managers and limited partners. Therefore, Section 3.07(a) should be limited to those "Management Expenses" listed in 13 CFR §17.520(a) and SBA should not seek to include additional expense items in the final model limited partnership agreement it publishes. Of course, an SBIC's fund managers and limited partners should be free to include additional expense items in Section 3.07(a) *should they choose to do so*. Otherwise, SBIC fund managers and limited partners should be free to include in Section 3.07(b) as expenses to be borne and paid by the SBIC, all expenses not specifically listed as "Management Expenses" in §17.520(a), as is customary market practice.

Section 3.07(a)(ii)(J) contains a modification which requires that the Management Compensation be reduced on a dollar-for-dollar basis by the amount of any expense reimbursements paid by any portfolio company or prospective portfolio company to the Investment Adviser/Manager or the SBIC with respect to the development, investigation and monitoring of investments. This modification creates the wrong incentives, especially for a more operationally focused SBIC and should be deleted in its entirety. SBA should encourage SBICs to take (and at the very least should not discourage SBICs from taking) an active approach with their portfolio companies and assist them with their businesses and work to improve their operations (including travelling to, and spending time at, the business location). If the Management Compensation is offset for any out-of-pocket travel expenses that are reimbursed by the portfolio company (no fees are being charged in these cases, but out-of-pocket expenses are merely being reimbursed)[17] for this work, then SBICs will be forced to do less of it. Said another way, the implementation of this sort of provision by the SBA could effectively eliminate the ability of SBIC funds to execute control buyouts. Also importantly, with this provision SBA would be putting SBIC funds on unequal footing relative to their competition because non-SBIC funds do not operate in this manner.

5. *Section 3.09 and Section 3.10* – Section 3.09 and Section 3.10 are mandatory provisions which address the standard of care and indemnification of various Persons. SBA has proposed significant modifications to these sections of the Existing Model. In our view, the proposed modifications to these two sections extend significantly beyond market norms and take positions which are contrary to well established legal principles and customary practices in the marketplace; thereby placing SBIC managers is a much more disadvantageous position than the fund managers of non-SBIC funds. As a result, SBA will likely have a more difficult time attracting well qualified management teams to participate in SBA's Debenture program.

General Observations and Comments – SBA Should Permit SBIC Fund Managers and Limited Partners Negotiate Their Own Standards of Care and Indemnification Provisions

The first sentence of Section 3.09(a) states "the standard of care is as set forth in the SBIC Act, including the fiduciary duties of loyalty, due care and good faith . . ." As a preliminary matter, we note that the SBIC Act does not set forth any specific standard of care and does not spell out any particular fiduciary duties. Rather, §314(b) of the SBIC Act makes it unlawful for any managers of an SBIC to engage in any act or practice in breach of the person's fiduciary duty if the result is imminent danger of suffering financial loss or other damages. Section 314(b) of the SBIC Act does not establish the nature, scope and extent of those fiduciary duties. Rather, the nature, scope and extent of fiduciary duties are established by State law.[18] Thus, the new proposed language at the beginning of Section 3.09(a) is simply incorrect and should be removed.

SBIC limited partnership agreements incorporate standards of care and indemnification provisions for two reasons. This first reason is to protect the SBIC's general partner and its related persons from the liability that a general partner of a limited partnership has

[17] In our experience, management fee offsets are universally applied against *fees, net of expenses* incurred in performing the services for which the fees are paid. We have not seen limited partners seek management fee offsets for expense reimbursements.

[18] The fiduciary duties of a limited partnership's general partner and, if the general partner is an entity, the directors and officers of such general partner to the limited partnership and the limited partners are governed by the laws of the jurisdiction of formation of the limited partnership. In our experience, virtually all SBIC's are formed and organized pursuant to the Delaware Revised Uniform Limited Partnership Act (as amended, "***RULPA***"). Therefore, our comments to Sections 3.09 and 3.10 of the Proposed Model focus on Delaware law.

as a matter of law to third persons for the obligations of the limited partnership.[19] The second reason is to define the parameters within which the general partner and its related persons will not have any liability, and will be indemnified and held harmless by the limited partnership, for their respective acts (or omissions) when they act and make decisions on behalf of the limited partnership in furtherance of its business. RULPA empowers a limited partnership to provide such protection.[20]

Delaware courts have held that the general partner of a limited partnership owes the limited partnership and its limited partners the fiduciary duties of care and loyalty. However, RULPA gives the partners of a limited partnership considerable flexibility to shape the applicable standard of care and the indemnification provisions that a partner or other person is entitled to under a limited partnership agreement. This flexibility is enshrined in RULPA §17-1101(c), which provides that it is the policy of RULPA "to give maximum effect to freedom of contract and to the enforceability of partnership agreements." This concept is fleshed out in several of the subsequent paragraphs of §17-1101. Specifically:

- Paragraph (d) provides, "to the extent that, at law or equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by the provisions of the partnership agreement." Paragraph (d) is, however, qualified by the requirement that a partnership agreement may not eliminate "the implied contractual covenant of good faith and fair dealing." This qualifying principle applies to every contract under Delaware law.

- Paragraph (e) provides, "unless otherwise provided in the partnership agreement, a partner or other person shall not be liable to the limited partnership to another partner or to another person that is a party to or otherwise bound by the partnership agreement for a breach of fiduciary duty for the partner's or other person's good faith reliance on the partnership agreement."

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[19] §17-403(b) of RULPA provides that a general partner of a limited partnership generally has the liabilities of a partner in a general partnership governed by the Delaware Revised Uniform Partnership Act. Under §15-306 of the Delaware Revised Uniform Partnership Act, all partners of a general partnership are generally liable jointly and severally for any obligation of the general partnership, unless otherwise agreed by the claimant or provided by law. Therefore, it is customary for limited partnership agreements to include indemnification provisions to protect the general partner from these obligations.

[20] Section 17-108 of RULPA provides, "[s]ubject to such standards and restrictions, if any, as are set forth in its partnership agreement, a limited partnership may, and shall have the power to, indemnify and hold harmless any partner or other person from and against any and all claims and demands whatsoever."

- Paragraph (f) states that a partnership agreement may provide for "the limitation or elimination of any or all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership agreement or to another partner or to another person that is a party to or bound by a partnership agreement" so long as the limited partnership agreement does not "limit or eliminate liabilities for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing."

Although it may have been appropriate for SBA to require a particular standard of care in its model limited partnership agreement when SBA was a preferred limited partner in SBICs issuing Participating Securities, we do not believe a "one size fits all" standard of care for Debenture SBICs is appropriate. In our view, SBA should defer to State law and the negotiations between SBIC fund managers and the limited partners to define the contours for the standard of care that they feel is appropriate. In our experience, limited partners care deeply about the standard of care for indemnification and often negotiate hard with fund managers both the standard of care and conditions for indemnification.[21] While RULPA enshrines the principle of freedom of contract, the Proposed Model fails to provide the partners of an SBIC the power to shape the standard of care and indemnification provisions of their limited partnership agreement. Over the past two decades, the exculpation and indemnification provisions contained in the Existing Model, together with the uneven manner in which SBA's Office of General Counsel has reviewed attempts by the institutional limited partner community and the large law firms which represent them to make those provisions conform to typical private equity, mezzanine and venture capital fund standards has caused numerous delays in the licensing process and has materially increased the costs for applicants. We, therefore, strongly urge that SBA accept commonly used standards seen in the marketplace by permitting an SBIC's fund managers and investors to negotiate the standard of care and indemnification conditions in a fashion that suits their needs. In making our recommendation, we are cognizant of §314(b) of the SBIC Act and recognize that this provision would apply whether or not it is set forth in the final model limited partnership agreement published by SBA. Thus, we agree that §3.09(d) of the Proposed Model should be retained and be required if SBA were to adopt our recommendation to permit the SBIC's fund managers and investors to negotiate the standard of care and indemnification provisions.

<u>Comments and Concerns Relating to the Standard of Care and Indemnification Provisions in the Proposed Model</u>

If SBA, nevertheless, maintains the position that requiring a particular standard of care in its model limited partnership agreement is necessary, then we believe the standard of care as set forth in Section 3.09 of the Existing Model should be retained because the proposed modifications to Section 3.09 as reflected in the Proposed Model create more stringent standards

[21] In our experience, the elimination of fiduciary duties in the private fund context is virtually non-existent.

that are contrary to well established legal principles and customary practices in the marketplace. We are very concerned that these modifications will make it much more difficult for SBA to attract well qualified management teams to participate in SBA's Debenture program and thereby impair the policy and purpose of the SBIC Act The proposed changes will also add additional confusion and anxiety in the limited partner community that they are entering into unknown territory when dealing with SBA and SBICs.

Section 3.09(a)

The standard of care and exculpation provisions of Section 3.09(a) of the Existing Model are based upon the standards of care and indemnification with respect to directors in §145(a) of the Delaware General Corporation Law (the "DGCL"). SBIC fund managers and limited partners have lived with this standard since 1994. However, unlike §102(b)(7) of the DGCL, which permits a Delaware corporation to exculpate fully a director from monetary damages even if the director breached his or her standard of care, Section 3.09(a) of the Existing Model exculpates a Designated Party (now referred to in the Proposed Model as a "Covered Party") only if the Designated Party satisfies the standard of care set forth in Section 3.09(a). Thus, the exculpation provisions of Section 3.09(a) of the Existing Model are already more stringent than those which are available to directors of a Delaware corporation and should not be made more stringent. Accordingly, the inclusion of the new language in Section 3.09(a) of the Proposed Model that the Covered Party act "with the same care that an ordinarily prudent person in a like position would use under similar circumstances" should be eliminated. In this regard, we note that the standard of care set forth on Section 3.09(a) already requires that the Covered Party act or omit to act in a manner ***reasonably*** believed to be in or not opposed to the best interests of the Partnership. Thus, Section 3.09(a) of the Existing Model already provides an objective standard against which to measure the Covered Party's belief that he or she acted in the SBIC's best interest as applied by Delaware courts. However, to the extent that SBA maintains a position that the new language is necessary, the new language should be revised so as to make clear that the conduct is being measured against what a prudent person under the circumstances then prevailing at the time the decision was made would use in the conduct of an investment fund with substantially similar investment objectives as the SBIC. Such a provision would read as follows:

> " . . ., and with the care under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an investment fund with substantially similar investment objectives as the Partnership would exercise, and, with respect to criminal . . ."]

We refer SBA to the end of our comments to Section 3.09(e) of the Proposed Model for our suggested modification to Section 3.09(a).[22]

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[22] Consistent with our view that the new "with the same care" language in Section 3.09(a) of the Proposed Model should not be included in the final model limited partnership agreement SBA publishes, our suggested

Section 3.09(b)

We refer SBA to Item 4 under "Section 1.01 – Definitions" above for our suggested modification to Section 3.09(b) of the Proposed Model.

Section 3.09(c)

In our view, the additional provisions in Section 3.09(c) of the Proposed Model which require that counsel be selected with reasonable care and provided with all material facts relevant to such counsel's opinion or advice creates a standard that enables a revisiting (perhaps after the lapse of many years) of a good faith decision through the prism of 20/20 hindsight and should, therefore be deleted. Although adding such additional language may seem innocuous, the concepts embodied by it have not been widely adopted in the market due to the uncertainty it creates in a Covered Party's ability to seek and rely in good faith upon counsel's advice. Thus, the inclusion of the new language will put SBIC fund managers at a disadvantage relative to fund managers of non-SBIC funds and make the formation and management of an SBIC a less attractive alternative to well-qualified fund managers who have other choices. We note that the provision already mandates that reliance on counsel's advice be in good faith. If a Covered Party concealed material facts or retained a lawyer who had no experience with the subject matter about which he or she was retained, it could hardly be said that the Covered Party's reliance was in good faith. SBA should not, through the publication of a model limited partnership agreement, impose standards that are not widely adopted in the market. However, if SBA nevertheless maintains a position that inclusion of such a standard is necessary, then the standard should be designed more in line with §141(e) of the DGCL, which would permit reliance upon such counsel (as well as other persons) as to matters reasonably believed to be within the such counsel's (or other person's) professional or expert competence and who has been selected with reasonable care. Drawing upon the DGCL for this standard would be consistent with use of §145(a) of the DGCL to establish the standard of care in Section 3.09(a). Section 3.09(c) would then read as follows:

> "(c) Any Covered Party, and Limited Partner, and any member of a Partnership committee or board[, including the Advisory Board,] may consult with independent legal counsel and other persons selected by it and will be fully protected, and will incur no liability to the Partnership or any Partner, in acting or refraining to act in good faith reliance upon the opinion or advice of such counsel or other person as to matters reasonably believed by such Covered Party, Limited Partner, or committee or board member to be within such counsel's or other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the Partnership, such Covered Party, Limited Partner or Partnership committee or board."

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modification to Section 3.09(a) found at the end of our comments to Section 3.09(e) does not include our proposed changes to the new "with the same care" language.

Section 3.09(d)

As we previously mentioned, we support the retention of Section 3.09(d) of the Proposed Model in the final form of limited partnership agreement irrespective of whether SBA permits SBIC fund managers and limited partners to negotiate standards of care and indemnification provisions which suit their needs or requires a particular standard of care be included in the final model limited partnership agreement it publishes.

Section 3.09(e)

We have significant concerns about Section 3.09(e) of the Proposed Model and strongly believe it should be eliminated.

Section 3.09(e) is a provision which seeks, as a matter of contract, to impose *personal liability* on a Covered Party to the Partnership for any act or omission inconsistent with the standard of care set forth in Section 3.09(a). Section 3.09(e) then purports to establish a non-exhaustive list of matters that SBA views are inconsistent with the standard of care. This non-exhaustive list includes: (1) a material breach of the Partnership Agreement; (2) breach of fiduciary duty, negligence (to the extent fiduciary duty so requires under applicable law), gross negligence, fraud, bad faith, misfeasance or willful misconduct with respect to any Partner, the Partnership or any Portfolio Company; (3) a violation of the SBIC Act or (iv) a material violation of any applicable provision of the Securities Act, the Investment Advisers Act or the Investment Company Act. The inclusion of Section 3.09(e) potentially eviscerates the protections afforded by standard of care and exculpation provisions set forth in Section 3.09(a) and the indemnification provisions of Section 3.10. Alarmingly, Section 3.09(e) potentially creates personal liability for a Covered Party in circumstances where, under well settled law, there is none. This provision could single handedly cause fund managers to avoid seeking an SBIC license and eliminate SBA's Debenture program as a program of choice for well qualified fund managers.

The whole point of the exculpation provisions contained in Section 3.09(a) and the indemnification provisions contained in Section 3.10 is to protect a Covered Party from liability for any matter so long as the standard of care set forth in Section 3.09(a) (*i.e.*, the Covered Party's act or omission was taken or omitted to be taken in good faith in a manner reasonably believed to be in or not opposed to the best interests of the SBIC) or Section 3.09(b) is satisfied. Consistent with widely accepted practice and legal principles, private fund managers and limited partners intend that this protection be extended to insulate Covered Parties from *personal liability to the SBIC or any other partner* for liabilities and other adverse consequences that may arise from their acts or omissions so long as they satisfied the applicable standard of care. As we have previously noted, the exculpation provided to Covered Parties in Section 3.09(a) is already more stringent than that typically afforded to directors of corporations. Thus, if a Covered Party does not satisfy the standard of care set forth in Section 3.09(a) (*i.e.*, the Covered Party's act or omission was taken or omitted to be taken in bad faith or the Covered Party's act or omission was not taken in manner he or she reasonably believed to be in or not opposed to the best interests of the SBIC) or Section 3.09(b), then he or she will *not* be exculpated from *personal liability to the SBIC or any other partner* that he or she may otherwise have under the law as a result of such acts omission.

Section 3.09(e), however, turns these principles on their head by deeming as a matter of contract a non-exhaustive list of matters to be inconsistent with the standard of care set forth in Section 3.09(a). Section 3.09(e) deems a material breach of the Partnership Agreement, a violation of the SBIC Act, or a material violation of any applicable provision of the Securities Act, the Investment Advisers Act or the Investment Company Act to be inconsistent with the standard of care. However, a Covered Party could in good faith make a mistake in judgment with respect to how a particular provision of the Partnership Agreement, the SBIC Act, the Investment Advisers Act or the Investment Company Act could be interpreted and decide to pursue a course of action (or decide not to pursue a course of action) in a manner he or she reasonably believed to be in the best interests of the SBIC based on that good faith mistake in judgment. Under Section 3.09(a), the Covered Party would not have personal liability to the SBIC or any other Partner for that act or omission. However, Section 3.09(e) seeks to impose personal liability on the Covered Party solely because the adverse consequence was a breach of the Partnership Agreement or a violation of any one of the enumerated laws and a breach of the Partnership Agreement or a violation of such laws is deemed by the Partnership Agreement to be inconsistent with the standard of care. Such a result is completely at odds with the expectations and legal protections afforded to fund managers by limited partners when establishing an exculpatory provision and standard of care of the type contained in Section 3.09(a).

Moreover, it is black letter law that owners, directors, officers, managers and similarly situated persons of entities are not personally liable on contracts signed by them for and on behalf of the entity unless they bind themselves individually or are subject to liability under common law veil piercing or alter ego principles. Nor are such persons personally liable for an entity's torts or violations of law. Although we recognize that directors, officers, managers and other similarly situated persons may, under applicable legal principles, have personal liability for their own participation in an entity's tortious conduct or violations of law, we must emphasize that private fund managers and investors carefully design the standard of care, exculpation and indemnification provisions of their limited partnership agreements with all of the foregoing legal principles in mind. Simply put, many of the matters enumerated in Section 3.09(e) that SBA purports to deem inconsistent with the standard of care set forth in Section 3.09(a) are not, in and of themselves, inconsistent with that standard of care. It is for this reason that there is no widely held view or consensus among fund managers and investors as to whether or not a breach of the Partnership Agreement or the violation of law should be an exception to the exculpation and indemnification provisions of a limited partnership agreement. In our experience, inclusion of breaches of the Partnership Agreement and violations of law as exceptions to the exculpation and indemnification provisions of a partnership agreement are not the market norm and, to the extent they are included as exceptions, there are very often stringent conditions that must be satisfied before the exceptions are triggered.[23] These exceptions and conditions are carefully negotiated between the fund managers and investors. Therefore, we strongly believe it is both wholly inappropriate and a significant mistake for SBA to change these fundamental principles by seeking to impose personal liability to Covered Parties for breaches of the Partnership Agreement or any violations of law.

Section 3.09(e)(iii) includes a violation of the SBIC Act within the list of enumerated matters that SBA purports to deem inconsistent with the standard of care set forth in Section 3.09(a) and for which it purports to extend personal liability to Covered Parties. The SBIC Act sets forth specific remedies for violations of the SBIC Act, including transfer of an SBIC to restricted operations and liquidations, removal of an SBIC's principals, acceleration of an SBIC's outstanding Debentures, revocation and suspension of an SBIC's license, injunctive relief, and institution of proceedings for appointment of SBA or a designee as receiver for an SBIC.[24] Importantly, the SBIC Act does not provide for any right to recover monetary damages for violations of the SBIC Act. Thus, there is no legal basis under the SBIC Act for SBA to seek to include in its model limited partnership agreement a remedy that can only be extended by Congress through a legislative amendment to the SBIC Act.

Section 3.09(e)(ii) also includes breach of fiduciary duty, negligence (to the extent fiduciary duty so requires under applicable law), gross negligence, fraud, bad faith, misfeasance or willful misconduct with respect to any Partner, the Partnership or any Portfolio Company within the list of enumerated items that SBA purports to deem inconsistent with the standard of care in Section 3.09(a). While we agree that gross negligence, fraud, bad faith or willful misconduct with respect to the Partnership are inconsistent with the standard of care and are fairly customary carve-outs from the exculpation and indemnification provisions of a private fund limited partnership agreement, we believe that SBA should leave the negotiation of these carve-outs to the SBIC's managers and investors. Moreover, these carve-outs are typically utilized in private fund limited partnership agreements when the standard of care and exculpation provision provides broader protection than that afforded by Section 3.09(a) – that is, to <u>any</u> act or omission <u>unless</u> the conduct in question constituted gross negligence, fraud, bad faith or willful misconduct with respect to the fund.[25] As discussed earlier, the standard of care and exculpation provisions in Section 3.09(a) are more stringent than this.

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[23] Examples of such conditions include, without limitation: notice and cure periods; materiality thresholds; scienter requirements (such as the applicable party must have known the conduct constituted a material breach or violation); and req**u**irements that the determination of breach must be finally determined by a court of competent jurisdiction with no opportunity to appeal.

[24] <u>See</u> 13 CFR §107.1810 generally.

[25] Indeed, SBA has itself articulated the position during its legal review of SBIC applicant limited partnership agreements that such carve-outs to Section 3.09(a) are not necessary because it can hardly be said that a person acted in good faith in a manger reasonably believed to be in or not opposed to the best interests of the SBIC if the person's conduct in question constituted gross negligence, fraud, bad faith or willful misconduct with respect to the SBIC.

However, if SBA nevertheless maintains a position that these concepts must be included in the final model limited partnership agreement to be published by SBA, then they should be incorporated in Section 3.09(a) as carve-outs to the exculpation provisions in accordance with customary industry practice. In our view, it is not appropriate to include a broad carve out for breach of fiduciary duty because Section 3.09(a) itself establishes the standard which defines the applicable fiduciary duties. In our experience, inclusion of carve-outs for negligence or misfeasance are quite far outside the market norm. It is well settled in Delaware that fiduciary duty is governed by a gross negligence standard. Thus, SBA should not include a simple negligence carve-out in the final model limited partnership agreement. The concept of "misfeasance" merely refers to the improper doing of an act which one might lawfully do and we have not seen fund managers and limited partners include concepts of misfeasance as carve-outs to the exculpation and indemnification provisions of a limited partnership agreement. Therefore, SBA should not incorporate a misfeasance carve-out.

In light of all of the foregoing comments regarding Section 3.09(e), we strongly urge SBA to eliminate Section 3.09(e) in its entirety. We also propose alternative language for Section 3.09(a) should SBA maintain a position that there should be carve-outs for certain types of conduct from the exculpation and indemnification provisions of the final model limited partnership agreement SBA publishes. We note that, in our experience representing SBIC license applicants through SBA legal document review process, SBA has expressed concerns about carving out certain types of conduct from the standard of care provisions of Section 3.09(a) because it did not want the failure to prove the occurrence of the carved out conduct to be deemed a finding that the standard of care in Section 3.09(a) was satisfied. We have kept this concern in mind when preparing the following alternative language to Section 3.09(a):

> "(a) Standard of Care for Covered Parties. No Covered Party will be liable to the Partnership or any Partner for any action taken or omitted to be taken by it or any other Partner or other person in good faith and in a manner it reasonably believed to be in or not opposed to the best interests of the Partnership, and, with respect to any criminal action or proceeding, had no reasonable cause to believe its conduct was unlawful, unless and to the extent that a court of competent jurisdiction finally determines that such Covered Party's conduct in question constituted gross negligence, fraud, bad faith or willful misconduct. A determination that a Covered Party's conduct did not constitute gross negligence, fraud, bad faith or willful misconduct does not itself create any presumption that such Covered Person has acted in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the Partnership as set forth in the first sentence of this Section 3.09(a).

Section 3.10(a) and Section 3.10(b)

We believe that the reference in Section 3.10(a) to 13 CFR §107.560 is intended to be a reference to 13 CFR §107.550. Although we agree that indemnification should be limited to "Assets Under Management" less Outstanding Leverage, we do not understand the reasons for reducing Assets Under Management by other third party debt and strongly suggest such reduction be removed.

Section 3.10(f) and Section 3.10(g)

We notice that there are references to the Advisory Board in each of Sections 3.10(f) and 3.10(g), each of which is a mandatory provision. However, the Advisory Board concept is an optional provision in Section 3.11. Although is quite common in our experience for SBICs to have advisory boards, not all do. Thus, the inclusion of the Advisory Board in each of Sections 3.10(f) and 3.10(g) should be placed within brackets so it can be removed from the language in cases of SBICs that do not have an advisory board.

Section 3.10(h)

Section 3.10(h) includes a new provision that prohibits the advancement of expenses to any person that may be entitled to indemnification before the final disposition of any claim, action or proceeding if the claim, action or proceeding is brought by either (1) a Majority in Interest of the Limited Partners or (2) by any receiver appointed in accordance with the SBIC Act. In our experience, although a very small limited number of SBICs have included a prohibition on the advancement of expenses in the case of actions asserted by a defined threshold percentage in interest of its limited partners (typically much higher than a majority in interest), we have not seen such prohibitions recently and they are quite far outside the market norm. Again, we strongly urge SBA to not impose such a prohibition in the model limited partnership agreement because it will likely serve as a significant deterrent to well-qualified fund managers from seeking an SBIC license. SBIC fund managers and limited partners should be free to negotiate whatever constraints on the advancement of expenses they may desire. We also strongly oppose SBA seeking to prohibit the advancement of expenses solely because an action has been brought by a receiver appointed in accordance with the SBIC Act. A claim, action or proceeding brought by a receiver is no different than any claim, action or proceeding brought by any other third party. This provision represents a significant fundamental unfairness to persons who may be entitled to indemnification but do not have the resources to defend themselves. SBA should not seek to so "stack the deck" against such persons. Therefore, this prohibition is wholly unwarranted and should also be eliminated.

Section 3.10(i)

Section 3.10(i) seeks to prohibit indemnification or reimbursement under Section 3.10 in respect of any Indemnifiable Costs that may be incurred and that result from any dispute solely among the General Partner, its Affiliates or Associates,[26] or any of their respective

[26]As mentioned previously, the use of the term "Associates" in reference to the General Partner is not appropriate and should be eliminated because the term "Associates," as defined in the SBIC Act, is defined with reference to a "Licensee" (i.e., the SBIC) not the General Partner or any other person. Thus, there is no legal basis for SBA or an SBIC to apply the multi-dimensional and complex concepts embodied within the definition of "Associate" to a General Partner.

employees or agents. Although we have seen some fund managers and limited partners agree to indemnification limitations with respect to "intra-GP" disputes, in our experience, there is not a widely held view or consensus among fund managers and investors as to whether or not such limitations should be included in a limited partnership agreement and, if they are to be included, the extent to which the limitation applies. For example, in circumstances where fund managers and the limited partners have agreed to include this type of a limitation, we have seen more stringent conditions required to be satisfied before the limitation is applicable. Given that there is no market consensus on the "intra-GP dispute" limitation, and consistent with the theme of our comments that SBIC fund managers and investors should be free to negotiate the parameters of indemnification limitations, we strongly urge SBA to eliminate Section 3.10(i) from the final form of limited partnership agreement it publishes. However, if SBA nevertheless maintains a position that such a limitation is necessary, then we suggest that Section 3.10(i) be revised to read as follows:

> "(i) General Partner Disputes. No person may be entitled to claim any indemnity or reimbursement under Section 3.10(a), (b) or (c) in respect of any Indemnifiable Cost that may be incurred by such person which results from any dispute solely among the General Partner or its Affiliates or any of their respective employees or agents which has not arisen as a result of a claim by a third party against the Partnership or any of them with respect to Partnership matters."

6. *Section 3.11* – Section 3.11 is an optional provision which provides language concerning the establishment of an Advisory Board and its duties. Section 3.11(a)(iii) purports to include within the scope of the Advisory Board's duties a duty to "provide any approvals SBA may require." SBA should not have the right or power to create any duty within the Advisory Board or to ask the Advisory Board to take any action or provide any consent. The role of the Advisory Board is carefully delineated in limited partnership agreements because members of limited partnership advisory boards (and limited partners who are serving or have designees serving on advisory boards) want to ensure that they will not be treated as controlling the business of the limited partnership and, therefore, potentially liable as a general partner of the limited partnership to third parties. Section 3.11(a)(iii) is a very unusual provision that is far outside market norms. Therefore, Section 3.11(a)(iii) should be not be included in SBA's final form of limited partnership agreement.

ARTICLE 5 – PARTNERS' COMMITMENTS AND CAPITAL CONTRIBUTIONS

1. *Section 5.01* – Section 5.01 is a mandatory provision which contains certain basic terms with respect to the Partners' Commitments. We note that Section 5.01 contemplates "amendments" to Schedule A (which sets forth the respective names and Commitments of each Partner) of the limited partnership agreement. SBA's policy is that all amendments to an SBIC's limited partnership agreement require prior SBA written approval. We believe that SBA should clarify that changes to Schedule A as a result of subsequent closings of an SBIC during which the SBIC is permitted to accept additional Commitments from newly admitted Limited Partners and increased Commitments from existing Partners do not require SBA prior written approval.

We believe that such clarification is consistent with longstanding SBA practice and will significantly reduce SBA's administrative burden.

2. *Section 5.02(d)* – We welcome the proposed modification to Section 5.02(d), which is an optional provision that allows an SBIC to return drawn capital to its Partners under certain circumstances subject to certain conditions. We note, though, that while the inclusion of this provision will be very useful to SBICs, it will not eliminate the need for SBICs to obtain unsecured capital call lines of credit, which are most often used to bridge the gap between the timing of the receipt of capital from its partners and SBA leverage draws and the closing of investment transactions.

3. *Section 5.12* – Section 5.12 is an optional provision which addresses circumstances where an SBIC withholds distributions from a Defaulting Limited Partner. The Proposed Model includes a revision mandating that withheld distributions must first be applied to the unfunded Commitment and then second to other amounts owed by the Defaulting Limited Partner to the SBIC (including default interest). In our experience, SBICs would prefer to apply the withheld distribution in the inverse order because they would always want the Defaulting Limited Partner still obligated to fulfill its Commitment. We also believe such a provision would be in the best interests of SBA. Such application of withheld distributions is similar to how a lender would apply prepayments of debt – first to interest and then to principal. We would expect SBA to prefer an order of application which maintains the Defaulting Limited Partner's obligation to pay its unfunded Commitment.

ARTICLE 6 – CAPITAL ACCOUNTS AND ALLOCATIONS

1. *Section 6.09* – Section 6.09 is an optional provision which addresses tax allocations. The first sentence of Section 6.09 should refer to Sections 5.04(e), 5.04(f), 6.05, 6.06 and 6.07.

ARTICLE 7 – DISTRIBUTIONS

1. *Section 7.03* – Section 7.03(a) is an optional provision which permits an SBIC to make tax distributions. Section 7.03(b) is an optional provision which permits an SBIC to make payments with respect to any Partner in amounts necessary to discharge any legal obligation of the SBIC to withhold and make payments to governmental authorities on account of a Partner's tax liability arising as a result of that Partner's interest in the SBIC.

We note that Section 7.03(a) states that tax distributions can only be made from Retained Earnings Available for Distribution ("READ"). SBIC's are permitted under 13 CFR §107.585 to make distributions even if they do not have READ so long as they do not reduce their Regulatory Capital by more than two percent (2%) per year. Thus, Section 7.03(a) should be revised to permit tax distributions to be made from READ or as otherwise permitted by the SBIC Act. We also suggest that the last sentence of Section 7.03(a) clarify that tax distributions not only debit capital accounts, but are also treated as an advance against, and therefore reduce, distributions to be made under Section 7.01(b). This clarification would ensure the proper functioning of the "Target Accounts" allocation mechanisms used in the Proposed Model.

The reference to Section 7.03(b) in the last sentence of Section 7.03(b) should be to Section 7.03(a) rather than Section 7.01(b).

2. *Section 7.05* – Section 7.05 is an optional provision which purports to permit an SBIC to reinvest proceeds. We encourage that SBA either: (1) remove Section 7.05 in its entirety or (2) retain the place saver consistent with the Existing Model for a recycling provision and drop a footnote which indicates that SBICs may want to include a provision for recycling of proceeds. However, if SBA maintains a position that language providing guidance regarding a recycling provision should be included, then we believe the Proposed Model's language is overly restrictive and inconsistent with the manner in which SBICs often negotiate and implement recycling and reinvestment of proceeds provisions. It is very important for an SBIC to obtain robust reinvestment and recycling rights given the tight restrictions contained in 13 CFR §107.530 on an SBIC's use of cash not invested in Small Businesses and an SBIC's inability to make distributions other than from READ or as permitted by 13 CFR §107.585 (permitting reductions in Regulatory Capital by not more than 2% per year). SBIC fund managers and limited partners negotiate reinvestment and recycling of proceeds provisions very carefully, balancing the need for liquidity against allowing the SBIC to deploy and use its idle cash in the most efficient and effective manner based upon the particular circumstances of the SBIC, including its investment strategy. Therefore, SBIC's fund managers and limited partners should be free to negotiate the parameters of the SBIC's recycling and reinvestment rights.

We hope that the specificity with which SBA drafted Section 7.05 is not intended to implement a *de facto* policy or interpretation change. SBA's inclusion of a reinvestment cap equal to 110% of the sum of the SBIC's aggregate Commitments plus Assumed Leverage will very likely be insufficient for many SBIC's.[27] In addition, the limitation on an SBIC's ability to reserve or reinvest proceeds to not more than 12 months after the end of the SBIC's investment period is wholly inappropriate and could have significant adverse consequences to an SBIC's returns; thereby putting SBIC fund managers at a potentially great relative disadvantage to non-SBIC fund managers. In our experience, many SBIC's do not have a cap on their reinvestment rights. Rather, the fund managers and investors have often determined that there is an inherent limitation on reinvestment because the SBIC is only permitted to make follow-on investments after the end of the investment period and the overline provided in 13 C.F.R. §107.740 limit the amount an SBIC is permitted to invest in a single portfolio company and its affiliates. To the extent there is a reinvestment cap, it is typically much higher than 110% in our experience. We strongly urge SBA to remove any cap on reinvestment. To the extent that SBA believes it is important to provide guidance to investors, the percentage should be left blank. An arbitrary and artificially mandated time restriction for recycling and reinvesting proceeds could significantly

[27] In our experience, there are no limitations on a fund's ability to recycle proceeds for the payment of fund expenses.

and adversely impair an SBIC's ability to protect or enhance the value of its investments after the end of the SBIC's investment period. Therefore, the 12 month limitation should be eliminated in its entirety.

<u>ARTICLE 8 – DISSOLUTION, LIQUIDATION, WINDING UP AND WITHDRAWAL</u>

1. *Section 8.01(a)(iii)* – We appreciate the modifications made to Section 8.01(a)(iii), a mandatory provision, which remove unnecessary impediments to the ability of an SBIC upon the election of the Partners to dissolve so long as all Outstanding Leverage and other amounts due SBA, its agent or trustee have been paid. We note that Section 8.01(a)(iii) still includes the regulatory requirement contained in 13 CFR §107.160(c)(1) which requires that an SBIC must have at least a 10 year term and observe that if an SBIC were to utilize the mechanisms of Section 8.01(a)(iii) in the manner suggested by SBA in footnote 76 of the Proposed Model before the 10th anniversary of the SBICs formation, SBA would need to approve an amendment to the SBIC's limited partnership agreement for the SBIC to implement such mechanisms. As written, Section 8.01(a)(iii) would permit a threshold percentage in interest of the SBIC's Limited Partners to elect to dissolve the SBIC without the approval of the SBIC's General Partner. Such a provision is not customary in the marketplace. Given that Section 8.01(a)(iii) is a mandatory provision, we strongly urge SBA to revise this provision so that the consent of the SBIC's General Partner be required as follows:

> "(iii) the election of the General Partner and at least [______] Percent (___%) in Interest of the Limited Partners to dissolve the Partnership, notice of which election must be given to each Partner and SBA. Such election will be effective on the date stated in the dissolution notice, provided that . . ."

2. *<u>Section 8.01(d)</u>* – Section 8.01(d) is an optional provision which permits the General Partner to extend an SBIC's term for two successive periods of one (1) year each, subject in the case of the second extension to the approval of either the Advisory Board or a Majority in Interest of the Limited Partners. We appreciate SBA's inclusion of a customary provision which permits the General Partner to extend the SBIC's term. However, in our experience, it is quite customary for the General Partner to have these extension rights without the need to obtain any Advisory Board or limited partner approval for either the first or the second one (1) year extension, although we have seen fund managers and limited partners negotiate a consent provision (many times limited to the second extension). We hope that this provision is not intended to implement a *de facto* policy change which would require Advisory Board or Limited Partner approval to any such extension. To avoid the appearance that this is SBA's position, we encourage SBA to remove the requirement that either the Advisory Board or any particular threshold in interest of limited partners be obtained in order to allow the second extension.

3. *<u>Section 8.12</u>* – Section 8.12(a) is a mandatory provision which gives a Limited Partner who properly withdraws from the SBIC rights to distributions as provided under the limited partnership statute of the state in which the Partnership was organized. If that state were Delaware, RULPA provides that a withdrawing limited partner is entitled (unless the partnership

agreement otherwise provides) to the fair value of its partnership interest and is to be treated as a creditor at the time the partner is entitled to receive a distribution.[28] For a variety of business reasons, an SBIC may want to restrict distributions to a withdrawing Limited Partner. For example, an SBIC may wish to have the withdrawing limited partner only have rights to distributions as if the limited partner had continued as a partner, depending upon the circumstances. Such treatment would, in our experience, be consistent with market norms for non-SBIC private equity funds. Therefore, we suggest that Section 8.12(a) of the Proposed Model be removed and that the final model published by SBA permit the partners to build in flexibility for the SBIC with respect to the timing of payments and the treatment of the withdrawing limited partner so long as such timing is permitted by RULPA and the SBIC Act. In that regard, we support retaining the language in Section 8.12(b) and Section 8.12(c). Below is a suggested revision for Section 8.12(a):

> "(a) Subject to the provisions of the SBIC Act and Sections 8.12(b) and 8.12(c), upon withdrawal by a Limited Partner under any provision of this Agreement, the General Partner will value the interest of the withdrawing Limited Partner and that value will be paid to the withdrawing Limited Partner when determined by the General Partner in the exercise of its sole discretion either (i) at the time and in the amounts that the withdrawing Limited Partner would have been entitled had it remained a Limited Partner with an interest (including a Capital Account) in the Partnership equal to its interest at the time of withdrawal or (ii) at such times after withdrawal as the General Partner determines would permit the Partnership to make a reasonable distribution.

ARTICLE 9 – ACCOUNTS, REPORTS AND AUDITORS

1. *Section 9.02(b)* – Section 9.02(b) is a new mandatory provision added by the Proposed Model which requires an SBIC to provide notice to its Limited Partners within 15 days of the occurrence of an event of default under 13 CFR §107.1810. We believe that this provision could create an unnecessary burden on SBICs under certain circumstances. 13 CFR §107.1810 is a complex regulation which delineates various types of events of default and SBA remedies, some of which allow cure periods. In addition, in situations where an SBIC may anticipate an event of default (e.g., a condition of capital impairment), the SBIC would likely bring that to the attention of SBA in order to discuss the matter with SBA so that it can provide a more complete disclosure to its Limited Partners. In addition, some of the events of default include cure periods. In such cases, an SBIC should not be required to provide notice prior to having an opportunity to cure.

ARTICLE 10 – MISCELLANEOUS

1. *Section 10.01(d)(v)* – Section 10.01 is a partially mandatory provision and a partially optional provision which addresses Limited Partner transfers. Section 10.01(d)(v) of the Proposed Model is derived from Section 10.01(d)(vi) of the Existing Model and prohibits

[28] See §§17-604 and 17-606 of RULPA.

transfer of a Limited Partner's interest if the transfer would result in a violation of the Securities Act. In the Existing Model, this provision is an optional provision. In the Proposed Model, this provision is a mandatory provision. In our view, it should remain an optional provision because neither the SBIC nor the General Partner should be required to ensure that the Limited Partner's transfer complied with the Securities Act. Compliance with the Securities Act within the context of a Limited Partner transfer is solely the obligation of the transferring Limited Partner.

2. *Section 10.01(e)* – Section 10.01(e) is an optional provision which appears to permit a Limited Partner to transfer its interest in an SBIC without prior SBA approval if: (1) the transfer complies with the requirements of Section 10.01; (2) the transfer does not result in the transferee and its Affiliates owning 10% or more of the aggregate interest in the SBIC; and (3) the SBIC provides SBA with notice of such transfer within 30 days after the effectiveness of such transfer. If the incorporation of this provision is intended to signal a change in SBA's interpretation of the SBIC Act and in its policy concerning Limited Partner transfers, it is a very much appreciated and welcome change. However, it is unclear if SBA is intending to permit Limited Partner transfers which do not result in the transferee or any of its Affiliates owning 10% or more of the aggregate interests in the SBIC because footnote 101 in the Proposed Model includes a reference to Section 10.01(e) when it states that "for certain Amendments, including transfers permitted pursuant to Section 10.01(e), *only post-transfer approval is required. See 13 CFR §17.680*." (emphasis added).

SBA issued guidance with respect to Limited Partner transfers on December 11, 2014 (the "December 2014 Guidance") which purported to simplify the approval process for a transfer of an SBIC limited partnership interest involving less than 10% of the SBIC's total partnership interests. In this guidance, SBA advised that pre-approval of a transfer involving less than 10% of the SBIC total partnership interests would not require pre-approval, but that post-approval under 13 CFR §17.680(b) would be required and that, as provided in 13 CFR §17.680(b), the SBIC should consider the transfer approved unless SBA notifies the SBIC to the contrary within 90 days of receiving the notice. SBA has received feedback from various constituencies that the December 2014 Guidance created uncertainty and was not a practical or workable solution to SBICs for a whole host of reasons.[29] If SBA intends that the December 2014 Guidance will still be effective, then SBA needs to make more clear in the final model limited partnership agreement it publishes that a transfer made in accordance with Section 10.01(e) still requires post-SBA approval in accordance with the December 2014 Guidance.

That said, we strongly encourage SBA to abandon the December 2014 Guidance and permit without any SBA approval transfers of limited partnership interests that do not

[29] See, for example, Letter from the Small Business Investor Alliance to SBA dated January 11, 2015 (available at http://c.ymcdn.com/sites/www.sbia.org/resource/resmgr/SBIA_Letter_to_SBA_on_Transf.pdf)

involve more than 10% of the SBIC's total partnership interests. Subjecting a Limited Partner transfer involving less than 10% of an SBIC's total limited partnership interests to a post-approval process is, in our, view, contrary to the SBIC Act. 13 CFR §107.400(a) requires an SBIC to obtain SBA prior written approval for any proposed transfer of ownership interests that results in the ownership by an person, or group of persons acting in concert, of at least 10% of any class of an SBIC's partnership capital. This regulation specifically states 10% or more. There are no other regulations that require prior written approval for transfers involving less than 10% of an SBIC's total partnership interests. In addition, the December 2014 Guidance promotes an uncertain regulatory outcome to parties who require certainty in their transactions. For example, if an SBIC needs to make a capital call to fund a transaction, it is unclear whether it will be able to do so because the transfer is potentially subject to reversal. Post-approval uncertainty also creates issues for an SBIC that wants to make distributions and allocations of income and losses. As a practical matter, few if any, SBICs find this post-approval process outlined in the December 2015 Guidance useful and, therefore, we suspect, it is not widely utilized. We certainly advise our clients not to rely upon it.

3. *Section 10.06(b)(iii)* – Section 10.06(b) is an optional provision which requires any amendment to the SBIC's limited partnership agreement that increases the amount of a Partner's commitment or causes a Limited Partner to become liable as a general partner of the SBIC to be approved by the applicable Partner. Section 10.06(b)(iii) is a provision that is designed to prevent Section 10.06 from being amended without the consent of all Partners (as opposed to a specified threshold in interest of the Partners). We believe that the reference to "Section 10.06" in Section 10.06(b)(iii) should be to "Section 10.06(b)." There is no reason why the appropriate threshold in interest of an SBIC's Limited Partners should not be able to amend any of the provisions of Section 10.06 other than 10.06(b).

4. *Section 10.08* – Section 10.08 is a mandatory provision which reflects the Proposed Model's governing law clause. Limited partnerships are formed and their internal affairs are governed under the limited partnership statute of the jurisdiction in which they are organized. Non-SBIC fund limited partnership agreements do not contain references to Federal law even though for example, the general partner or management company is subject to the Investment Advisers Act of 1940. That said, we understand that the SBIC Act is specifically applicable the operation and management of SBICs. Accordingly, we suggest revising Section 10.08 to read as follows:

> "10.08 Applicable Law. This Agreement is governed by, and shall be construed in accordance with the laws of the [State of Delaware] without reference to the conflict or choice of laws principles of [Delaware] or any other jurisdiction and, to the extent applicable, the SBIC Act."

5. *Section 10.10* – Section 10.10 is a mandatory provision which reflects the Proposed Model's "integration clause." In our experience, limited partnership agreements for non-SBIC funds always include within the list of agreements comprising a part of the "entire agreement" among the parties the limited partner's subscription agreement and any side letters with a limited

partner. SBIC limited partnership agreements should be no different. The main issues presented by Section 10.10 of the Proposed Model relate to SBA's treatment of side letters and subscription agreements.

Side Letters

We appreciate SBA's inclusion of 10.10(b) which expressly permits side letters. We agree with the prohibition contained at the end of Section 10.10(b) which does not permit any side letter to modify the obligation of a limited partner to contribute its Commitment as provided in the limited partnership agreement. However, footnote 104 of the Proposed Model states, "[a]ny provision of a Side Letter that purports to control, alter or supplement a section of this Agreement must expressly identify each such section" and "[i]f a Side Letter fails to expressly identify any such section, the conflicting provision of the Side Letter will be deemed to be without force or effect, even if the Side Letter is or has been approved by SBA." In our view, this footnote inappropriately exalts from over substance, creates uncertainty when certainty is required and provides no meaningful protection to SBA. Side Letters often do not necessarily control, alter or even supplement a *specific provision already included* in the limited partnership agreement. Institutional investors in private equity funds, including by way of example, banks, state pension funds and private pension funds, often require additional understandings from the SBIC and its general partner to comply with legal requirements and information needs that are not specifically provided for in the limited partnership agreement. For example, a bank may wish to address Community Reinvestment Act credit, a state pension fund may want to address confidentiality requirements in light of applicable state freedom of information (FOIA) requirements as well as other regulatory matters applicable to them, and a private pension fund may wish to address ERISA issues. As SBA is aware, often the provisions of side letters are extensive and detailed. Although some side letter provisions address a specific provision already included in the limited partnership agreement, other side letter provisions may be said to supplement an SBIC's obligation only in a broader sense. A public pension fund seeking to modify its confidentiality obligations in light of applicable FOIA requirements would be altering a specific confidentiality obligation contained in the limited partnership agreement. However, a bank seeking to address Community Reinvestment Act credit would not be modifying any specific provision but could be seen as supplementing the SBIC's specific reporting obligations in a broader sense. It seems nonsensical to us to require the side letter with the bank to state specifically that the provisions addressing Community Reinvestment Act credit in the side letter supplement or alter the reporting requirements contained in Section 9.02(c) of the SBIC's limited partnership agreement because the parties' understanding of the obligation contained in the side letter is not dependent upon them understanding which provision of the limited partnership agreement is altered. The side letter provision speaks for itself. Therefore, the effectiveness of side letter provisions should not hinge upon whether the parties identified a specific provision in the limited partnership agreement.[30] After all, Section 10.10(b) of the Proposed Model expressly

[30] Moreover, it would be inequitable to deem a side letter provision invalid if it specifically identified one or more sections of the limited partnership agreement being altered or supplemented, but failed to specifically identify other sections that may also arguably apply.

requires that SBA review and approve the applicable Side Letter. In fact, SBA routinely provides comments to side letters that are negotiated by the parties. SBICs and their investors are entitled to know that the side letters will be effective and should have certainty that they will not be "sandbagged" because a provision of a side letter (which speaks for itself) did not specifically identify the applicable provisions of the limited partnership agreement those side letter provisions could be viewed as altering or supplementing. Therefore, we strongly urge SBA to eliminate footnote 104 in its entirety.

Subscription Agreements

Subscription agreements reflect important understandings between the SBIC and its limited partners. SBA, however, has taken the position that subscription agreements are not and cannot be "SBA Agreements" as that term is defined in §10.10(a) of the Proposed Model. Footnote 102 of the Proposed Model SBA states, "[t]o the extent that an applicant desires to retain specific representations and warranties from such [subscription agreements], such applicant should include those provisions in Section 1.06 of this Agreement." We strongly believe that footnote 102 should be eliminated and that subscription agreements should be included in the list of documents comprising a part of the "entire agreement" among the parties irrespective of whether SBA reviews them. There are other ways in which SBA can protect its creditor position in the SBIC. The mandate contained in footnote 102 is not a practical or workable solution because subscription agreements customarily include very detailed and complex questionnaires and certifications from limited partners that are necessary for the SBIC and its general partner to determine the qualifications of the limited partner for purposes of complying with, among other laws, the Securities Act, the Investment Company Act, the Investment Advisers Act (to the extent applicable), the Internal Revenue Code and ERISA. The certifications, representations, warranties and covenants in the subscription agreement are designed, among other reasons, to: (1) permit the limited partnership interests that are being offered and sold to be exempt from Federal and state securities law registration; (2) exempt the Partnership from the requirement to register as an investment company under the Investment Company Act; (3) permit the SBIC to complete its Capital Certificate accurately; (4) determine whether the Partnership must withholding taxes from distributions to particular Limited Partners; (5) determine compliance with applicable money-laundering laws; and (6) sometimes provide the General Partner with a power of attorney to execute certain documents on behalf of the Limited Partner. None of these items is of direct consequence to the protection of SBA's creditor position. Moreover, SBA's position, which contradicts customary market and legal practice, makes the first sentence of §10.10(a) of the Proposed Model inaccurate and could result in problems for the SBIC. Subscription agreements should be explicitly recognized as agreements covered by the integration clause because they, together with the limited partnership agreement, embody the agreement of the partners. SBA could protect itself by providing that no subscription agreement can include any provision which modifies the obligation of a Partner to pay its Commitment as provided in the limited partnership agreement. Accordingly, we propose that Section 10.10(a) be revised to read as follows:

"(a) This Agreement and all other written agreements executed by or on behalf of the General Partner and/or the Limited Partners and approved by SBA, and all written subscriptions agreements that in no way modify the obligation of the Partner to pay its Commitment as provided in this Agreement (such other written agreements, collectively, the "SBIC Agreements"), state the entire understanding among the parties relating to the subject matter of this Agreement and the SBIC Agreements. Any and all prior conversations, correspondence, memoranda or other writings are merged in, and replaced by this Agreement and the SBIC Agreements, and are without further effect on this Agreement and the SBIC Agreements."

We appreciate the opportunity to provide our comments to the Proposed Model. This is a very important initiative for SBA and we thank you for your time and efforts in preparing and publishing the Proposed Model. ***We strongly believe that SBA would be well served if we and others who have provided their comments, such as the Small Business Investor Alliance, have an opportunity to meet with SBA representatives as often as necessary to discuss the comments you receive and finalize a model that reflects market terms and expectations and is useful to the SBIC community.***

Please contact either Michael B. Staebler (248.359.7394; stablem@pepperlaw.com) or Christopher A. Rossi (610.640.7846; rossic@pepperlaw.com) if you have any questions about any of our comments.

Very truly yours,

PEPPER HAMILTON LLP