



March 11, 2005

Dear Allied Capital Corporation Director:

I write to inform you directly of the continuing misconduct of Allied Capital's management, conduct that I believe warrants an independent investigation by the Board.

As you know, I have been a critic of your company for almost three years and have documented many of my criticisms publicly. These criticisms have largely proven to be true over time and have been bolstered by the ongoing investigations by the U.S. Attorney for the District of Columbia and the SEC into Allied and its small business lending unit, Business Loan Express ("BLX").

Yet, instead of addressing the underlying problems with the company, Allied's management has attempted to deflect attention from such criticism by misrepresenting facts to the public, levying personal attacks against me and using other tactics which are troubling, to say the least. Such actions signal that Allied's management has more interest in concealing the company's problems than in addressing them. This is hardly surprising since it was Allied's management that engineered these problems in the first place. As this has all unfolded, however, it appears that Allied's Board of Directors has remained strangely silent.

As you are no doubt aware, the SEC and the U.S. Attorney's Office in the District of Columbia are investigating Allied and BLX. Management has told the public that these investigations relate to "issues similar to those raised by short sellers over the past two and one-half years,"<sup>1</sup> apparently referring to, among other things, the assignment of several defaulted loans by BLX to Allied in early 2003. That assignment, however, is only one example of the widespread fraud that has occurred at BLX under the stewardship of the current management.

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

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<sup>1</sup> See Allied Press Release dated December 27, 2004, attached to its Form 8-K dated December 27, 2004 as Exhibit 99.1.

By approving such loans, BLX is able to immediately recognize income around the time of loan origination, because it uses gain-on-sale accounting. BLX needs to continually increase its origination volume to support its revenue growth. This pressure to increase origination volume leads to the approval of additional fraudulent loan applications. This pyramid scheme has allowed Allied to recognize enormous fees, interest and dividends from BLX, while it values BLX far above its actual worth. And it is Allied's and BLX's execution of this scheme, I believe, that has led the SEC and the U.S. Attorney's Office to initiate their investigations.

Eventually, when the loans default, BLX receives a guarantee payment from the SBA by concealing the fact that the loans should not qualify for a guarantee because of the fraudulent origination. It would not surprise me if BLX or Allied is ultimately required to repay the government millions of dollars upon completion of the government investigations.

Allied's management, however, has entirely failed to respond to these problems. Instead, management has issued false and misleading public statements dealing with such clearly material facts as the status of government investigations. For example, during Allied's fourth quarter 2002 conference call on February 13, 2003, I asked Ms. Joan Sweeney the following question:

EINHORN: Could you comment at all relating to the office of Inspector General in the SBA that I understand has been calling around people close to Business [Loan] Express, what do you think they're looking into and is there an investigation and if so what do you believe the status to be?

SWEENEY: You know, David, I don't know. I mean, clearly, BLX is a regulated entity by the SBA. They're routinely audited by the SBA. I know that the office of Inspector General typically works with the SBA looking at SBA lenders. It's usually a routine – they are usually routine inquiries, if there is an inquiry. So that's about all I can say. **We don't know the nature of any sort of inquiry.** So, you know, again this happens routinely in the SBA lending market. (Emphasis added.)

Ms. Sweeney made the above statement only weeks after she personally executed the questionable Assignment Agreement and the SBA required Allied/BLX to reimburse it for \$5.3 million in guarantee payments relating to loans that the SBA had investigated and disqualified.

In light of these facts, Ms. Sweeney's claim that "we don't know the nature of any sort of inquiry" was materially false and misleading. Moreover, Allied management chose not to disclose either the SBA investigation, the disqualification of the loans, or the Assignment Agreement until more than a year afterward. This raises serious issues about the honesty of management with its shareholders and perhaps with the Board. As the Board of



Directors could not have sanctioned such public misrepresentations, the question you need to ask is, are they lying to you as well?

Finally, you may already have read a MarketWatch article published on February 1 of this year, which noted that an unknown individual had illegally accessed phone records of several prominent Allied critics. The article further noted that the FBI was conducting an investigation of this incident. Although I have refrained from commenting publicly on this matter, my home phone records were among the records that were illegally accessed. Specifically, according to my long distance provider, someone opened an online account in my wife's name, and directed the phone company to send copies of our bills to an AOL account. Like me, at least four additional individuals have been the victims of this identity theft and access device fraud. The only link that connects the victims is that they have all been critics of Allied.

I am quite familiar with Allied's aggressive tactics against its critics, including attacking them with untrue disparaging statements by management and its agents like Lanny Davis. It would not be surprising to me if the FBI discovered that Allied management was somehow involved in these identity thefts.

In short, there is considerable evidence that Allied's management has conducted business in a dishonest and inappropriate manner. Indeed, I have refrained from including in this letter the bulk of my research, numerous false and misleading statements issued by management and my financial criticism of the company.

I believe you have an obligation to examine the possibly unethical or even criminal behavior of Allied's management and take action to prevent further misconduct. I believe that the Board has a responsibility to ensure that individuals who act in this manner do not serve in a management capacity in a publicly traded company.

Respectfully,



David Einhorn

