

SBIC TechNotes

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Guidelines Concerning the Use of Side Letters and Withdrawal Provisions in SBA’s Model Limited Partnership Agreement (LPA)

The guidance below was developed by the Investment Division of the U.S. Small Business Administration (“SBA”) for SBIC applicants, investors and service providers to use in drafting, negotiating and amending the limited partnership agreement for prospective and licensed SBICs. This guidance is intended to clarify SBA’s position with respect to certain legal tools and provisions.

Side Letters

1. SBA strongly encourages SBIC applicants and licensees to avoid the use of side letters.
2. Terms that (i) apply to all of a fund’s investors; (ii) impose restrictions on the activities of the fund or general partner; (iii) require the fund to engage or refrain from engaging in particular activities; (iv) require the managers to make best or reasonable efforts to achieve a particular result; or (v) may be construed to provide preferential treatment to or adversely affect certain investors should be included in the limited partnership agreement, not in a side letter.
3. If a fund or its general partner determines that a side letter will contain terms that are appropriate for a side letter and not more properly included in the fund’s limited partnership agreement, the fund’s limited partnership agreement must be amended to include a provision that specifically authorizes the fund and the general partner to enter into side letters and sets forth any conditions under which the fund or GP may do so. The provision must state that all side letters require to SBA’s prior written approval.
4. An applicant must submit drafts of all contemplated and executed side letters with its license application. If an applicant negotiates a side letter with an investor after filing its application, the applicant must submit a draft to its assigned SBA licensing analyst as soon as possible to minimize delay.
5. Any licensed SBIC that is still fundraising and determines that a side letter with a new investor is necessary must submit a draft of the side letter to its operations analyst along with an amendment to its LPA authorizing the fund and GP to enter into side letters if the LPA does not already include such a provision.

6. SBA will not approve a side letter containing a “Most Favored Nation” clause which automatically extends to the LP any more favorable rights and benefits established by another investor’s side letter or similar agreement. However, SBA will allow an LP to require disclosure of other side letters and the ability to veto the extension of more favorable rights and benefits to other investors. Sample language for such a provision is as follows:

Neither the Partnership, the General Partner nor any of the General Partner’s officers shall have entered into any side letter or similar agreement on or prior to the date hereof with any investor in the Partnership or any Parallel Investment Fund in connection with such investor’s investment in the Partnership or any Parallel Investment Fund, except as disclosed to the Investor in writing on or prior to the date hereof (“Disclosed Side Letters”). If at any time and from time to time an investor in the Partnership or any Parallel Investment Fund receives any other side letter or similar agreement, then the Investor will be given copies of such side letter or other agreement. In the event that the Partnership, the General Partner or any of the General Partner’s officers shall enter into any Disclosed Side Letter or other side letter or similar agreement with an existing or future investor in the Partnership or any Parallel Investment Fund on or after the date hereof that has the effect of establishing rights or otherwise benefiting such investor in a manner more favorable in any material respect to such investor than the rights and benefits established in favor of the Investor by the Partnership Agreement and this letter agreement, the Investor shall be offered in writing the opportunity to veto such rights and benefits of such Disclosed Side Letter, other side letter or similar agreement.

Withdrawal Provisions

1. Opt-out provisions provide LPs the right to withdraw, without penalty, from the partnership under specified circumstances. SBA’s Model Limited Partnership Agreement contains mandatory provisions that provide withdrawal rights for certain types of investors. For example, an LP that is exempt from taxation under Section 501(a) or 501(c)(3) of the Internal Revenue Code may elect to withdraw from the Partnership if it must withdraw in order to avoid loss of its tax exempt status. An LP that is an “employee plan” or “government plan” within the meaning of ERISA or an “investment company” subject to registration under the 1940 Act similarly can elect to withdraw to avoid violations of applicable laws or 1940 Act registration requirements. See sections 8.06 to 8.10 of the Model Limited Partnership Agreement. In addition, optional section 8.12 of the Model Limited Partnership Agreement provides certain withdrawal rights for banks and bank holding companies. In all of the cited sections, the right to withdraw must be supported by an acceptable opinion of counsel.
2. In addition to the withdrawal provisions noted paragraph 1, SBA may approve a provision that permits an LP to withdraw from the partnership if the partnership or

general partner violates a stated written policy adopted by the LP. In determining whether to approve such a provision, SBA will consider whether the LP's policy promotes best practices and ethical behavior in the management of SBICs; whether it has been widely adopted by a significant important class of institutional investors; and whether it is compatible with the laws, regulations and policies governing the SBIC program. For example, many State pension funds have implemented a policy prohibiting the undisclosed use of placement agents, and SBA will generally approve a withdrawal right for a pension fund investor triggered by a violation of that policy. However, SBA will apply the following restrictions to the capital committed by an investor that has a withdrawal right approved under this paragraph 2:

- a. The unfunded commitments subject to the withdrawal right will not be considered "Regulatory Capital" as defined in 13 CFR §107.50 (capital contributed by the investor will be included in Regulatory Capital as it is paid in). The exclusion of unfunded commitments from Regulatory Capital will affect the SBIC's overline limit, capital impairment percentage calculation, and management fee.
 - b. Although the investor's unfunded commitment is excluded from Regulatory Capital, SBA may allow the SBIC to include the investor's entire commitment in its Management Fee Base (see SBIC TechNote 7A) if SBA determines that the full amount of the investor's commitment is likely to be collectable. However, SBA will not allow the Management Fee Base to include any Assumed Leverage on the investor's unfunded commitment.
 - c. If the investor requires not only the right to withdraw, but also the right to a refund of management fees in the event of a violation, the limited partnership agreement must provide that (1) the general partner or management company, not the SBIC, must pay the required refund to the investor; (2) the general partner or management company must refund to the SBIC the management fees paid by the SBIC based on the investor's unfunded commitment; and (3) if the general partner or management company should fail to make the payments required under (1) or (2), the SBIC's principals will be personally liable to make the payments.
3. If a prospective investor in an SBIC requires, as a condition of investing, that the SBIC either will or will not engage in certain activities, those conditions should be negotiated and set forth in the SBIC's limited partnership agreement. For example: The SBIC must maintain an office in a specified location; must make a certain percentage of its investments within a specified region; must not invest in any business involving alcohol or tobacco. SBA will not approve a special withdrawal right for a particular LP based on the SBIC's failure to fulfill such requirements. In addition, SBA will not approve a provision that allows an LP to opt out of funding a particular investment.