Book **Fooling Some of the People All of the Time**

A Long Short Story

David Einhorn
Wiley, 2008

Recommendation

Call hedge fund manager and author David Einhorn a glutton for punishment. In 2002, he first became skeptical of Allied Capital, a small business lender based in Washington, D.C. He shorted the stock, publicly criticized the company and earned the enmity of its management. Over the next six years, Einhorn feuded with Allied, growing increasingly outraged over what he considered bogus accounting. He repeatedly brought his findings to the attention of regulators and reporters, with little result. For years, Allied shares held steady or gradually rose. It wasn't until after this book was published in 2008 that Allied stock cratered. Einhorn's tale of his battle with Allied is often riveting, although at times he veers into levels of detail only a forensic accountant could appreciate. Still, *BooksInShort* recommends the book to investors seeking an inside look at high-level chicanery, a short seller's strategy and a Wall Street war story.

Take-Aways

- Allied Capital is a business development company that originates Small Business Administration (SBA) loans. It has been publicly traded since 1960.
- Hedge fund manager David Einhorn sold Allied shares short in 2002, after research and interviews with its officials convinced him it engaged in accounting fraud.
- Instead of carrying loans and portfolio companies at their market value, Allied ignored key factors, such as bankruptcy filings, when valuing such assets.
- In 2002, Einhorn made a speech outlining the issues at Allied; its shares plunged.
- Allied responded to the speech by attacking Einhorn and his motives.
- Einhorn could not get regulators and journalists to be interested in Allied's fraud.
- Other Allied critics began to dig into the company and found massive loan fraud.
- Allied subsidiary Business Loan Express (BLX) routinely made SBA loans to unsavory borrowers who put up overvalued capital.
- In 2006, a Business Loan Express official was indicted on federal fraud charges.
- In spite of the indictment and an SEC ruling critical of Allied's accounting, the company continued business as usual as of early 2008.

Summary

Shady Accounting, a Short Position and a Speech

In early 2002, hedge fund manager David Einhorn of Greenlight Capital met with managers of another fund who thought they had spotted an opening for a short sale of the shares of Allied Capital Corp. Allied, a business development firm that had been public since 1960, made loans through the Small Business Administration's 7(a) program and ran a real-estate investment trust that invested in small-business mortgages. Late in 1997, Allied had $800 million in assets, including a $200 million portfolio of investments in other firms. When Einhorn and Greenlight's analysts began to look into Allied's books, they spotted a worrisome trend. Allied marked down the value of troubled assets only reluctantly. When one of its companies ran into problems, Allied reduced the value of its equity kickers, but held the loan at cost. Then it took a small write-down, often followed by another small write-down. This seemed to be a clear example of accounting fraud. Einhorn thought Allied's practices, when exposed, would send its shares tumbling.

> "Allied's management has had unending opportunities to answer my allegations, and I have not seen them once address the actual facts that form the basis of my allegations. They can't."

Suspicious that Allied was hiding bad news from investors, Einhorn recorded phone calls with the CFO and with people from its investor relations department. He didn't attack Allied's accounting, but simply asked questions about its practices. Allied officials told him that they didn't begin to mark down the value of loans until they "believed that we had a permanent impairment of the asset." This was an obvious breach of fair-value accounting, which mandates that companies value securities at the current price they'd fetch on the market, that is, it forbids them to hold investments at cost after they've lost value.

> "Certainly, one of the biggest things I have learned from the Allied experience is the surprising reluctance of the media to dig into complicated financial stories."

Allied's CFO showed little regard for the truth, telling Einhorn that Allied's credit losses were less than 1%, even though the firm specialized in high-interest mezzanine loans. In that niche, 3% would be considered a stellar loss ratio. Einhorn understood that Allied was valuing its assets at cost almost indefinitely, even if the assets' true value dropped. To note just one signal of Allied mishandling, it took ownership stakes in some firms that remained in debt to it. In a circular process, Allied charged its portfolio firms, such as Business Loan Express (BLX), outrageous interest rates of 25% – much higher than the 15% it charged most other firms. Unable to pay such rates, BLX relied on Allied's cash infusions to pay interest back to Allied itself. In turn, Allied propped up its income statement by reporting BLX's interest payments as revenue, even though it had lent the money to BLX.

> "I like stocks. I enjoy finding provocative opportunities on the long side. I am an optimist and want to participate in the market's long-term positive trend."

Convinced he had unearthed accounting fraud, Einhorn put 7.5% of Greenlight's capital into a short sale of Allied shares at $26.25. A short sale is a bet that the price would fall. Greenlight's short position in Allied went unnoticed until May 15, 2002, when Einhorn spoke at a fundraiser for the Tomorrows Children's Fund, a charity that supports a New Jersey hospital for cancer-stricken children. Einhorn was one of 11 speakers who offered investment picks to ticket buyers. By the time he spoke, the market had closed. The next day, Allied shares plunged nearly 20% based on Einhorn's speech, but he didn't cash in his gains. He thought the opportunity was too compelling to take a quick gain.

The Spinning Begins

After the plunge in Allied's shares, its officials hosted a conference call to defend themselves. During this call, Dan Loeb, manager of Third Point Partners, needled Allied CEO Bill Walton about flouting fair-value accounting. Allied tried to deflect Loeb's queries, but it was engaged in "pyramid-scheme accounting": Say Allied carried two investments at $10 million each; one held its value at $10 million, while the other fell to $5 million. The company would sell the first and keep the second on its books at an inflated value, hoping the investment would recover or that Allied's overall growth would render the loss less relevant. Allied offered only a feeble defense, though Loeb had raised issues similar to Einhorn's concerns. Walton, trying to undermine Einhorn's research, lied that Einhorn had never contacted Allied about its accounting.

> "I...was frustrated that the government was investigating the wrong party."

After the call, Einhorn felt so confident about his investment decision that he shorted more Allied shares. Other investors started filing class action suits against Allied (these suits were later dismissed). But the tide quickly turned, in part because analysts leapt to Allied's defense. Merrill Lynch called Allied's response "meritorious." Wachovia gave it a "strong buy" rating. No analyst checked with Einhorn, and when he contacted Wachovia analyst Joel Houck, he found Houck parroting management's story. Supported by analysts' endorsements, Allied shares bounced back to $25.

> "Was the SBA really asking outsiders how to obtain its own loan numbers? Apparently, giving them the borrower's name and address wouldn't do."

Allied shares took another hit in June 2002 when independent researcher *Off Wall Street* published a sell recommendation echoing some of Einhorn's findings. *Off Wall Street* said BLX was using aggressive gain-on-sale accounting, which front-loads revenue and – inappropriately for BLX's risky loan portfolio – assumes stellar loan performance. Rather than address the substance of the criticism, Allied portrayed itself as the victim of a vast conspiracy. Allied repeated the lie that Einhorn had never contacted the company. An Allied official told Bloomberg News that Einhorn and *Off Wall Street* wanted to "scare the little old ladies" who held Allied's high-yield shares.

> "The SBA's lack of concern that taxpayers were being ripped off, are being ripped off and will be ripped off – all in its name – is nothing short of appalling."

During the course of their long battle, Allied routinely accused Einhorn of scare tactics and shoddy research, and repeatedly charged him with slamming the company in a venal attempt to cash in his short position. CEO Walton urged shareholders to move their shares from margin accounts to cash accounts to thwart short sellers. His actions proved truly cynical. For example, he paid $46,000 for 2,000 shares of Allied shortly after Einhorn's speech. Insider buying generally is a bullish sign, but in light of Walton's $2.4 million salary and $10 million stake in Allied, his insider buy was little more than window dressing. Walton's fortunes and Allied's were so intertwined that he was motivated to lie about the company's merits and his critics' shortcomings.

Others Find Problems

Jim Carruthers of Eastbourne Capital Management contacted Einhorn in June 2002. Carruthers loved to mine court records and other public data to dig up dirt on companies. He found that Business Loan Express, Allied's largest investment, had made suspicious loans in Michigan. In one loan to a car wash, the borrower had a previous federal embezzlement conviction. BLX lent money to a gas station that showed its property appraised at three times its actual value. One hotel had defaulted on its loan after its access road closed. Securities regulators had issued sanctions against a BLX loan broker who generated $40 million a year in loans. Einhorn learned that the head of BLX's office in Richmond, Va., had a felony securities fraud conviction. These details, plus the high default rates, convinced him that BLX was making loans recklessly and perhaps fraudulently. BLX could report earnings, even though they were based on bad loans, and, through the SBA, U.S. taxpayers were on the hook for 75% of each debt.

> "Now, it was no longer just Greenlight and a few others pointing to Allied's shoddy accounting. The SEC gave our analysis its stamp of approval."

In July 2002, Allied stock fell to $16.90 on disappointing earnings. Shares rebounded, held steady and didn't fall back below that level until 2008 – so much for Einhorn's hopes of a quick profit. His attempts to interest regulators, journalists and other investors in his findings fell on deaf ears. Convinced that he had discovered securities fraud, Einhorn fired off a detailed missive to the Securities and Exchange Commission. After all, in a white paper Allied had essentially admitted to following SBA accounting rules, rather than the SEC rules it should have obeyed. Einhorn provoked little interest from the SEC. He told his story to a reporter at *Barron's*, the financial weekly, and to a manager at Wasatch Advisors, the second-largest holder of Allied shares. Neither was especially interested. Einhorn later gave *The Wall Street Journal* and *The New York Times* his analysis of Allied. Once again, the discussions yielded no stories.

> "At its most basic level, Allied Capital is the story of Wall Street at its worst.""A Ponzi scheme can exist in what economists call 'stable disequilibrium.' Though it is not permanently sustainable, it doesn't have to fail in any given time frame."

While newspapers and regulators weren't jumping on the Allied story, retired real-estate developer Jim Brickman began looking into it. He found a number of unsavory details. One of Allied's investments, Fairchild Industries, had defaulted on a loan from another bank and stopped paying Allied's interest early in 2002. Yet Allied carried its debt investment at cost for months. In other cases, Allied refused to mark down the value of loans to and investments in struggling firms, because it was attempting to smooth earnings by timing write-downs, rather than recording them when it should have.

> "Relative to most stocks, it has little institutional ownership. With the enormous fees it generates for Wall Street, there are plenty of financial incentives to support [its] scheme."

In late 2002, Einhorn hired a private investigator to dig further into Allied. The investigator found many loans made by Business Loan Express that appeared to be frauds against the SBA. In one case, BLX gave $1.6 million for a Georgia hotel to a borrower who already had defaulted on one SBA loan. The investigator also found several defaulted gas station loans in the Detroit area, and bankers told him that BLX had earned a reputation as lender of last resort. Even so, the SBA made little attempt to recover taxpayers' money or to crack down. Einhorn set up a meeting with SBA officials to explain the findings; their disinterest was nearly comical. In a classic bureaucratic boondoggle, SBA officials asked if Einhorn had the SBA loan numbers for the fishy loans. Einhorn was incredulous. He had provided the borrowers' names and addresses, and the lender's name, yet SBA said the information was worthless without the loan numbers. The Allied saga was beginning to weigh on Einhorn, but its stock price held steady.

> "Allied's general investor relations practice: Officials answer the easy questions and avoid the hard ones."

In one small bit of progress, Wachovia analyst Joel Houck gradually turned bearish about Allied and lowered his rating. But instead of criticizing Allied, Wachovia simply decided in 2004 to stop reporting on it. Meanwhile, the media continued to ignore the story. After *Barron's* decided not to pursue it, Einhorn flew to Dallas to take his shot at the *New York Times* by meeting with reporter Kurt Eichenwald. He seemed enthusiastic but never wrote anything.

> "Allied does not disclose bad news unless it was really bad news."

Finally the SEC began looking into the matter – but instead of focusing on Allied, the SEC investigated the possibility that Einhorn was manipulating the market for personal profit. Einhorn was forced to pay legal fees and burn up time complying with the SEC's requests for e-mails and other documents. Meantime, a Harvard Business School professor prepared a case study about Allied that sided entirely with the company and described Einhorn's questions as "a short attack." The professor agreed to some changes suggested by Einhorn, who later discovered that the professor's assistant previously had worked for Allied's largest shareholder. Allied's lies about Einhorn's motives were bad enough, but the feud turned truly creepy in 2004, when Einhorn discovered that someone had stolen his cell phone records. The same thing had happened with the cell phone records of Herb Greenberg, the Marketwatch.com columnist who wrote critically about Allied, and another financier who had dug into Allied. The company later acknowledged that its private investigator had stolen its critics' phone records, a practice known as "pretexting."

An Indictment, but Business as Usual

Jim Brickman found more disturbing patterns of fraud in the Business Loan Express portfolio. In one case, the same $300,000 shrimp boat collateralized two loans totaling $1.85 million. The first one defaulted, as did other BLX loans on Gulf Coast shrimp boats. In fact, Business Loan Express conducted a massive fraud against U.S. taxpayers. Since 1998, the SBA has paid $280 million in guarantees for loans made by Allied's BLX subsidiary. Instead of thanking Einhorn for bringing this fraud to its attention, however, the SBA seemed uninterested in pursuing his findings. Several theories speculate about why the SBA wouldn't investigate obvious fraud. One is that it wants to be a seen as a "lender-friendly" agency and thus can't crack down on a lender. Another is that the SBA doesn't have the manpower to look into fraud allegations. Finally, Allied gives lavishly to political campaigns and cultivates relationships with Washington power brokers, none of whom would be pleased to see a division of Allied slapped for fraud.

> "The consequence of Allied's illegal action was the lightest tap on the wrist with the softest of feathers."

In 2006, a federal grand jury indicted a BLX executive vice president and loan broker, plus two dozen other people for defrauding the SBA with bogus loans in Michigan. The most prominent person charged was Patrick Harrington, accused of originating nearly 100 SBA-guaranteed loans with fraudulent applications. Once his indictment became public in early 2007, Allied began to spin the story, saying it was the innocent victim of a rogue employee. Even so, BLX paid the SBA $10 million to cover fraudulent loans and put another $10 million in escrow. The indictments brought much-needed press and Congressional scrutiny of Allied. The SEC also began to look harder at Allied. In 2007, it issued a scathing order faulting Allied's bookkeeping and valuations, and essentially siding with Einhorn. However, the SEC's cease-and-desist order carried no fines or penalties. As of the book's publication, no regulator, prosecutor or journalist had taken an interest in Allied's practices, and it continued business as usual.

About the Author

David Einhorn is president and founder of Greenlight Capital, a long-short hedge fund launched in 1996 that has earned returns of more than 25% a year for its partners.