

INTERVIEW-Einhorn says Allied rise, fall shows oversight poor

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- * Greenlight still has small short position on Allied
- * Einhorn says Allied entered downturn with weak portfolio
- * Says poor oversight, credit bubble let weak firms thrive

By Joseph A. Giannone

NEW YORK, March 11 (Reuters) - Shares of Allied Capital Corp have been wiped out over the past year, but David Einhorn, the hedge fund manager who has famously shorted the business lender's stock, feels more vexed than vindicated.

That's because the past year's financial markets collapse has produced even more serious fall-out. From the demise of Lehman Brothers to Bernard Madoff's massive Ponzi scheme, the questionable accounting practices of a small lender was just one product of sleepy regulatory oversight, Einhorn told Reuters in an interview.

"What we've seen a year later is that Allied was the tip of an iceberg; that this kind of questionable ethic, philosophy and business practice was far more widespread than I recognized at the time," he said. "Our country, our economy, is paying a huge price for that."

Einhorn, head of the \$5 billion hedge fund firm Greenlight Capital, made headlines in May 2002 when he told an audience he believed Allied's stock was overvalued. He argued Allied was slow to mark down depressed assets -- often equity stakes in small private companies -- and stretched accounting rules.

Greenlight shorted the stock, meaning it would profit if Allied's price fell. Einhorn also submitted what he considered red flags to the Securities and Exchange Commission, expecting that the agency would investigate.

Instead, what followed was a long public battle between Einhorn and Allied, which denied and continues to deny wrongdoing, as well as SEC scrutiny of the hedge fund manager's short-selling activities.

An SEC spokesman declined to comment.

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Einhorn described his experience with Allied and recalled his frustrations with regulators in the book "Fooling Some of the People All of the Time," which hit bookstores last May. At that time, Allied shares had held up reasonably well and it appeared Einhorn's efforts had been only modestly successful.

Then the credit crisis caught up with Allied.

Last September, a key component of Allied's portfolio, Ciena Capital LLC, formerly known as Business Loan Express, filed for bankruptcy. Allied itself reported more than \$1 billion of net unrealized investment losses last year.

By February, the Washington-based firm defaulted on a revolving credit line and some

private notes. Last week, Allied suspended its dividend, William Walton stepped aside as chief executive, and auditors said they had "going concern" worries.

Allied shares closed Wednesday at 95 cents, down 97 percent since Einhorn disclosed his short sale. Einhorn, who years ago promised to donate to charity any profits from his short, says he still has a "small" short position on Allied.

Allied, which questioned Einhorn's credibility as a short-seller and defends its financial reporting and business practices, said the credit crisis punished all banks.

"To imply that the decline in Allied's stock price and decrease in the value of Allied's portfolio somehow validate Mr. Einhorn's seven-year-old unfounded allegations is simply absurd and ignores the reality of today's global credit crisis and the generalized collapse in financial sector stock prices," Allied spokesman Jeff Lloyd said.

GARDEN OF WEEDS

Einhorn says Allied's decline was largely self-inflicted and predictable.

"It wasn't the economic recession that caused Allied to implode," he told Reuters. "It was the fact that we had an enormous credit bubble, combined with a very favorable regulatory environment, that allowed Allied to be sustained as long as it was."

Einhorn called Allied a pyramid scheme, where new investors must be tapped to cover investments, while management maintains lofty dividend payments to existing shareholders. He said the company also was forced to raise cash by selling its more successful investments.

Allied tumbled quickly when it could not issue new shares, he said.

"They had been selling winners and keeping their losers -- picking their flowers and watering the weeds. So they entered this down-cycle with a garden of weeds," he said.

Yet, Einhorn complained, it took years for the SEC to follow up on his allegations. In June 2007 the agency reached a settlement that found Allied did not fairly value investments and broke record-keeping and internal control rules.

There was no fine and Allied did not admit wrongdoing.

It also took years for the U.S. Small Business Administration, which guaranteed loans made by Business Loan Express, to probe fraud allegations raised by Einhorn and another individual.

Allied still maintains that "Einhorn's allegations against Allied have been examined by numerous independent third parties, including the SEC, various courts and leaders in the capital markets, and none of his claims has been substantiated," the Allied spokesman said.

Last month, a federal appeals court dismissed a false-claims lawsuit filed by Einhorn against Business Loan Express. Einhorn said Greenlight has requested a full-panel appellate review.

Einhorn said Allied symbolized an environment where companies could stretch the rules for years and get away with it, hurting investors and spoiling the field for honest players.

"If you got very close, you'd see a number of companies that were allowed to play fast and

loose with the rules, knowing there was no regulatory oversight," he said. "And even if they were caught, nothing bad would happen." (Editing by John Wallace)

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