Defrauded Fund Investors Sue Goldman

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Samuel Israel III bilked his investors out of $250 million, but they are hoping to recoup some of their money from one of Wall Street's deepest pockets: Goldman Sachs.

Bayou's creditors were taking aim at Goldman even before Mr. Israel, the former manager of the Bayou Group hedge fund firm, surrendered to the authorities on July 2. His faked suicide on a Hudson River bridge 40 miles north of Manhattan and subsequent disappearance on the day he was to start a prison term had set off an international manhunt.

Bayou's unsecured creditors committee sued Goldman in late May, claiming the investment bank had failed to detect Mr. Israel's fraud, one of the biggest ever in the hedge fund industry, and to investigate signs that something was amiss at Bayou.

For six years, Goldman acted as the so-called prime broker for Bayou, clearing trades, taking custody of securities and providing reports on the fund firm's investments. The claim seeks $20 million.

The lawsuit, filed as a private arbitration and in federal court, underscores the bind that prime brokers face when a hedge fund client blows up. In cases of fraud, prime brokers are often bamboozled too. But Bayou's creditors claim that Goldman should have realized something was amiss, and argue that Goldman did nothing to investigate various warning signs.

"Through either gross negligence or a willful choice to ignore the signs of the fraud, G.S.E.C. failed to diligently investigate the red flags it was made aware of, to contact Bayou's auditors to request additional information, or to alert the appropriate authorities of what it had learned," the suit says. The initials refer to Goldman Sachs Execution and Clearing.

A Goldman spokesman declined to comment. Ross B. Intelisano, from Rich & Intelisano, who represents the creditors committee, said the case had been referred to arbitration and declined to comment further.

Goldman provided monthly statements to Bayou outlining its losses. From August 1999 to August 2005, Bayou had losses of more than $88 million — a figure disclosed as a line item under “year-to-date profit or loss” on the Goldman statement.

But Goldman knew that Bayou was reporting significant gains to investors, the suit charges. In September 2003, and in November of that year, Kyle R. Czepiel, a senior vice president at Goldman, requested marketing materials from Bayou.

In early 2004, Bayou provided materials to Goldman that claimed it had earned a return of almost 18 percent since its inception — a figure the suit says was “completely inconsistent with the actual returns the Bayou Funds had been realizing in their trading accounts at G.S.E.C., in which they had done nothing but lose money.”

Goldman’s prime brokerage desk was not the only part of the bank that was aware of Bayou’s poor performance, the suit claims. In January 2004, the risk management department of the clearing unit listed the top 10 money losers among the firm’s clients for the previous year. One Bayou hedge fund was at the top of the list, having lost $35 million; two others also were in the top 10, losing $14 million between them.

When the fraud at Bayou came to light in 2005, the case transfixed Wall Street. Mr. Israel is the son of a prominent New Orleans businessman, and a number of investors had been charmed by Mr. Israel’s pedigree — much of it inflated or made up — or taken by his charm and humor.

But Bayou, started in 1996 with $1.2 million, bled money almost from the start. To conceal the losses, Mr. Israel, with the help of his chief financial officer, Daniel Marino, falsified financial documents, and even created a fictitious auditing firm, Richmond-Fairfield, to hide their scheme.

In September 2005, Mr. Marino and Mr. Israel pleaded guilty to a number of charges in the Federal District Court for the Southern District of New York and were sentenced to 20 years in prison.

Mr. Israel created a stir again when he failed to show up for prison in early June. He abandoned his sport utility vehicle on the Bear Mountain Bridge and was on the run for weeks before his mother persuaded him to turn himself in. The judge in his case added 10 years to his sentence.