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Goldman, Still Playing in Bayou's Mud

By GRETCHEN MORGENSON

THE story of the Bayou Group, the hedge fund firm that collapsed in a whirl of lies and drugs, was always a little weird. But it just keeps getting weirder.

You may recall Bayou — or at least its founder-turned-con man, Samuel Israel III. To the world, Mr. Israel was a trading whiz. Then, one August afternoon in 2005, the police responded to a 911 call from Bayou's offices in Stamford, Conn., and found a note explaining how he had perpetrated a giant fraud.

Mr. Israel, it turned out, wasn't managing a hedge fund at all. He was running a Ponzi scheme — a small-time version of the Madoff racket that, at that very moment, was still going strong. Mr. Israel, who said he'd become addicted to painkillers, was later sentenced to 20 years in prison — then two more for jumping bail, faking his suicide and going on the lam. His abandoned vehicle was found on the Bear Mountain Bridge over the Hudson River, the words "suicide is painless" written in the dust on the hood.

Now, as Mr. Israel sits in jail, this tale has taken yet another twist. It came late last month from, of all places, Goldman Sachs.

Goldman had executed and cleared trades for Bayou, and there were questions about how well Goldman supervised the account. On July 30, Goldman paid \$20.7 million to roughly 200 Bayou investors in the United States. Those investors, unsecured creditors in a separate Bayou bankruptcy case, were awarded that amount by a securities arbitration panel in June 2010.

It was one of the few bright spots of the Bayou story, but it didn't last. The same day Goldman paid the investors, the firm filed its own creditor's claim for the same amount — \$20.7 million — in the Bayou bankruptcy. Goldman contended that paying the award had made it, too, a Bayou creditor. If the court agrees, the investors who won their arbitration case — also unsecured creditors of Bayou — will be out of luck.

Ross B. Intelisano, a partner at Rich, Intelisano & Katz in New York who represented the Bayou investors, said they would fight Goldman's latest filing.

I asked Goldman last week about the bankruptcy court filing. Michael DuVally, a spokesman, said Goldman never controlled the money at issue in the arbitration.

“Our claim is consistent with bankruptcy law,” he said in a statement. “The arbitration panel, which was not ruling on wrongdoing, determined that money the Bayou funds deposited with us while insolvent needed to be returned to the estate to distribute to creditors. With the ruling, we became a creditor entitled to compensation along with the other victims of the fraud.”

The statement continued: “We were harmed by the Bayou funds and those funds should bear responsibility for the actions we took on their behalf and at their direction. At the end of the day, it was their fraudulent behavior that was the principal cause of any damage suffered by Bayou investors.”

As other clearing firms have argued in similar cases, Goldman has rejected any contention that it was liable for Bayou investor losses. In the arbitration, for example, investors’ lawyers argued that Goldman, as the clearing firm, failed to identify and investigate Bayou’s fraudulent activities. Goldman objected to this argument, even though it had full access to Bayou’s books and the wealth of information that provided.

The investors contended that Goldman knew from its own records that the original Bayou fund had suffered significant losses but that Goldman nevertheless allowed Bayou to lure new money from investors in 2003, which went into the funds’ accounts at Goldman. In total, the investors contended, \$20.6 million shifted between March 2003 and June 2005 from certain Bayou accounts at Goldman to others at the firm. As such, these were fraudulent transfers to Goldman, the investors argued.

Though the arbitrators hearing the matter did not specifically concur, their award of 100 percent of the money transferred during that time suggests the panel agreed.

No matter. After losing the arbitration, Goldman appealed to the Federal District Court to vacate the award, contending that the panel “manifestly disregarded the law.” In November 2010, Jed S. Rakoff, the New York district court judge hearing the matter, affirmed the arbitrators’ decision. None of Goldman’s arguments “remotely suggests that the arbitration panel manifestly disregarded the law,” he said.

UNDETERRED, Goldman took its brief to the Second Circuit Court of Appeals. Last month, a three-judge panel there affirmed Judge Rakoff’s ruling against Goldman.

By this time, post-judgment interest added to the initial award had increased it to \$20.7 million, an amount Goldman paid to the Bayou Hedge Funds litigation trust on July 30. It

simultaneously filed its bankruptcy court claim, keeping Bayou's investors from an award they won more than two years ago.

"The Bayou victims are extremely disappointed that Goldman's bankruptcy court tactics will further delay the distribution of millions of dollars back to the investors," Mr. Intelisano said. "If Goldman thought they can just go into bankruptcy court and get the \$20.7 million back after they lost three times, we're surprised they didn't mention that to the arbitrators, Judge Rakoff or the Second Circuit."

Throughout these courtroom forays, of course, Bayou investors have had to pay legal fees. Now they will have to hire additional lawyers to battle Goldman's most recent action.

Arbitration awards are rarely overturned, so Goldman's decision to appeal the award began as an uphill battle. But while such appeals do occur, securities lawyers not involved in the case said Goldman's effort to recover the payment of an arbitration award in bankruptcy court was unusual.

"The legal threshold question comes down to 'What is the basis of their claim?'" said Gerald H. Silk, a senior partner at Bernstein Litowitz Berger & Grossmann who is familiar with the facts of the case. "I have a hard time believing that after three tribunals said Goldman has to pay these victims this money, the firm could somehow use the bankruptcy process to get that money back."

A spokeswoman for the Financial Industry Regulatory Authority, which oversaw the arbitration, said the organization does not believe it has ever seen a situation like this.

For years, brokerage firms that cleared trades for other institutions were not held responsible for fraudulent activities occurring there. But some big cases, notably a 1999 matter involving Bear Stearns and responsibility for dubious activities at A. R. Baron, a penny stock outfit, have shifted the balance. (Bear agreed to settle the case for \$38.5 million without admitting or denying allegations.)

While some courts continue to rule in favor of clearing firms in these kinds of cases, arbitration panels have sided with investors against firms that claim ignorance of activities going on under their noses.

Lewis D. Lowenfels, an authority on securities law, said Goldman's bankruptcy filing circumvents some bedrock principles of arbitration. "Arbitrators are appointed for equity and justice to prevail," he said. "After an arbitrator's decision and two levels of failed appeals, Goldman's claim in bankruptcy court, which will further delay distribution to long-suffering

customers, only impedes the realization of these ends.”

Who knows if Goldman will prevail. What’s clear is that seven years on, Bayou remains one for the record books.