Goldman Must Pay Some Bayou Losses

By LOUISE STORY and GRETCHEN MORGENSON

Goldman Sachs has been ordered to pay $20.58 million to creditors of a failed hedge fund to settle claims that the bank helped the fund perpetrate a Ponzi scheme.

The award represents the first time that a bank has been held accountable for a Ponzi scheme because of its role as a middleman.

Goldman cleared trades and lent money to the Bayou Group, a Connecticut hedge fund that collapsed in 2005, when state and federal investigators said the firm defrauded investors of hundreds of millions of dollars.

The Bayou fraud resurfaced in 2008 when its founder, Samuel Israel III, faked his own suicide after being sentenced to 20 years in prison for fraud. He later turned himself in and is now serving 22 years.

Bayou's creditors filed a complaint against Goldman two years ago, saying the bank either knew or should have known of Bayou's fraud. Goldman, the complaint said, had access to Bayou's trading records, which showed losses, as well as its marketing materials, which showed profits.

The award, in a decision by an arbitration panel of the Financial Industry Regulatory Authority issued on Thursday, may put other banks on notice to

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better scrutinize their hedge fund clients' activities.

"This case shows that you can't just stick your head in the sand when a fraud is going on in your shop," said Ross B. Intelisano, a lawyer at Rich & Intelisano, who brought the arbitration against Goldman. The bank "argued that you could, and the panel disagreed."

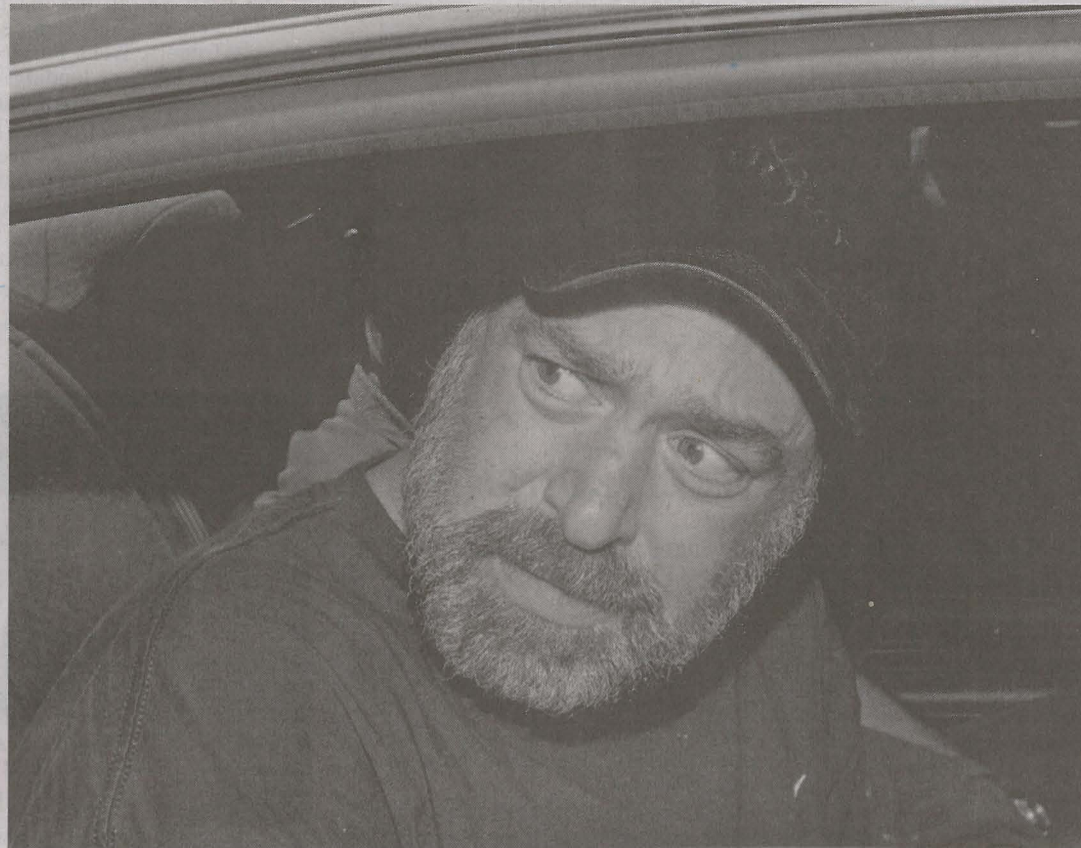
A Goldman spokesman pointed to the bank's filing in the case, which questioned whether the creditors could use bankruptcy laws to hold Goldman accountable for the $20.58 million of investor money that Bayou transferred among its Goldman accounts. The money was never actually conveyed to Goldman, the bank said, so it should not be considered a fraudulent transfer.

The arbitration panel does not determine whether wrongdoing occurred, but merely decides on compensation.

"We are disappointed with the award and are considering our options," said Ed Canaday, a spokesman for Goldman.

Goldman has limited grounds for vacating an arbitration award, however.

The award to Bayou's creditors is yet another legal woe for Goldman. The bank is also the target of a Securities and Exchange Commission investigation of its mortgage operations before and during the financial crisis, and Goldman is fighting an S.E.C. complaint and private lawsuits about mortgage securities it created. Goldman has defended its actions in the mortgage market and said the parties that purchased its mortgage deals should have known what they were dealing with.



STEVEN LEE MILLER/BLOOMBERG NEWS

Samuel Israel III, the founder of the Bayou Group hedge fund, is serving a 22-year term in prison.

An arbitration panel cites Goldman as being a middleman in a Ponzi scheme.

Although the Bayou case dates long before the financial crisis and has nothing to do with mortgage bonds, Goldman made similar claims in its reply. The bank, for instance, said the creditors of Bayou were "highly sophisticated investors." Goldman also said it had no duty to monitor the "honesty and the finances" of its account holders.

Goldman served as Bayou's main prime broker from 1999 to 2005, meaning that the bank had a wide view of the hedge fund's activities, according to the creditors' complaint. In that role, Goldman was the custodian of Bayou's assets and a lender to the fund. Goldman also prepared Bayou's account statements, the creditors said.

The award represents the amount of money that was put into the Bayou funds held at Goldman between March 2003 and June 2005. It accounts for just over 8 percent of the $250 million in losses that Bayou investors incurred in the fraud. If this award is included in the total recovered by Bayou investors, it will rise to more than half of their losses.

Bayou began losing money long before it went bust, for more than $88 million in losses during its association with Goldman. At the same time, Bayou told prospective investors that it had positive returns. During those years, Bayou marketed its relationship with Goldman as a mark of legitimacy, the creditors said.

Goldman was aware that Bayou was losing money, the creditors said. In 2004, Goldman's risk managers created a list of the top 10 money losers among its clients. The No. 1 loser was a Bayou fund, and two other Bayou funds were ranker lower. The list, the complaint said, was circulated among Goldman executives.

A month after that list was circulated, Goldman requested and received a copy of Bayou's marketing materials, which falsely claimed positive returns. Goldman also was warned about Bayou by an outside firm in 2002, the complaint said.

Goldman's employees, the complaint said, "have repeatedly claimed that they had no obligation to concern themselves with what had occurred at the Bayou Hedge Fund at anytime."