

Schulte Roth Loses Bid to Wipe Out \$20.6 Million Goldman Arbitration Award

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The Litigation Daily July 3, 2012



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Eighteen months after U.S. District Judge Jed Rakoff set off alarm bells on Wall Street by concluding that Goldman Sachs must pay more than \$20 million for clearing trades for a fraud-riddled hedge fund, an appellate panel has tepidly endorsed the ruling.

The U.S. Court of Appeals for the Second Circuit affirmed Rakoff's decision on Tuesday, finding that the Manhattan federal judge was right to confirm a \$20.6 million arbitration award for the "unsecured creditors" committee of the bankrupt Bayou Group of hedge funds. Bayou collapsed in 2005 in the wake of a \$400 million Ponzi scheme orchestrated by the fund's former CEO, Samuel Israel III.

The creditors' committee won the award in June 2010, following an arbitration before the Financial Industry Regulatory Authority. The FINRA arbitrators agreed with the committee's lawyers at Rich, Intelisano & Katz that Goldman had fraudulently allowed millions to be transferred into four Bayou funds at the heart of the Ponzi scheme.

Goldman's lawyers at Schulte, Roth & Zabel sued to vacate the award, arguing that the FINRA panel's decision stood in "manifest disregard of the law." Among other things, Goldman argued that it had acted as a conduit for the transfers, not as an "initial transferee," and had no duty to police the Bayou funds for fraud. Judge Rakoff disagreed, ruling in November 2010 that the award must stand—despite his misgivings about the merits of arbitration over litigation.

Judge Rakoff's ruling rattled clearing firms, which understandably don't want to be forced to monitor every trade for signs of fraud, and the decision prompted us to ask whether Goldman's bid to overturn the award had hugely backfired. The Securities Industry and Financial Markets Association, represented by Sidley Austin, stood up as an amicus for Goldman both at the district court and on appeal, to no avail.

In an unsigned summary order, the Second Circuit upheld Rakoff's ruling in its entirety on Tuesday, finding that it must be "highly deferential" to the FINRA panel's findings. The appellate court made it clear that it didn't necessarily agree with the arbitrators' reasoning, but nevertheless rejected Goldman's contention that the award manifestly disregarded the law.

That's bad news for Goldman, and also for others in the clearing industry that were likely hoping the Second Circuit would take the opportunity to clarify the law on fraudulent transfers in their favor. It's very good news for Bayou's creditors, however, said John Rich of Rich Intelisano, who argued for the committee before the Second Circuit in May.

"The investors are very pleased that hopefully they are one step closer to having a good portion of their losses covered by this award," Rich told us. "It's also important that the court reaffirmed the extreme deference under the law that's supposed to be given to these arbitration awards."

We reached out to Goldman counsel Howard Schiffman of Schulte Roth to ask about the ruling, but we didn't immediately hear back.