Basis takes on Goldman Sachs

Downtown

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ne curious aspect of the Securities and Exchange Commission's civil fraud case against Goldman Sachs has been the lack of related private lawsuits by investors who were allegedly defrauded by Goldman's failure to make proper disclosures in relation to a synthetic collateralised debt obligation it created and sold in 2007.

So far neither German bank IKB Deustche Industriebank nor ACA Capital, the two investors that lost out in the deal, have come forward with claims against Goldman. Maybe they are waiting to see how the SEC case turns out, or maybe they are embarrassed about what the case says of their investing nous.

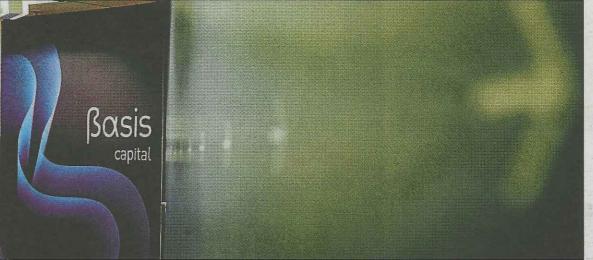
In any case, it has taken an Australian hedge fund, Basis Capital, to get the ball rolling by coming forward with a lawsuit against the Wall Street firm over a similar mortgage securities deal.

Here's Reuters take: "Basis' lawyer, Eric Lewis, said Basis Yield Alpha Fund was suing Goldman to recoup the \$US56 million it lost on the now notorious Timberwolf collateralised debt obligation, which garnered a lot of attention during a recent congressional hearing.

"The lawsuit, being filed on Wednesday in US District Court for the Southern District of New York, also seeks \$USI billion in punitive damages...

punitive damages . . . "The 36-page complaint, a copy of which was provided to Reuters, opens with a rhetorical flourish that repeats a Goldman executive's description of the Timberwolf CDO as 'one s**tty deal'.

"The suit alleges that Goldman pitched the Timberwolf deal to Basis even as the bank's sales force and mortgage traders knew the market for CDOs could soon crumble. In June 2007, Basis paid \$US78 million for two pieces of the CDO with a face value of \$US100 million."



Basis Capital has got the ball rolling by suing Goldman Sachs

According to the Basis statement, the fund invested \$US42 million in the AAA-rated tranche of the Timberwolf CDO and \$US36 million in the AA-rated tranche of the same CDO, but within two-and-a-half weeks Goldman — which had also financed the transaction — made large margin calls on the fund and quickly forced it into insolvency. The fund remains in liquidation while Basis Capital (the manager) continues to operate out of its Sydney base.

It is worth noting that Basis's former outside director, David Mapley, has been complaining for several years to the SEC about the transaction, but it wasn't the Timberwolf deal that the SEC decided to sue Goldman over.

The lawsuit apparently comes after months of settlement talks failed. It is, of course, ideally timed to coincide with the separate SEC/Abacus case and general ill-will towards Goldman and its ability to profit handsomely while others have suffered huge losses.

Perhaps it could be said again in this case that litigation is just a form of negotiation. For its part, Goldman insists that Basis is simply trying to shift its investment losses.

Here's the statement that
Goldman Sachs' New York office
emailed to Downtown: "The lawsuit
is a misguided attempt by Basis, a
hedge fund that was one of the
world's most experienced CDO
investors, to shift its investment
losses to Goldman Sachs.

"At the time of the Timberwolf transaction, Basis specifically stated that it would not place any

Basis, it seems, was trying to catch a falling knife

reliance on Goldman Sachs, and this decision formed part of the agreement Basis signed. Basis made its investment at market levels — levels that it deemed attractive. These levels were substantially below the face value of the securities and consistent with where other investors were purchasing the same Timberwolf securities during the same time period.

"Basis is now trying to recoup its losses based on false allegations that it was misled about aspects of the

Photo: BLOOMBERG

transaction and market conditions. A material fact worth noting is that Goldman Sachs also had substantial exposure to Timberwolf securities and lost several hundred million dollars as a result. We believe the lawsuit is without merit."

One observation to make is that Basis made its investment at a discount to face value — therefore the value of the CDO was falling when it invested. So Basis, it seems, was trying to catch a falling knife.

As with the SEC case, Goldman is hoping it all boils down to whether Basis was a client to which Goldman had any legal or moral duty to act in the best interest of "clients".

At a United States Senate committee hearing in late April, Goldman staff insisted that while the firm had a duty to do well for its clients, the firm's role was as a market maker not as an investment adviser (notably no investors were called before Congress).

As the statement of claim notes: "The Timberwolf security was a key part of the Goldman strategy of continuing the 'business flow' of creating securities and thereby earning fees, while at the same time 'cleaning out left over

positions', that is, dumping its inventory of toxic securities on customers while simultaneously providing a vehicle for Goldman to profit from the decline in the value of such securities.

"The Timberwolf marketing material provided by Goldman to [Basis], as well as the specific statements made by Goldman, both in writing and orally, were designed both by omission and false and misleading statements to disguise and cover up that Timberwolf was a key plank in Goldman's strategy to 'clean out' positions and otherwise to short the market for such securities so that Goldman could be in a position to gain advantage when the market went in distress."

In particular, Basis alleges Goldman's statement that an independent third party, Greywolf Capital Management, was responsible for "initial asset selection" was false because Goldman wielded substantial influence over the portfolio selection process.

It also claims Goldman's pitch book said Timberwolf "was intended to result in portfolios that will generate positive performance for the benefit of both the debt and equity investors", a claim that is laughable in hindsight and directly in contrast with the views of Goldman executives at the time.

The statement also includes an email sent by a Goldman staff member, Donald Mullen, to mortgages boss Daniel Sparks discussing concerns about the representations that Goldman makes to clients.

Within five months of issuance, Timberwolf lost 80 per cent of its value. It was subsequently liquidated in 2008. The statement of claims says damages "should be set in excess of \$USI billion to punish and deter Goldman with respect to its pervasive fraudulent practices".

If Basis only can now convince the court that it was misled, it may also turn out to be one "shitty" deal for Goldman as well.

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