

FINRA DISPUTE RESOLUTION, INC.

In the Matter of the Arbitration Between:

FINANCIAL TRUST COMPANY, INC., and
THE C.O.U.Q. FOUNDATION, INC.,

Claimants,

v.

THE BEAR STEARNS COMPANIES, INC.,
BEAR, STEARNS & CO. INC., BEAR
STEARNS ASSET MANAGEMENT INC.,
and WARREN SPECTOR,

Respondents.

FINRA No. 09-00979

STATEMENT OF ANSWER

Pursuant to Rule 12303 of the NASD Code of Arbitration Procedure for Customer Disputes, Respondents The Bear Stearns Companies, Inc. ("BSC"), Bear, Stearns & Co. Inc. (BS&Co.), and Bear Stearns Asset Management Inc. ("BSAM") (collectively, the "Bear Stearns Respondents"), by their attorneys, Kramer Levin Naftalis & Frankel LLP, respectfully submit this Statement of Answer.

PRELIMINARY STATEMENT

In this proceeding, highly sophisticated investors seek to recover losses they suffered as a result of their own speculation. Claimants Financial Trust Company, Inc. ("FTC") and The C.O.U.Q. Foundation, Inc. ("COUQ") are entities that billionaire investor Jeffrey Epstein operates from a 75-acre private island he owns in the U.S. Virgin Islands, and from offices in New York. As of June 2008, when Epstein pleaded guilty to two felonies and was sentenced to 18 months' imprisonment, he had over 25 years of experience as an investment adviser. FTC, the entity through which Epstein ran his advisory business, had a clientele limited to individuals

whose net worth exceeded \$1 billion, and managed several billion dollars belonging to Epstein and others.

Epstein has invested hundreds of millions of dollars at Bear Stearns over the course of his career. From 2004 through 2007, Epstein, on behalf of a number of entities, including FTC and COUQ, invested at least \$100,000,000 in various BSAM hedge funds alone. Two of these investments, originally totaling \$35,000,000, returned Epstein approximately \$52,500,000.

Between January 2004 and November 2006, Epstein caused FTC and COUQ to invest nearly \$35 million in Bear Stearns High-Grade Structured Credit Strategies, L.P. (the "HG Fund"), Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage, L.P. (the "EL Fund"; together with the HG Fund, the "HG Funds") and Bear Stearns Asset Backed Securities Partners, L.P. (the "ABS Fund") -- three hedge funds offered by BSAM whose strategies focused on trading in esoteric structured finance securities, all utilizing a degree of leverage.

Epstein -- and hence FTC and COUQ -- were well aware of, and understood, the high degree of risk that investing in the HG Fund, EL Fund and ABS Fund (collectively, the "Funds") entailed, including that investors could lose their entire investment. While the HG Funds and the ABS Fund pursued different investment strategies and were managed by two distinct sets of portfolio management teams, offering documents respecting all three funds, which Epstein acknowledged reading, disclosed among other things that:

- Investors could lose all of their principal, as investments in the Funds were "speculative" and involved a high degree of risk;
- The Funds' use of leverage would have the effect of magnifying losses as well as gains, as a result of changes in the value of portfolio securities;
- The structured finance securities in which the Funds traded were highly illiquid, and there might be no secondary market into which the Funds could sell those securities if necessary;

- Hedging strategies employed by the Funds might or might not work, and the Funds' investment strategies would give rise to some risks that could not be hedged at all; and
- Excessive redemptions by investors could overwhelm the Funds' liquid resources and lead to losses.

Epstein executed documents representing that Claimants completely understood all of these risks.

For over three years, FTC and COUQ enjoyed positive returns on their investments in the Funds, and in February 2007 Epstein caused COUQ to redeem \$3,000,000 of its ABS Fund investment. Subsequent to that redemption, however, the risks of which the Funds warned in their offering materials came to pass. Tremendous volatility put pressure on the Funds and led to losses during the spring of 2007. Anxiety in the credit markets pushed the prices of the Funds' assets well below what their values would have been in a more rational market. Ultimately, these forces precipitated an implosion in global credit markets, not only leading to the collapse of the HG Fund and the EL Fund and forcing the ABS Fund to wind down, but also inflicting massive, highly publicized losses at major financial institutions such as Citigroup and Merrill Lynch. The rare convergence of forces that rocked the financial markets in early to mid-2007, and produced Claimants' losses, has been likened in the media to a "perfect storm."

Rather than accept responsibility for the consequences of the speculative investment choices that Epstein made for them, FTC and COUQ now claim to be the victims of a "massive fraud." But as FTC and COUQ well know, their losses resulted from the overall collapse in worldwide credit markets, rather than from any wrongful act or omission by Bear Stearns. There is no basis to place blame on Bear Stearns when the Funds' strategies -- fully disclosed by the Funds, agreed to in writing by FTC and COUQ, and profitable for several years -- ultimately

failed due to the unprecedented dislocation in the credit markets. Claimants' attempt to turn the Bear Stearns Respondents into guarantors of success in the face of the market-wide phenomenon fails under governing New York law and as a matter of indisputable fact.

THE FACTS

A. Epstein Manages Money for Billionaires

Jeffrey Epstein, dubbed by the press as "international moneyman of mystery," is an American financier and money manager.¹ According to the Amended Statement of Claim, Epstein began his career at Bear Stearns in 1977 after being personally recruited as a trader by Alan Greenberg ("Greenberg"), Bear Stearns' former Chairman. (ASOC ¶ 18). At Bear Stearns, Epstein traded options and served in the "special-products division," advising some of the firm's wealthiest clients on the tax implications of their portfolios. Despite making partner, he abruptly departed the firm in 1981. Nevertheless, Epstein maintained a close personal and professional relationship with Greenberg and Jimmy Cayne, Bear Stearns' former long-time Chief Executive Officer.

On his own, Epstein set up J. Epstein & Co. (the predecessor to Claimant FTC) and began managing money for ultra-high net worth individuals. He invested hundreds of millions of dollars of both his own money and his clients' money at Bear Stearns following his departure from the firm. In fact, prior to recent well-publicized legal troubles that resulted in his incarceration, Epstein maintained *seven* separate brokerage accounts at Bear Stearns.²

¹ See Landon Thomas, Jr., *Jeffrey Epstein: International Moneyman of Mystery*, NEW YORK MAGAZINE, Oct. 28, 2002, available at http://nymag.com/nymetro/news/people/n_7912/ (last visited Dec. 4, 2009) (attached hereto as Exhibit A). See also Andrew Marra, *The Man who had Everything*, PALM BEACH POST, Aug. 14, 2006, at 1A (referring to Epstein as "a quintessential man of mystery") (attached hereto as Exhibit B).

² See Larry Keller, *Palm Beacher Pleads in Sex Case*, PALM BEACH POST, July 1, 2008, at 1A (attached hereto as Exhibit C); Sonja Iger, *Epstein's Release 'Upsets' Jane Does'; Their Attorney Says*, PALM BEACH POST, July 23, 2009, at 1B (attached hereto as Exhibit D).

Claimant FTC is a financial consulting firm that, through Epstein, provides financial consulting services to third-parties and also invests its own funds. Epstein is FTC's sole shareholder. FTC is headquartered in the U.S. Virgin Islands and run by Epstein from his 75-acre private island in St. Thomas as well as from offices in New York.

As widely reported in the media, all of FTC's clients are hand-picked by Epstein and all have assets of \$1 billion or more. The *New York Times* reported:

As Mr. Epstein explains it, he provides a specialized form of superelite financial advice. He counsels people on everything from taxes and trusts to prenuptial agreements and paternity suits, and even provides interior decorating tips for private jets. Industry sources say he charges flat annual fees ranging from \$25 million to more than \$100 million.³

While FTC reportedly employs over 100 persons, upon information and belief, Epstein personally makes all of the firm's investment decisions.

B. Epstein Invests \$100 Million in BSAM Funds

Claimants Invest in the Funds

In 1999, Epstein opened a retail investment account at BS&Co. on behalf of FTC. FTC's stated investment objective was "speculation." Epstein later represented to Bear Stearns that FTC had net assets of over \$100,000,000. That same year, Epstein opened a retail investment account at BS&Co. on behalf of COUQ, a private foundation managed by Epstein.

In 2004, seeking speculative investments for FTC and COUQ, Epstein considered various hedge funds offered by BSAM to sophisticated investors and high net-worth individuals. After having received prospectuses and other written documentation for the HG Fund and the ABS Fund, Epstein executed subscription agreements (the "Subscription Agreements") for

³ Landon Thomas, Jr., *From Paradise to County Jail*, *N.Y. TIMES*, July 1, 2008, at C1 (attached hereto as Exhibit E).

investments in those Funds. In that connection, Epstein acknowledged reviewing the various disclosure documents and being apprised of and accepting the attendant risks. (Copies of the executed Subscription Agreements are attached hereto as Exhibits F-I). Pursuant to the Subscription Agreements, in or about January 2004, Epstein, on behalf of FTC and COUQ, invested \$15,000,000 in the HG Fund and \$10,000,000 in the ABS Fund, respectively.⁴

By August 2006, the value of Epstein's HG Fund investment had increased to over \$20,000,000 and the value of Epstein's ABS Fund investment had increased to over \$13,000,000. Ever the speculator, Epstein, seeking even higher returns, then chose to transfer FTC's investment from the HG Fund to the EL Fund in August 2006. (Copies of the executed transfer document and the executed Subscription Agreement for the EL Fund are attached hereto as Exhibit H).

Apparently pleased with his initial investment in the ABS Fund, Epstein, on behalf of FTC, invested an additional \$10,000,000 in the ABS Fund in or about November 2006. In February 2007, when the investment had increased to approximately \$14,600,000, Epstein, on behalf of COUQ, redeemed \$3,000,000 worth of profits from the ABS Fund. (A copy of the Redemption Request is attached hereto as Exhibit J).⁵

Claimants invested a total of \$35,000,000 into the Funds at issue, despite their claims otherwise. Since Claimants redeemed \$3,000,000 from the ABS Fund and have been paid out an

⁴ Simultaneously, Epstein, in his capacity as trustee of the The Wexner Children's Trust II, invested an additional \$20,000,000 in the ABS Fund. Epstein was removed as trustee of the trust in 2008. See Jessica Hall, *JPMorgan's Hersch succeeds colorful money manager*, REUTERS DEALZONE, Feb. 11, 2008, available at <http://blogs.reuters.com/reuters-dealzone/2008/02/11/jpmorgans-hersch-succeeds-colorful-money-manager/> (last visited Dec. 4, 2009). This investment is not the subject of any claims in this arbitration.

⁵ In or about May 2004, Epstein transferred COUQ's interests to the overseas version of the ABS Fund, the Bear Stearns Asset Back Securities Overseas, Ltd., for tax purposes.

additional \$3,000,000 from the ABS Fund, Claimants out-of-pocket losses on these Funds total \$29,000,000, not the \$45,000,000 alleged in the Amended Statement of Claim.⁶

*Epstein Invests an Additional \$35 Million
in Other BSAM Hedge Funds and Profits Greatly*

Conspicuously absent from the Amended Statement of Claim is reference to the fact that Epstein, apparently satisfied with his investments in the HG Funds and the ABS Fund, invested an additional \$35,000,000 in other BSAM-managed hedge funds during the same period Claimants held their investments in the Funds.

In October 2005, Epstein caused FTC to invest \$25,000,000 in the Bear Stearns Emerging Markets Macro Fund, L.P. The Emerging Markets Marco Fund traded and invested in the currencies and securities of developing counties and countries with new or developing capital markets. The performance of the Emerging Markets Marco Fund was phenomenal. In June 2008, FTC's investment was worth approximately \$42,000,000. At that point, Epstein redeemed FTC's entire interest and reaped profits of over \$17,000,000.

Further, in April 2007, Epstein personally invested \$10,000,000 in the Bear Stearns Europe Long/Short Fund, L.P.⁷ The Europe Long/Short Fund invested in the developed European equity market. The fund employed long and short positions in publically-traded equity securities and other equity-related instruments of European companies. By May 2008, when Epstein redeemed his entire interest, the investment had grown to approximately \$10,500,000.

⁶ After COUQ assigned its interest in the ABS Fund to the YLK Charitable Fund in 2008, as discussed below, there was an additional \$3,000,000 paid out as part of the ABS wind-down. Thus, if COUQ is permitted to bring this claim, which it has no standing to do, then the out-of-pocket losses to Claimants are \$26,000,000.

⁷ In addition, at the same time, Epstein, in his capacity as trustee of the The Wexner Children's Trust II, invested \$10,000,000 in the Europe Long/Short Fund.

By April 2007, Epstein had executed at least \$100,000,000 worth of subscription agreements for BSAM-managed hedge funds. Despite his overall success at Bear Stearns, Epstein now seeks to "cherry pick" by looking to recover for Claimants' losing investments.

COUQ Assigns Away its Interest in the ABS Fund

Shortly before Epstein began serving his prison sentence, he divested COUQ of its assets. Epstein transferred much of COUQ's assets to the YLK Charitable Fund ("YLK"). YLK is a foundation controlled by Leslie Wexner, a billionaire who was at one-time a client of Epstein's and the founder of the Limited Brands.

On January 1, 2008, COUQ entered into an Assignment Agreement with YLK concerning COUQ's interest in the ABS Fund. (A copy of the Assignment Agreement is attached hereto as Exhibit K). The agreement clearly states: "The Assignor [COUQ] hereby assigns, transfers and sets forth over to the Assignee all of the Assignor's right, title and *interest of every kind, nature and description* in 100% of the Shares owned by the Assignor." (Exh. K at 1) (emphasis added).

Thus, COUQ no longer holds an interest in the ABS Fund and is therefore not a proper claimant in this arbitration.

C. The Basic Features of the Funds Were Disclosed to Claimants

Epstein sought from Claimants' investments in the Funds returns in excess of the returns available from other funds holding fixed income securities.⁸ From their inception through early 2007, the Funds achieved that objective. Between January 2004 (when FTC first invested in the HG Fund) until the end of January 2007, the HG Fund was up approximately 38%. Similarly,

⁸ The Funds each "fed" another hedge fund, either the Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., the Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd., or the Bear Stearns Asset Back Securities Master Fund, Ltd. (the "Master Funds"), which conducted the investment and trading activities for the Funds. The Master Funds were financed by several feeder hedge funds, including the Funds.

from its inception in August 2006 until January 2007, the EL Fund was up more than 6%. Further, between January 2004 (when COUQ first invested in the ABS Fund) until the end of May 2007, the ABS Fund was up approximately 43%. Not surprisingly, Epstein never complained when Claimants' investments were profitable.

1. The HG Funds

Substantial Leverage Used to Seek Heightened Returns

The HG Funds sought above market returns, in part, through the use of substantial leverage. In connection with FTC's investments in the HG Fund and the EL Fund, Epstein received Private Placement Memoranda (together, the "HG Memoranda") dated September 4, 2003 and August 1, 2006, respectively. (Copies of the HG Memoranda are attached hereto as Exhibits L and M). The HG Memoranda disclosed to investors, among other things, the HG Funds' use of substantial leverage.

The HG Memoranda state that, while the Master Funds "will be capable of using leverage to invest in securities with an aggregate value of as much as fifteen times the Net Asset Value of the Master Fund," they would generally operate up to a net leverage of ten times the net asset value of investments on a gross basis. (See e.g., Exh. L at 9; Exh. M at 15). In addition, with respect to the EL Fund, potential investors such as FTC were informed of the "enhanced leverage" and that they "will therefore be exposed to generally up to . . . 27.5 times the Net Asset Value of the Master Fund." (Exh. M at 14). Many of the parties that extended leverage to the HG Funds were "repo counterparties," whose loans were secured by collateralized debt obligations ("CDOs") and other securities held by the HG Funds. This leverage allowed the HG Funds to magnify their returns greatly, whenever the investment returns exceeded the cost of the borrowed money, as it had from the inception of each of the HG Funds.

The HG Funds' Acquisition of CDOs

As the HG Memoranda and other documents explained, the HG Funds principally purchased and held "investment-grade structured finance securities," such as CDOs, asset-backed securities, synthetic asset-backed securities and mortgage-backed securities, and invested in various derivatives, including credit-default swaps. (See e.g., Exh. L at 8; Exh. M at 1). Structured finance securities are complex securities built by packaging together mortgages or other debt obligations, commonly referred to as collateral. In building a structured finance security, such as a CDO, different classes, or "tranches," are created, and each tranche is given a different priority to the cash stream of interest and principal payments generated by the underlying obligations. The "top" or "senior" tranches, which typically are rated AAA to AA- by independent rating agencies such as Moody's or Standard & Poor's, receive highest priority to the stream of cash, and are structured to provide returns of principal and interest even when the underlying collateral suffers certain levels of losses. To take an oversimplified example, a top tranche might be entitled to the first \$80 for each \$100 of the cash stream due from thousands of mortgages. Under this structure, so long as the delinquency rate stays below 20%, the top tranche will continue to be fully funded.

Underpriced, Illiquid Securities Bought by the HG Funds

Central to the success of the HG Funds was the acquisition of underpriced, illiquid securities. Structured finance securities, such as CDOs, are illiquid as they are traded "over-the-counter" rather than on a public exchange. The value of these types of illiquid securities is determined by broker-dealers and other institutional investors.

The EL Fund

The EL Fund was launched at the request of investors in the HG Fund such as Epstein who, not content with the fund's 10-12% yearly returns, clamored for higher returns. The EL Fund was an ideal investment opportunity for FTC whose stated investment objective was "speculation."⁹

The EL Fund followed the same investment strategy as the HG Fund and was managed in a similar fashion, but employed additional leverage to increase returns. Of course, the increased leverage also led to increased volatility. As a result, the EL Fund was managed in a separate fund "silo" so that any increase in volatility associated with the additional leverage would only affect those investors who knowingly chose to invest in the riskier EL Fund. Claimants' assertion that the EL Fund was created as part of some "massive fraud" or "scheme" is patently false.

Further, to the extent Claimants somehow attempt to connect their baseless allegations about the creation of the EL Fund to the indictment of Ralph Cioffi and Matthew Tannin, the portfolio managers of the HG Funds, it must be noted that Messrs. Cioffi and Tannin were acquitted of all charges on November 10, 2009.¹⁰

⁹ Every investor in the HG Fund was informed about the launch of the EL Fund, provided with the marketing and offering materials, and given the opportunity to transfer their investment from the HG Fund to the EL Fund. Some investors, like FTC, chose to transfer their entire holdings from the HG Fund to the EL Fund, others chose to transfer a portion of their holdings, and others chose to transfer none.

¹⁰ Epstein's penchant for lies and half-truths was further displayed in June 2008, when he authorized his publicist to tell the press that he was the "Major Investor No. 1" described in the indictment of Messrs. Cioffi and Tannin. See *Bear Bites Billionaire*, N.Y. POST, June 30, 2008, at 11. According to the indictment, "Major Investor No. 1" invested \$57,000,000 in the HG Funds. Of course, Epstein never had anywhere near \$57,000,000 invested in the HG Funds and now that the trial has concluded, the entire world knows that "Major Investor No. 1" was Concord Management, not Epstein.

2. The ABS Fund

The ABS Fund pursued a different investment strategy and was managed by a separate portfolio management team. The ABS Fund sought to achieve high total returns through investments in a variety of U.S. and non-U.S. undervalued asset-backed securities by identifying and capturing market inefficiencies. In connection with Claimants' investments in the ABS Fund, Epstein received Private Placement Memoranda (the "ABS Memoranda;" with the "HG Memoranda," the "Memoranda") dated January 2001 and June 2006, respectively. (Copies of the ABS Memoranda are attached hereto as Exhibits N and O).

The ABS Fund invested in a broad spectrum of public and private securities including asset-backed securities, collateralized mortgage obligations, commercial mortgage-backed securities, CDOs, global structured asset securitizations, whole loans, and whole loan mortgages. The fund also purchased various derivatives for hedging purposes. (*See e.g.*, Exh. N at 1; Exh. O at 1). The ABS Fund pursued a relative value investment strategy that attempted to capture a stable income stream and minimize return volatility over time. This strategy relied on three components: the ability to identify and purchase undervalued securities; an intensive analytical approach to risk management; and a stable long-term capital base. The positions in the ABS Fund could be substantially leveraged by various sources of funding including banks and "repo counterparties." Leverage was capped at "six times net assets." (*Id.*).

The ABS Fund's sources of return included income from its investments and capital appreciation. The vast majority of the ABS Fund's portfolio was comprised of structured finance securities rated BB/B or not rated. These ratings are classified as speculative/highly speculative by the independent rating agencies. Compared to the securities in the HG Funds, the ABS Fund's securities had lower priority to the cash streams generated by the securities' underlying obligations.

D. Claimants Were Fully Apprised of the Significant Risks of Investing in the Funds

The Memoranda for all three funds – HG Fund, EL Fund and ABS Fund – each of which Claimants acknowledged receiving and reading when Epstein executed the Subscription Agreements, disclosed the risks associated with investments in the Funds. All of the Memoranda contained approximately ten pages under the heading “Risk Factors.” (See e.g., Exh. L at 10-17; Exh. M at 17-29; Exh. N at 24-37; Exh. O at 28-43). In combination with other warnings spelled out throughout the Memoranda and in the Subscription Agreements, Claimants were fully apprised of the risks. The Memoranda explicitly warned of the possible total loss of investment, of the risks posed by leverage, of the illiquidity of the Funds’ investments, of the limited protection afforded by hedging, and of the risks posed by significant redemptions.

1. The Funds Disclosed the Risk of Loss of Principal

At the beginning of the HG Memoranda, in “Notices to All Investors,” FTC was warned about the risks concerning these investments:

“INTERESTS ARE SPECULATIVE AND INVOLVE A SUBSTANTIAL RISK.”

(See e.g., Exh. L at i; Exh. M at i) (capitalization and bold in original). Claimant was also informed that:

“[The Fund is] suitable only for investors who can afford to lose all or a substantial portion of their investment.”

(See e.g., Exh. L at 2; Exh. M at 5) (italics and bold in original). See also Exh. L at 1; Exh. M at

2 (“There can be no assurance that [the Fund] will achieve its objectives or avoid substantial losses.”) (bold and italics in original).

The ABS Fund’s Memoranda similarly warned:

THESE SECURITIES ARE SUITABLE FOR SOPHISTICATED INVESTORS (i) WHO DO NOT REQUIRE IMMEDIATE LIQUIDITY FOR THEIR INVESTMENTS, (ii) FOR WHOM AN

INVESTMENT IN THE PARTNERSHIP DOES NOT CONSTITUTE A COMPLETE INVESTMENT PROGRAM AND (iii) WHO FULLY UNDERSTAND AND ARE WILLING TO ASSUME THE RISKS INVOLVED IN THE PARTNERSHIP'S INVESTMENT PROGRAM.

(See e.g., Exh. N at ii; Exh. O at ii) (capitalization in original). See also Exh. N at 22; Exh. O at 27) ("THE [FUND'S] INVESTMENT PROGRAM IS SPECTULATIVE AND ENTAILS SUBSTANTIAL RISKS. THERE CAN BE NO ASSURANCE THAT THE INVESTMENT OBJECTIVES OF [THE FUND] WILL BE ACHIEVED, AND RESULTS MAY VARY SUBSTANTIALLY OVER TIME.") (capitalization in original).

2. The Funds Disclosed that Leverage Magnified Gains and Risks

The HG Memoranda explicitly stated what a sophisticated investor such as Epstein already knew:

The more leverage is employed, the more likely a substantial change will occur in the value of [the Fund]. Accordingly, any event which adversely affects the value of an investment would be magnified to the extent leverage is utilized. The cumulative effect of the use of leverage with respect to any investments in a market that moves adversely to such investments could result in a substantial loss which would be greater than if the investments were not leveraged.

(See e.g., Exh. L at 10; Exh. M at 17).

The ABS Memoranda contained a similar warning. See Exh. N at 29; Exh. O at 35 ("While leverage presents opportunities for increasing the total return of [the Fund], it has the effect of potentially increasing losses as well.").

3. The Funds Disclosed the Significant Risk of Illiquidity

The Funds also explicitly warned investors that their portfolio securities were highly illiquid. As the HG Memoranda expressly state, "Securities purchased . . . may lack a liquid trading market, which may result in the inability . . . to sell any such security or other

investment" risking "*potentially unlimited losses.*" (See e.g., Exh. L at 14; Exh. M at 22) (emphasis added).

The ABS Fund's Memoranda similarly warned:

The [Fund] may invest in securities which are subject to legal or other restrictions on transfer or for which no liquid market exists. The market prices, if any, for such securities tend to be volatile and the [Fund] may not be able to sell them when [it desires] to do so or realize what [it perceives] to be their fair value in the event of a sale. The sale of restricted and illiquid securities often requires more time and results in higher brokerage charges or dealer discounts and other selling expenses than does the sale of securities eligible for trading on national securities exchanges or in the over-the-counter markets. Restricted securities may sell at a price lower than similar securities that are not subject to restrictions on resale.

(See e.g., Exh. N at 29; Exh. O at 34).

4. The Funds Disclosed That Their Investments Could Not Be Fully Hedged

The Memoranda further disclosed what a sophisticated market participant such as Epstein would have known already: no investment portfolio can be completely hedged. The Memoranda warned that the Funds' portfolios "will always be exposed to certain risks that *cannot be hedged*" at all. (Exh. L at 14; Exh. M at 24; Exh. N at 31; Exh. O at 36) (emphasis added). Finally, Claimants were warned that, to the extent the Investment Manager's assessment of certain market movements were incorrect; the Funds were subject to the risk that the use of hedging could result in losses greater than if hedging had not been used. (See e.g., Exh. L at 14; Exh. M at 23; Exh. N at 30; Exh. O at 35).

5. The Funds Disclosed the Risk of Redemptions

Claimants were informed that substantial redemptions could force the Funds to liquidate positions more rapidly than would otherwise be desirable, and could impair the Funds' ability to implement their investment strategy. The Funds therefore imposed significant limitations on the ability of investors to redeem, from delaying the actual return of redeemed investments to the

suspension of redemptions altogether. See Exh. L at 6, 29-31; Exh. M at 9, 45-47; Exh. N at 5-7, 64-66; Exh. O at 7-10, 76-80 (providing for a suspension of redemptions when necessary); see also Bear Stearns High-Grade Structured Credit Strategies, L.P. Limited Partnership Agreement, dated August 26, 2003, attached hereto as Exhibit P, at 21; and Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Fund, L.P. Limited Partnership Agreement, dated June 20, 2006, attached hereto as Exhibit Q, at 29; Amended and Restated Limited Partnership Agreement of Bear Stearns Asset Backed Securities Partners, L.P., dated January 31, 2001, attached hereto as Exhibit R, at 15.

E. Claimants Acknowledged That They Fully Understood These Risks

Epstein knew or should have known that Claimants' entire investment could be lost because the *exact risks* that ultimately caused the Funds to fail repeatedly were disclosed. However, before Claimants invested in the Funds, Epstein, on Claimants' behalf, represented that he read and understood the risks outlined in the Memoranda and that Claimants were willing to assume such risks. The Subscription Agreements for the HG Funds, which Epstein signed on behalf of FTC, contained the following two passages:

The Investor has received and read a copy of the Memorandum outlining, among other things, the organization and investment objectives and policies of, and the risks, conflicts of interest, and expenses of an investment in the [Fund]. *The Investor acknowledges that in making a decision to [invest] the Investor has relied solely upon the Memorandum, the [Governing Agreement], the most recent annual report and accounts of the [Fund] (if any) and (where applicable) the most recent unaudited monthly report, and independent investigations made by the Investor.* The Investor understands the investment objectives and policies of, and the investment strategies which may be pursued by, [the Fund]. The Investor's investment in the [Fund] is consistent with the investment purposes and objectives, and cash flow requirements of the Investor and will not adversely affect the Investor's overall need for diversification and liquidity.

The Investor has carefully reviewed and understands the various risks of an investment in the [Fund], including those summarized under "Risk Factors" and described in greater detail elsewhere in the Memorandum; the undersigned understands that an investment in the [Fund] is speculative and the undersigned can afford to bear the risks of an investment in the [Fund], including the risk of losing the undersigned's entire investment.

(See e.g., Exh. F at 11-12; Exh. H at 7) (emphasis added).

The Subscription Agreements for the ABS Fund, which Epstein also signed on behalf of Claimants, contained the following passage:

The Investor has received, carefully read and understands the Partnership Agreement and the Memorandum outlining, among other things, the organization and investment objectives and policies of, and the risks and expenses of an investment in, the [Fund] . . . The Investor acknowledges that in making a decision to invest, the Investor has relied solely upon the Memorandum, the [Governing Agreement], and independent investigations made by the Investor. The Investor is not relying on the [Fund] or the General Partners, or any other person or entity with respect to the legal, tax and other economic considerations involved in this investment other than the Investor's own advisers. The Investor's investment in the [Fund] is consistent with the investment purposes, objectives and cash flow requirements of the Investor and will not adversely affect the Investor's overall need for diversification and liquidity.

(See e.g., Exh. G at 2; Exh. I at 2) (emphasis added).

Claimants also agreed that they had been afforded the opportunity to ask questions and obtain any additional information necessary to verify the accuracy of any representation or information set forth in the offering documents. (See e.g., Exh. F at 12; Exh. G at 2; Exh. H at 7; Exh. I at 2). Further:

The Investor has such knowledge and experience in financial and business matters that the Investor is capable of evaluating the merits and risks of the Investor's investment in the [Fund] and is able to bear such risks . . . The Investor has evaluated the risks of investing in the [Fund] . . . and has determined that the [Fund] is a suitable investment for the Investor.

(Id.).

Claimants represented they had relied “solely” on the written materials provided to them and on their own “independent investigations.” (Exh. F at 11; Exh. G at 2; Exh. H at 7; Exh. I at 2). By signing the Subscription Agreements, Epstein represented that Claimants understood the risks outlined in the Memoranda and they are estopped from claiming otherwise.

F. The Credit Market Implosion in 2007 Led to the Failure of the Funds

The HG Funds’ eventual collapse and the ABS Fund’s wind-down were caused by a convergence of extraordinary external forces in the credit market beyond the Funds’ control. These multiple forces unexpectedly impacted the Funds at the same time, triggering the very risks the Funds had contemplated and disclosed to investors. The rare convergence of these forces in early- to mid-2007 has been likened by the media to a “perfect storm.” *See, e.g., Vance Cariaga, Brokerages Face Perfect Storm of Subprime and Buyout Woes*, *Inv. Bus. Daily*, Aug. 10, 2007, at A01.

1. The HG Funds

Until the end of January 2007, FTC enjoyed substantial gains from its investments in the HG Funds. February 2007 was the first month since the creation of the EL Fund in 2006 that it did not return a profit to investors. The HG Funds did have instruments and strategies in place to hedge potential market volatility. However, in March – as the Memoranda explicitly warned might happen – the price of one of the HG Funds’ principal hedges moved in an unexpected direction, increasing (rather than mitigating) losses. When this loss combined with the continued drop in prices of highly rated CDOs, the HG Funds had a negative month.

The HG Funds’ returns were down for March and April. In May and June, investors made significant redemption requests and repo counterparties became more forceful in making margin calls and demanding the return of collateral. Investors were advised by letters dated June

7 and 26, 2007, that redemptions for the HG Fund and the EL Fund would be suspended as of June 30th. On July 18, 2007, BSAM sent letters to investors advising that the preliminary estimated return for June was -86% for the HG Fund and -100% for the EL Fund. Soon thereafter, investors were notified that the HG Funds had closed.

The HG Funds could not withstand the crisis, which has caused, and continues to cause, staggering losses to financial institutions worldwide. The implosion of the market for subprime debt inflicted severe losses on many market participants. For example, as of 2009, it was reported that UBS has written off subprime losses of \$53 billion; Merrill Lynch, \$46 billion; Citigroup, \$24 billion; Morgan Stanley \$10.8 billion.¹¹ It is reported that, in 2008, financial institutions wrote off over \$500 billion in losses in connection with the subprime mortgage industry.¹²

Not only investors have been affected; the crisis has caused massive shocks throughout the financial industry. CDO insurers MBIA Inc. and Ambac Financial Guaranty wrote off \$10 billion in losses in 2007, and hundreds of millions in January 2008.¹³ Standard & Poor's

¹¹ Eric Dash, *Citi Leaps a Hurdle and Faces More*, N.Y. TIMES, Apr. 19, 2008, at C1; Nelson D. Schwartz, *The Mortgage Bust Goes Global*, N.Y. TIMES, April 6, 2008, at B1; Landon Thomas, Jr., *What's \$34 Billion on Wall Street?*, N.Y. TIMES, Jan. 27, 2008, at B1; Dow Jones, *Factbox - Write-downs and Losses at Major Global Banks*, Apr. 17, 2008; Nelson D. Schwartz, *For Swiss Banks, An Uncomfortable Spotlight*, N.Y. TIMES, Mar. 5, 2009, at B1; Susanne Craig, Randall Smith and Serena Ng, *Merrill Aims to Raise Billions More - Firm Dumps Mortgage Assets as Crisis Drags On; Another Big Write Down*, WALL ST. J., July 29, 2008, at A1.

¹² *Senate Appropriations Subcommittee on Commerce, Justice, Science and Related Agencies Hearing* (June 4, 2009) (statement of Robert Mueller, Director, Federal Bureau of Investigations), available at <http://www.fbi.gov/congress/congress09/mueller060409.htm> (last visited Dec. 4, 2009).

¹³ Christine Richard, *MBIA, Ambac Filings Show Subprime Losses Continued (Update1)*, Bloomberg.com, Mar. 3, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601103&sid=a97EQBeRf2mQ&refer=news#> (last visited Dec. 4, 2009).

downgraded \$882 billion in residential mortgage-backed securities and an additional \$1.3 trillion might be downgraded.¹⁴

The unprecedented impact of the world-wide credit crisis continues to negatively impact financial institutions and the economy as a whole. Last year, the federal government intervened to place Fannie Mae and Freddie Mac, which together owned or guaranteed nearly \$5 trillion in mortgages, into conservatorship after concluding that those institutions could not survive on their own.¹⁵ In 2008, Lehman Brothers, one of America's oldest banks, filed a bankruptcy petition and listed \$613 billion in debt – the largest bankruptcy in American history as of the date of its filing.¹⁶ In response to the tremendous turmoil caused by the credit meltdown, in October 2008, Congress approved the first in a series of rescue plans to assist troubled financial institutions and to stabilize the economy.¹⁷ To date, the current administration has committed \$1 trillion in federal spending for economic recovery through a variety of programs.¹⁸

2. The ABS Fund

In the summer of 2007, the concerns surrounding the credit market resulted in the ABS Fund receiving an unusually large number of redemption requests. Investors were advised by

¹⁴ Barbara Hagenbaugh, Pallavi Goi, and Matt Krants, *Will Potential Profits Lure the Private Sector?*, USA TODAY, Mar. 24, 2009, at 1A.

¹⁵ See e.g., Stephen Labaton, *Scramble Led to Rescue Plan on Mortgages*, N.Y. TIMES, July 15, 2008, at A1; James B. Lockhart, Federal Housing Finance Agency, Statement of FHFA Director James B. Lockart (Sept. 7, 2008), available at <http://www.fhfa.gov/webfiles/23/FHFAStatement9708final.pdf> (last visited Dec. 4, 2009).

¹⁶ Yalman Onaran and Christopher Scinta, *Lehman Files Biggest Bankruptcy Case as Suitors Balk (Update 4)*, Bloomberg.com, Sept. 15, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=aPTIdpST8HJ0&refer=worldwide> (last visited Dec. 4, 2009).

¹⁷ Christopher Stern and Laura Litvan, *Bank Rescue-Plan Wins Approval As House Reverses Vote (Updated 5)*, Bloomberg.com, Oct. 3, 2008, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aTRUXZrt.eMY> (last visited Dec. 4, 2009).

¹⁸ Sheryl Gay Stolberg, *Obama Aims to Revive "Pay as You Go"*, N.Y. TIMES, June 10, 2009, at A20.

letter dated July 31, 2007, that redemptions for the ABS Fund would be suspended as of July 31st. Due to structural differences between the HG Funds and the ABS Fund, BSAM was optimistic that the ABS Fund could ultimately weather the "perfect storm" and rescind its suspension of redemptions.

Unfortunately, by December 2007, it became apparent that, based on continued market deterioration, furtherance of the ABS Fund's strategy was not in the best interest of investors like Claimants. Investors were advised by letter dated December 20, 2007, that the fund would be wound down. Pursuant to the wind-down, the ABS Fund's available capital was distributed to investors on a *pro rata* basis. Further, investors were informed by BSAM that the fund was positioned to sell its holdings into the market under the appropriate circumstances. The sale of assets gave rise to the potential for additional cash distributions to investors.

As a result, Claimants' investments in the ABS Fund are in the process of being liquidated and repaid. While it will likely take many months or even years to liquidate the entire ABS Fund and pay the proceeds out to investors, Claimants' losses, if any, will be much less than alleged. To date, as a result of the wind-down, Claimant FTC has been paid out nearly \$3,000,000. To date, YLK, the assignee of Claimant COUQ, has been paid out over \$3,000,000. This is in addition to COUQ's withdrawal of \$3,000,000 from the ABS Fund.

Moreover, upon information and belief, Claimants will have the option of receiving either future cash payments as the ABS Fund is liquidated, or a *pro rata* portion of in-kind securities, some of which have six to eight years of cash flows. Under the latter scenario, there is a realistic opportunity for Claimants to mitigate their losses even further as the securities continue to pay cash and some eventually get redeemed.

**THE CLAIMS FOR RELIEF FAIL TO
PROVIDE A BASIS FOR RECOVERY**

The Amended Statement of Claim fails to state a claim upon which relief can be granted. The crux of Epstein's complaints simply is that Claimants lost money in the "perfect storm" of market forces. The courts time and again have rejected "fraud by hindsight" claims such as this when losses are part of a global market decline. Claimants must accept responsibility for the risks they undertook in seeking to profit from investments that suffered losses due entirely to market forces outside of the Bear Stearns Respondents' control.

Each of Claimants' causes of action will be summarily addressed here and more thoroughly addressed at the hearings.

A. Claimant COUQ Lacks Standing

Claimants admit that, after the ABS Fund decided to wind down, COUQ transferred its interest in the ABS Fund. (ASOC ¶ 14). On January 1, 2008, COUQ entered into an Assignment Agreement with YLK. This agreement clearly states: "The Assignor [COUQ] hereby assigns, transfers and sets forth over to the Assignee all of the Assignor's right, title and *interest of every kind, nature and description* in 100% of the Shares owned by the Assignor." (Exh. K at 1) (emphasis added). Thus, COUQ has no standing to bring any claims against the Bear Stearns Respondents with respect to its investment. Claimants attempt to skirt this fact by claiming that "COUQ did not transfer its legal claims" is belied by the clear language of the assignment agreement between COUQ and YLK.

In *W. R. Huff Asset Mgmt. Co., LLC v. Deloitte & Touche LLP*, the Second Circuit held that, under the standing doctrine, "the minimum requirement for an injury-in-fact is that the plaintiff have legal title to, or a property interest in, the claim." 549 F.3d 100, 108 (2d Cir. 2008) (citing *Sprint Commc'ns Co., L.P. v. APCC Servs., Inc.*, 128 S. Ct. 2531, 171 L. Ed. 2d 424

(2008)). Thus, Claimant COUQ has no standing to bring its claim despite its unsubstantiated bald assertion to the contrary.

Any and all claims arising from COUQ's investment in the ABS Fund now belong to YLK. As a result, COUQ has no standing in this proceeding and its claim must be dismissed.

B. The Exculpation Clauses Bars Claimants Claims

The Limited Partnership Agreements for the HG Funds and ABS Fund contain exculpation clauses that bar claims by limited partners such as Claimants against the Bear Stearns Respondents for acting pursuant to the Partnership Agreement, including "errors" or "mistakes" of judgment by the General Partner, to the extent they reasonably believed to be acting within "the best interests of the Fund" and without "fraud, bad faith, gross negligence or willful misconduct." (See, e.g., Exh. P at 26-7; Exh. Q at 36; Exh. R at 6).

Similarly, the Subscription Agreements Claimants executed for the HG Funds contains exculpation clauses which state that the Partnership will "exculpate, indemnify, and hold harmless the General Partner and any member, partner, shareholder, manager, director, officer, employee or agent of the General Partner or any affiliate of any of them from and against any loss or expense suffered or sustained" in connection with their services to the Fund (again, provided that the losses were not the result of fraud, bad faith, gross negligence or willful misconduct). (See, e.g., Exh. F at 15; Exh. H at 12).

Thus, Claimants are barred from asserting these claims as a matter of law. See also, e.g., *Colnaghi, USA, Ltd. v. Jewelers Protection Servs., Ltd.*, 81 N.Y.2d 821, 823, 595 N.Y.S.2d 381, 382 (1993) (enforcing contractual exculpation agreement).¹⁹

¹⁹ Respondents BSC and BS&Co. were not parties to the Subscription Agreements.

C. Each of Claimants' Common Law Claims Fails

Breach of Fiduciary Duty

There can be no claim for breach of fiduciary duty absent a fiduciary relationship between the parties. *Cramer v. Devon Group, Inc.*, 774 F. Supp. 176, 184 (S.D.N.Y. 1991) (to establish breach of fiduciary duty “[f]irst, it must be shown that there is a fiduciary relationship between the parties”); *Compania Sud-Americana de Vapores, S.A. v. IBJ Schroder Bank & Trust Co.*, 785 F. Supp. 411, 425 (S.D.N.Y. 1992) (same). Claimants fail to allege facts sufficient to establish the existence of a fiduciary relationship between the Bear Stearns Respondents and Claimants. Simply put, BSC and BS&Co. cannot be held liable for breaching a fiduciary duty they did not owe.²⁰

Fraudulent Inducement and Constructive Fraud

Claimants' constructive fraud and fraudulent inducement claims suffer from a number of deficiencies.

Claimants have failed to set forth any of the elements of fraud required under governing New York law, and cannot do so. A claim of fraud under New York law must allege that: (1) the defendant failed to disclose material information, (2) the defendant had the intent to defraud, or *scienter*; (3) the plaintiff reasonably relied on the concealment; and (4) the plaintiff suffered damage as a result of the concealment. *Banque Arabe et Internationale D'Investissement v.*

²⁰ Claimants' breach of fiduciary duty claim also must be dismissed as a matter of law because New York's Martin Act bars Claimants' claim for breach of fiduciary duty. See N.Y. Gen. Bus. Law §§ 352a-352c (McKinney 2007). The Martin Act entrusts to New York State's Attorney General *exclusive* enforcement power over claims involving allegedly fraudulent and deceptive acts “engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation or purchase . . . of any securities or commodities.” *Id.* at § 352c. Private claimants are barred as a matter of law from bringing breach of fiduciary claims in connection with securities transactions such as these. See *Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 190 (2d Cir. 2001) (dismissing claims for breach of fiduciary duty as barred by the Martin Act); *Gabriel Capital, L.P. v. Natwest Fin., Inc.*, 137 F. Supp. 2d 251, 266-67 (S.D.N.Y. 2000) (same).

Maryland Nat'l Bank, 57 F.3d 146, 153 (2d Cir. 1995).²¹ The elements of constructive fraud are the same as those of fraud, except that the element of scienter is replaced by a fiduciary or confidential relationship between the parties. *Burrell v. State Farm & Cas. Co.*, 226 F. Supp. 2d 427, 438 (S.D.N.Y. 2002) (citing *Klembczyk v. Di Nardo*, 265 A.D.2d 934, 936, 705 N.Y.S.2d 743, 744 (4th Dep't. 1999)). The elements of a claim for fraudulent inducement are similar: the defendant must have made a misrepresentation of a material fact; that was known to be false and intended to be relied on when made (*scienter*); and the plaintiff justifiably relied on the misrepresentation to its injury. *Braddock v. Braddock*, 60 A.D.3d 84, 86, 871 N.Y.S.2d 68, 70 (1st Dep't. 2009) (citing *Gaidon v Guardian Life Ins. Co. of Am.*, 94 N.Y.2d 330, 348, 704 N.Y.S.2d 177, 185 (1999)). "State law claims of fraud and fraudulent inducement must be based on facts giving rise to a 'strong inference' of fraudulent intent." *Amida Capital Mgmt. II, LLC v. Cerberus Capital Mgmt., L.P.*, 08 Civ. 5516 (MGC), 2009 U.S. Dist. LEXIS 105738, at *35 (S.D.N.Y. Nov. 10, 2009) (quoting *Lerner v. Fleet Bank*, 459 F.3d 273, 290 (2d Cir. 2006)).

First, Claimants have not adequately pleaded that the Bear Stearns Respondents failed to disclose material information – the risks of investing in the Funds – because such allegation conflicts squarely with the risk factors clearly articulated and prominently displayed in the Memoranda and reiterated in the Subscription Agreements. (See pp. 13-16 *supra*). Because Claimants' allegations of misrepresentation or omission regarding the Funds conflict with the clear and prominent display of the extensive risk factors in the Memoranda, any claim of

²¹ In addition, Claimants fail to plead their claim with sufficient particularity. As the courts require under Federal Rule of Civil Procedure 9(b), fraud claims such as this must: "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent." *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994) (citations omitted). Claimants have not pled any of these elements in the Statement of Claim. Claimants' general allegations that Respondents misrepresented the nature and extent of risks involved with the Funds are insufficient as a matter of law to state a claim for fraud.

fraudulent inducement must fail. See e.g., *Olkey v. Hyperion 1999 Term Trust, Inc.*, 98 F.3d 2, 9 (2d Cir. 1996) (alleged misrepresentations (written and oral) that are “contradicted by the disclosure of risk made on the face of each prospectus” are “immaterial” as a matter of law); *id.* (investors’ allegations that they were “promised a secure investment without warning that preservation of capital was not guaranteed . . . founder[ed] on the face of the offering materials,” which indicated that the trust at issue may fail to return investors’ money); *Steinberg v. PRT Group, Inc.*, 88 F. Supp. 2d 294, 300 (S.D.N.Y. 2000) (“If a plaintiff’s claims of misstatement or omission conflict with the plain language of a prospectus, the prospectus controls and the court need not accept as true the allegations of the complaint.”).

Second, for their fraudulent inducement claim, Claimants have not set forth any facts demonstrating that the Bear Stearns Respondents acted with the requisite fraudulent intent or *scienter*. Claimants have neither alleged specific conscious misbehavior by the Bear Stearns Respondents nor have they adequately alleged a motive for committing fraud. *Odyssey Re (London) Ltd. v. Stirling Cooke Browne Holdings, Ltd.*, 85 F. Supp. 2d 282, 295 (S.D.N.Y. 2000), *aff’d*, 2 Fed. Appx. 109 (2d Cir. 2001).

For their constructive fraud claim, as mentioned above, Claimants fail to allege facts sufficient to establish the existence of a fiduciary relationship between the Bear Stearns Respondents and Claimants.

Third, Claimants also have not pleaded and will not be able to prove that the Bear Stearns Respondents’ conduct *caused* their losses. To recover damages from the Bear Stearns Respondents, Claimants bear the burden to prove both “transaction causation” (cause in fact) and “loss causation” (proximate cause). *Lentell v. Merrill Lynch & Co., Inc.*, 396 F.3d 161, 172-74 (2d Cir. 2005). The Amended Statement of Claim fails to plead either.

For transaction causation, Claimants must set forth facts establishing that, but for fraudulent conduct, Claimants would not have purchased the Funds at issue. *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 97-98 (2d Cir. 2001). The Amended Statement of Claim fails to do so. Nor do Claimants set forth any facts demonstrating loss causation – “a causal connection between the misrepresentation and the investment’s subsequent decline in value.” *In re Merrill Lynch & Co., Inc.*, 273 F. Supp. 2d 351, 363 (S.D.N.Y. 2003), *aff’d*, 396 F.3d 161 (2d Cir. 2005) (quoting *Robbins v. Koger Props., Inc.*, 116 F.3d 1441, 1448 (11th Cir. 1997)). To the contrary, the facts show that Claimants’ losses were caused by market forces. “[L]osses do not afford any basis for recovery if brought about by business conditions or other factors.” *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 344-45 (2005) (internal citations omitted). As one federal court explained in dismissing claims brought by investors:

[T]he Second Circuit has held that: “when the plaintiff’s loss coincides with a marketwide phenomenon causing comparable losses to other investors, the prospect that the plaintiff’s loss was caused by [defendant’s conduct]-decreases.”

Merrill Lynch & Co., 273 F. Supp. 2d at 365 (citing *Powers v. British Vita, P.L.C.*, 57 F.3d 176, 189 (2d Cir. 1995) (market value of stock fell as a result of recession); *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 772 (2d Cir. 1994) (investor’s loss caused by a marketwide real estate crash)). As the United States Supreme Court stated in *Dura Pharmaceuticals, Inc.*, the securities laws are “not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause.” 544 U.S. at 345.

Claimants cannot show that the losses here were caused by any misrepresentation made by the Bear Stearns Respondents and not by the precipitous downturn in the credit markets. As set forth above, the law is well settled that such losses are not compensable.

Negligent Misrepresentation

Claimants' negligent misrepresentation claims are barred because the Bear Stearns Respondents do not owe a duty of care to sophisticated parties, such as Claimants, with whom they have entered into commercial relationships. See *Vitolo v. Mentor H/S, Inc.*, 426 F. Supp. 2d 28, 36 (E.D.N.Y. 2006) (Under New York law, "imposition of an independent duty of care in an arms-length business transaction is reserved for the most serious of situations directly affecting the public at large, and not sophisticated parties."), *aff'd*, 213 Fed. Appx. 16 (2d Cir. 2007); *Primex Plastics Corp. v. Lawrence Prods., Inc.*, No. 89 Civ. 2944 (JSM), 1991 WL 183367, at *5 (S.D.N.Y. Sept. 12, 1991) ("The common law imposes no duty of care on parties involved in an arms-length business transaction.").

In any event, as set forth above, Claimants' losses were caused entirely by market forces. There is no act or failure to act by the Bear Stearns Respondents that was negligent and that caused Claimants' losses.

Breach of Contract

To state a claim for breach of contract under New York law, a party must allege, "(1) the existence of a valid, enforceable agreement; (2) performance of the contract by one party; (3) breach of the contract by the other party; and (4) damages." *Bridgeport Music, Inc. v. Universal Music Group, Inc.*, 440 F. Supp. 2d 342, 344-45 (S.D.N.Y. 2006). Respondents BSC and BS&Co. were not parties to the Subscription Agreements and did not make any representations to Claimants. Thus, there can be no breach of contract claim as against BSC and BS&Co.

Respondeat Superior

Under the doctrine of respondeat superior, "an employer may be vicariously liable for the tortious acts of its employees only if those acts were committed in furtherance of the employer's

business and within the scope of employment.” *N.X. v. Cabrini Med. Ctr.*, 97 N.Y.2d 247, 251, 739 N.Y.S.2d 348, 351 (2002) (citation omitted). However, this claim similarly fails because Claimants have not alleged a single specific tortious act by any employee of the Bear Stearns Respondents for which to sustain this claim.

D. Claimant Cannot Recover Punitive Damages

Claimants have no right to recover punitive damages. Punitive damages are not available because Claimants do not allege, and in any event cannot demonstrate, that the alleged misconduct of which they complain was both “egregious” and “part of a pattern of similar conduct directed at the public generally.” *Rocanova v. Equitable Life Assur. Soc’y of the U.S.*, 83 N.Y.2d 603, 613, 612 N.Y.S.2d 339, 343 (1994).

DENIAL OF CLAIMS

The Bear Stearns Respondents deny each and every allegation of wrongdoing and liability set forth or implied in the Amended Statement of Claim. The Bear Stearns Respondents further deny that Claimants have been injured as a result of any allegedly wrongful conduct by them. The Bear Stearns Respondents request that all claims be dismissed with prejudice, with all costs and fees incurred by the Bear Stearns Respondents assessed against Claimants.

The Bear Stearns Respondents reserve the right to amend their answer as additional information becomes available during the discovery process.

AS FOR A FIRST AFFIRMATIVE DEFENSE

The Amended Statement of Claim fails to state a claim against the Bear Stearns Respondents upon which relief may be granted.

AS FOR A SECOND AFFIRMATIVE DEFENSE

Claimants were not damaged by any action or inaction of the Bear Stearns Respondents.

AS FOR A THIRD AFFIRMATIVE DEFENSE

Claimants' claims are barred by the applicable exculpation clauses.

AS FOR A FOURTH AFFIRMATIVE DEFENSE

Any losses suffered by Claimants resulted from market conditions or fluctuations normally associated with investments in the securities markets that were beyond the control and responsibility of the Bear Stearns Respondents.

AS FOR A FIFTH AFFIRMATIVE DEFENSE

Claimants knowingly, willingly, and voluntarily assumed the risks of any alleged harm of which they now complain.

AS FOR A SIXTH AFFIRMATIVE DEFENSE

Claimants' claims are barred in whole or in part because of the contributory negligence or comparative fault of Claimants or other persons or entities not named as Respondents.

AS FOR A SEVENTH AFFIRMATIVE DEFENSE

The conduct of persons and/or entities other than the Bear Stearns Respondents was a superseding or intervening cause of any damage, loss, or injury allegedly incurred by Claimants.

AS FOR AN EIGHTH AFFIRMATIVE DEFENSE

Claimants are estopped from pursuing any claims against the Bear Stearns Respondents because they signed Subscription Agreements acknowledging that they were sophisticated investors who carefully reviewed the Funds' Memoranda, including the risk factors set forth therein, and that they were capable of understanding and in fact understood and agreed to take on these risks.

AS FOR A NINTH AFFIRMATIVE DEFENSE

Any loss Claimants suffered were the result of Claimants' own conduct or negligence.

AS FOR A TENTH AFFIRMATIVE DEFENSE

Claimant COUQ lacks standing to assert claims against the Bear Stearns Respondents.

AS FOR AN ELEVENTH AFFIRMATIVE DEFENSE

Claimants' claims are premature, as they have not realized any loss with respect to their investments in the ABS Fund.

CONCLUSION

As shall be demonstrated at the hearings, all of the claims are devoid of merit.

Respondents The Bear Stearns Companies, Inc., Bear, Stearns & Co. Inc., and Bear Stearns

Asset Management Inc., respectfully request that the Panel issue an Award:

- (a) dismissing the Amended Statement of Claim in its entirety;
- (b) directing Claimants to pay the costs, fees and expenses incurred in connection with this proceeding, including reasonable attorneys' fees; and
- (c) granting such other and further relief as the Panel deems just and proper.

Dated: December 4, 2009

Respectfully submitted,

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