INITIAL DECISION RELEASE NO. 1182
ADMINISTRATIVE PROCEEDING
FILE NO. 3-16462

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

In the Matter of		
	:	
LYNN TILTON;	:	INITIAL DECISION
PATRIARCH PARTNERS, LLC;	:	September 27, 2017
PATRIARCH PARTNERS VIII, LLC;	:	
PATRIARCH PARTNERS XIV, LLC; and	:	
PATRIARCH PARTNERS XV, LLC	:	

APPEARANCES: Dugan Bliss, Nicholas Heinke, Amy Sumner, and Mark L. Williams for the Division of Enforcement, Securities and Exchange Commission

Randy M. Mastro, Lawrence J. Zweifach, Barry Goldsmith, Caitlin J. Halligan, Reed Brodsky, Monica K. Loseman, Mark A. Kirsch, and Lisa H. Rubin of Gibson, Dunn & Crutcher LLP; and Susan E. Brune of Brune Law PC[1]
for Respondents Lynn Tilton, Patriarch Partners, LLC, Patriarch Partners VIII, LLC, Patriarch Partners XIV, LLC, and Patriarch Partners XV, LLC

BEFORE: Carol Fox Foelak, Administrative Law Judge

SUMMARY

This Initial Decision dismisses charges concerning Respondents' operation of three collateral loan obligation funds, known as the Zohar Funds.

I. INTRODUCTION

A. Procedural Background

The Commission instituted this proceeding with an Order Instituting Proceedings (OIP) on March 30, 2015, pursuant to Sections 203(e), 203(f), and 203(k) of the Investment Advisers

[1] These attorneys appeared for Respondents on the post-hearing briefs. Additional attorneys appeared for Respondents in other phases of the proceeding.

Act of 1940 and Section 9(b) of the Investment Company Act of 1940. The proceeding was stayed by order of the U.S. Court of Appeals for the Second Circuit between September 17, 2015, and June 2016, followed by a brief continuance of the stay until July 6, 2016, to permit Tilton to file a stay motion with the Supreme Court. *See Tilton v. SEC*, 824 F.3d 276, 291 (2d Cir. 2016), *cert. denied*, 137 S. Ct. 2187 (2017); *Tilton v. SEC*, No. 15-2103 (2d Cir.), ECF Nos. 76, 125. The undersigned held a fourteen-day hearing in New York City from October 24 through November 10, 2016. The Division of Enforcement called nine witnesses, including three expert witnesses, from whom evidence was taken, and Respondents called nine witnesses, including six expert witnesses. Respondent Tilton testified for three and one half days. Numerous exhibits were admitted into evidence.[2]

The findings and conclusions in this Initial Decision are based on the record and public official records of which official notice has been taken, pursuant to 17 C.F.R. § 201.323. Preponderance of the evidence was applied as the standard of proof. *See Steadman v. SEC*, 450 U.S. 91, 96-104 (1981). Pursuant to the Administrative Procedure Act, 5 U.S.C. § 557(c), the parties' post-hearing December 16, 2016, filings and January 13, 2017, replies were considered. All arguments and proposed findings and conclusions that are inconsistent with this Initial Decision were considered and rejected.

B. Allegations and Arguments of the Parties

This proceeding concerns Respondents' operation of three collateral loan obligation funds, known as the Zohar Funds. The OIP alleges that Respondents violated the antifraud provisions of the Investment Advisers Act of 1940 – Sections 206(1), 206(2), and 206(4); and Rule 206(4)-8 – by reporting misleading values for the assets held by the Funds and thus collecting unearned management fees and other payments; generally breaching fiduciary duties by failing to disclose a conflict of interest arising from Lynn Tilton's undisclosed approach to categorization of assets; and issuing false and misleading financial statements that purport to comply with GAAP but do not, in that they contain misleading information relating to impairment and fair valuing of assets. The Division is seeking a cease-and-desist order, bars, disgorgement, and civil penalties. Respondents argue that this proceeding is constitutionally and otherwise infirm, that there were no violations, and that, in any event, sanctions are inappropriate.

C. Procedural Issues

Respondents argue that the proceeding is unconstitutional because: the Commission appoints administrative law judges in a manner that is inconsistent with the Appointments Clause of the United States Constitution; it otherwise lacks due process; and Respondents' equal protection rights were violated. Resp. Concl. at 24-28; Resp. Br. at 45-47, 109-10. Respondents incorporate by reference and reiterate forty-one erroneous rulings on these and other topics. Resp. Br. at 46, 110, App. B.

[2] Citations to the hearing transcript will be noted as "Tr. __." Citations to exhibits offered by the Division and Respondents will be noted as "Div. Ex. __" and "Resp. Ex. __," respectively.

1. Appointments Clause

The Commission has rejected the Appointments Clause argument and adhered to its position, despite the contrary view of the Tenth Circuit in *Bandimere v. SEC*, 844 F.3d 1168 (10th Cir. 2016), *pet. for reh'g en banc denied*, 855 F.3d 1128 (10th Cir. 2017). *See Harding Advisory LLC*, Securities Act of 1933 Release No. 10277, 2017 SEC LEXIS 86, at *67-69 & nn.82, 90 (Jan. 6, 2017), *pet. for review pending*, No. 17-1070 (D.C. Cir.); *Raymond J. Lucia Cos.*, Securities Exchange Act of 1934 Release No. 75837, 2015 SEC LEXIS 3628, at *76-89 (Sept. 3, 2015), *pet. for review denied by an equally divided court*, No. 15-1345, 2017 WL 2727019 (D.C. Cir. June 26, 2017), *pet. for cert. filed*, No. 17-130 (U.S. July 21, 2017); *Timbervest, LLC*, Advisers Act Release No. 4197, 2015 SEC LEXIS 3854, at *89-103 (Sept. 17, 2015), *pet. for review pending*, No. 15-1416 (D.C. Cir.). Moreover, the Commission has denied Respondents' motion to stay this proceeding pending the resolution by the federal courts – and, possibly, the Supreme Court – of the Appointments Clause question. *See Lynn Tilton*, Advisers Act Release No. 4735, 2017 SEC LEXIS 2296 (July 28, 2017).

2. Due Process

Respondents argue that the Commission's administrative proceedings are inherently unfair and violate the Due Process Clause in that: salient factual allegations are not required to be specified in the OIP, and evidence relating to charges not specified in the OIP was admitted at the hearing; Respondents were constrained to a short timeline, with limited discovery that does not include depositions and without a meaningful opportunity to gather information from key witnesses; the Commission, essentially, has no rules of evidence, resulting in a record that includes hearsay and improper legal conclusions of expert witnesses; and the Commission forum requires enforcement cases to be tried in an unduly limited timeframe regardless of their complexity. Resp. Concl. at 25-28; Resp. Br. at 45-47, 109-10.

Respondents cite no authority to show that the procedures of the Commission's administrative proceedings violate the Due Process Clause. Indeed, "[t]he fundamental requirement of due process is the opportunity to be heard 'at a meaningful time and in a meaningful manner.'" *Mathews v. Eldridge*, 424 U.S. 319, 333 (1976) (quoting *Armstrong v. Manzo*, 380 U.S. 545, 552 (1965)); *see also Jonathan Feins*, Exchange Act Release No. 41943, 1999 SEC LEXIS 2039, at *25-26 (Sept. 29, 1999) ("Administrative due process is satisfied where the party against whom the proceeding is brought understands the issues and is afforded a full opportunity to meet the charges during the course of the proceeding."). In determining whether due process is satisfied, "the question . . . is not the adequacy of the [OIP] but is the fairness of the whole procedure." *Timbervest, LLC*, 2015 SEC LEXIS 3854, at *78 (alteration brackets in original). Here, Respondents received a Wells notice and the OIP; had at least nine months to prepare for the hearing (not counting the period in which this case was stayed), during which the parties exchanged expert reports and other evidence and notified each side of proposed witnesses, and filed and obtained rulings on numerous prehearing motions; had a fourteen-day hearing and the opportunity to call witnesses and cross-examine the Division's witnesses; and had the opportunity to present argument at the hearing and in post-hearing filings.

Respondents' contentions regarding the adequacy of the OIP are unpersuasive. In Commission administrative proceedings, the OIP must state: the nature of the hearing; the legal authority for holding the hearing; "the factual and legal basis alleged . . . in such detail as will permit a specific response" where, as here, the OIP directs an answer; and the nature of any relief sought. 17 C.F.R. § 201.200(b). But the OIP need not allege all of the evidence on which the Division intends to rely. *See Rita J. McConville*, Exchange Act Release No. 51950, 2005 SEC LEXIS 1538, at *51 (June 30, 2005) ("The OIP must inform the respondent of the charges in enough detail to allow the respondent to prepare a defense, but it need not disclose to the respondent the evidence upon which the Division intends to rely."), *pet. denied*, 465 F.3d 780 (7th Cir. 2006); *Morris J. Reiter*, Exchange Act Release No. 6108, 1959 SEC LEXIS 588, at *5 (Nov. 2, 1959) (a respondent "is not entitled to a disclosure of evidence" such as "the names of the persons to whom the alleged false and misleading statements were made"); *see also Clawson v. SEC*, No. 03-73199, 2005 WL 2174637, at *1 (9th Cir. Sept. 8, 2005) (finding notice sufficient where the facts ultimately found were "consistent with" or "subsumed in" the theory alleged in the OIP). Here, the OIP included seventy-three paragraphs of the Division's allegations, together with the asserted legal bases for this proceeding, the alleged violations, and the sanctions sought. Respondents' arguments throughout the course of this proceeding make plain that they "understood the issue[s] and [were] afforded full opportunity to justify [their] conduct during the course of the litigation." *Wendy McNeeley, CPA*, Exchange Act Release No. 68431, 2012 SEC LEXIS 3880, at *28-29 (Dec. 13, 2012) (internal quotation marks omitted).

Although the procedures of administrative proceedings may differ in some respects from those in district court, Respondents have not shown that they violate the Due Process Clause. The Commission and courts have rejected broad attacks on administrative process. *See Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099, 1107-08 (D.C. Cir. 1988); *Harding Advisory LLC*, 2017 SEC LEXIS 86, at *56. "Administrative proceedings have long been a key feature of the scheme of securities regulation established by Congress." *Timbervest, LLC*, 2015 SEC LEXIS 3854, at *90. Contrary to Respondents' claim, the availability of different discovery mechanisms in federal district court does not violate due process. *See John J. Aesoph, CPA*, Exchange Act Release No. 78490, 2016 SEC LEXIS 2730, at *72-73 (Aug. 5, 2016); *cf. Weatherford v. Bursey*, 429 U.S. 545, 559 (1977) ("There is no general constitutional right to discovery . . . ."); *McClelland v. Andrus*, 606 F.2d 1278, 1285 (D.C. Cir. 1979) ("The extent of discovery that a party engaged in an administrative hearing is entitled to is primarily determined by the particular agency . . . .").

Also unpersuasive are Respondents' due process objections to the admission of certain evidence that would not be admissible in a federal jury trial. "[T]he fact that the Federal Rules of Civil Procedure and the Federal Rules of Evidence do not apply in administrative proceedings is not a violation of due process." *Charles L. Hill, Jr.*, Exchange Act Release No. 79459, 2016 SEC LEXIS 4491, at *12-13 (Dec. 2, 2016). Rather, "'[c]ourts have consistently held that agencies need not observe all the rules and formalities applicable to courtroom proceedings,' and that 'agencies should be free to fashion their own rules of procedure.'" *Id.* at *13 (quoting *McClelland*, 606 F.2d at 1285, and *Vermont Yankee Nuclear Power Corp. v. NRDC*, 435 U.S. 519, 543-44 (1978)); *see also Opp Cotton Mills, Inc. v. Adm'r of Wage & Hour Div. of Dep't of Labor*, 312 U.S. 126, 155 (1941) ("[I]t has long been settled that the technical rules for the exclusion of evidence applicable in jury trials do not apply to proceedings before federal

administrative agencies in the absence of a statutory requirement that such rules are to be observed.").

The threshold for the admissibility of evidence in Commission proceedings is quite low. *See* 5 U.S.C. § 556(d); 17 C.F.R. § 201.320; *Herbert Moskowitz*, Exchange Act Release No. 45609, 2002 SEC LEXIS 693, at *46 n.68 (Mar. 21, 2002); *City of Anaheim*, Exchange Act Release No. 42140, 1999 SEC LEXIS 2421, at *4 & n.7 (Nov. 16, 1999). For example, "hearsay evidence is admissible in [Commission] administrative proceedings and, in an appropriate case, may even form the sole basis for findings of fact." *Edgar B. Alacan*, Securities Act Release No. 8436, 2004 SEC LEXIS 1422, at *23 (July 6, 2004) (internal quotation marks omitted); *see also Echostar Commc'ns Corp. v. FCC*, 292 F.3d 749, 753 (D.C. Cir. 2002) ("[A]dministrative agencies may consider hearsay evidence as long as it bears satisfactory indicia of reliability, and hearsay can constitute substantial evidence if it is reliable and trustworthy." (internal quotation marks, citations, and alteration brackets omitted)). Also, as the undersigned has observed, "[s]ince this proceeding is not a jury trial, the fact that [certain experts] arguably are providing legal opinions is not *per se* objectionable, even under [Federal Rule of Evidence] 702." *Lynn Tilton*, Admin. Proc. Rulings Release No. 4118, 2016 SEC LEXIS 3217, at *2 (A.L.J. Sept. 1, 2016) (collecting cases). To the extent Respondents believe the record contains unreliable evidence, they have been free to argue that it should be given little to no weight. *Cf. City of Anaheim*, 1999 SEC LEXIS 2421, at *4 ("Administrative agencies such as the Commission are more expert fact-finders, less prone to undue prejudice, and better able to weigh complex and potentially misleading evidence than are juries.").

Respondents have not shown a due process violation based on the Commission's procedural timelines and their allegation that their counsel did not have an adequate opportunity to prepare for the hearing. The Commission has rejected a facial due process attack on the procedural timelines set forth in 17 C.F.R. § 201.360. *Gregory M. Dearlove, CPA*, Exchange Act Release No. 57244, 2008 SEC LEXIS 223, at *142-44 (Jan. 31, 2008), *pet. denied*, 573 F.3d 801 (D.C. Cir. 2009).

More recently, in rejecting Respondents' petition for interlocutory review, the Commission stated:

> Respondents argue that interlocutory review is appropriate because the present hearing schedule denies them 'the opportunity to fully and fairly litigate their defense' and violates their 'right to counsel of [their] choice by effectively punishing Respondents for changing counsel recently.' But the Supreme Court has made clear that "only an unreasoning and arbitrary 'insistence upon expeditiousness in the face of a justifiable request for delay' violates the right to the assistance of counsel." This is not a case in which there are 'extraordinary circumstances' warranting postponement, such as when respondents are left without assistance of counsel at or near the hearing date through no fault of their own. Although Respondents recently replaced some of their attorneys, they have been represented by other attorneys from Brune Law P.C. throughout this proceeding.

> Nor are we persuaded by Respondents' claim that their new counsel will have insufficient time to review what they describe as a voluminous and complex record. When the court of appeals initially stayed this proceeding, the hearing was set to begin in three weeks and, as the Division notes, many phases of the proceeding had been completed, including the exchange of witness and exhibit lists and expert reports. Once the court of appeals lifted that stay on July 6, the law judge essentially granted the parties an additional 13 weeks in which to prepare by rescheduling the hearing for October 24.

Lynn Tilton, Advisers Act Release No. 4495, 2016 SEC LEXIS 2973, at *12-14 (Aug. 24, 2016). Although the Commission did not explicitly address Respondents' claim about their alleged inability to prepare adequately, *id*. at *14, counsel's conduct at the hearing and arguments made before, during, and after the hearing show that counsel understood the complexities of the case and was, in fact, adequately prepared.

3. Equal Protection

Respondents argue that their equal protection rights were violated in that the Commission denied them and similarly situated respondents the benefits of its amended procedural rules that it adopted to correct procedural and discovery deficiencies in administrative proceedings.

In August 2016, the Commission denied Respondents' request for an order applying certain amendments to its rules of practice to this proceeding. *Lynn Tilton*, 2016 SEC LEXIS 2973, at *16-18. The Commission explained that it had already specified how the amended rules would apply to pending proceedings in its July 2016 release adopting the amendments. *Id*. at *16-17; *see also* Amendments to the Commission's Rules of Practice, Exchange Act Release No. 78319, 81 Fed. Reg. 50,212, 50,229-30 (July 29, 2016). It reasoned: "Respondents provide no compelling reasons why we should treat their case uniquely from all the other pending cases in our administrative tribunals, and deviate from our decision that the availability of the Amended Rules for litigants in pending proceedings should depend on the stage of their proceeding." *Lynn Tilton*, 2016 SEC LEXIS 2973, at *18.

Respondents do not claim, let alone establish, that the Commission's regulatory classification "jeopardizes exercise of a fundamental right or categorizes on the basis of an inherently suspect characteristic." *Nordlinger v. Hahn*, 505 U.S. 1, 10 (1992). Nor do they base their claim on a class-of-one theory. *See Village of Willowbrook v. Olech*, 528 U.S. 562, 564 (2000). Rather, they claim to be part of a class of respondents "deliberately targeted" by the Commission. Resp. Concl. at 28. Respondents' post-hearing brief references a district court complaint in which they defined this class as "certain individuals who brought Appointments Clause challenges in federal district court and whose administrative proceedings were stayed pending a decision by the federal courts." Complaint at 5, *Tilton v. SEC*, 16-cv-7048 (Sept. 9, 2016), ECF No. 1; *see* Resp. Br. at 109 & nn.66, 68. As this purported class is not a suspect one, Respondents would have to show that the Commission's regulatory classification has no rational basis to establish a violation of the Equal Protection Clause. *See Heller v. Doe*, 509 U.S. 312, 319-20 (1993); *cf. Romer v. Evans*, 517 U.S. 620, 632 (1996) (rational basis not met where a law or regulation is "inexplicable by anything but animus toward the class it affects").

Respondents' claim is better suited for appeal to the Commission or a federal court of appeals, as the undersigned does not sit in review of Commission rules or regulations. In any event, Respondents have not offered anything other than speculation to support their claim.

4. Alleged Erroneous Rulings

Respondents maintain that "[n]umerous erroneous rulings in this particular proceeding manifest the lack of due process characteristic of this forum." Resp. Br. at 110. Many of these claims "are cast in due process terms but are in substance challenges to the [undersigned]'s evidentiary rulings" and denial of various prehearing motions. *Harding Advisory LLC*, 2017 SEC LEXIS 86, at *63. Insofar as Respondents seek reconsideration of forty-one "Key Erroneous Rulings" on their motions that they incorporate by reference and reiterate in their post-hearing briefing, reconsideration is denied.

Moreover, "[the Commission's] review is de novo and plenary as to evidentiary rulings, as well as to factual findings and legal conclusions." *Id*. Thus, the Commission is "not bound" by the undersigned's decisions. *Id*. Alleged procedural or evidentiary errors may be cured by the Commission on appeal. *See Heath v. SEC*, 586 F.3d 122, 142 (2d Cir. 2009); *Ronald S. Bloomfield*, Exchange Act Release No. 71632, 2014 SEC LEXIS 698, at *38-39 (Feb. 27, 2014), *pet. denied*, 649 F. App'x 546 (9th Cir. 2016).

II. FINDINGS OF FACT

A. Relevant Individuals and Entities

1. Lynn Tilton

Lynn Tilton manages the Patriarch Respondents, with the input of other employees. Answer ¶ 10.[3] The CEO, sole principal, and 100% indirect owner, she controls Respondent Patriarch Partners, LLC. *Id*. ¶¶ 11, 24; Tr. 1785. She started the firm in 2000 after a number of years of experience in the financial industry. Tr. 2076-80. Her business is distressed private equity. Tr. 1802. A relatively small number of firms specialize in this kind of investment. Tr. 1828-30.

2. Patriarch Entities

Patriarch Partners, LLC, is a Delaware limited liability company with a principal place of business in New York City. Answer ¶ 11. Its employees, including Tilton, run the businesses of

[3] Paragraph numbers in the Answer correspond to the paragraph numbers in the OIP and are cited as to allegations in the OIP paragraphs that the Answer admits.

Respondents Patriarch Partners VIII, LLC, Patriarch Partners XIV, LLC, and Patriarch Partners XV, LLC, which have no employees of their own.[4] *Id*. ¶¶ 11, 25.

Patriarch Partners VIII, Patriarch Partners XIV, and Patriarch Partners XV were, until March 2016, the collateral managers for Zohar CDO 2003-1, Limited (Zohar I), Zohar II 2005-1, Limited (Zohar II), and Zohar III, Limited (Zohar III), respectively. *Id*. ¶¶ 12-14; Tr. 1784. They are indirectly owned 100% by Tilton and a trust for her daughter. Answer ¶¶ 12-14. They were registered with the Commission from March 2012 to March 2016 – Patriarch XV as an investment adviser, and Patriarch VIII and Patriarch XIV as relying investment advisers. *Id*.; official notice.[5]

3. Zohar Funds

Zohar I, Zohar II, and Zohar III (Zohar Funds or Funds) are collateralized loan obligation (CLO) funds. Answer ¶ 15. A CLO fund is a securitization vehicle in which a special purpose entity, the issuer, raises capital through the issuance of secured notes and uses the proceeds to acquire a portfolio of commercial loans. *Id*. A collateral manager determines what loans to purchase or originate on behalf of the CLO fund. *Id*. Cash flows and other proceeds from the collateral are used to repay the investors in the CLO fund. *Id*.

Investors invested in the Zohar Funds in return for the promise of regular interest payments and the repayment of their principal on a specified maturity date. *Id*. ¶ 16. Every quarter, investors in a Fund receive an interest payment, generated from the collective interest payments made by the borrowers in the Fund's loan portfolio. *Id*. ¶ 20. As Tilton saw it, the Zohar noteholders were investing in "the maximization of cash flows that would originate from multiple interest, principal and equity upside, and the expertise and standard of care that [she] would provide in order to maximize that value and those cash flows." Tr. 1792.

The three Zohar deals have the following details:

Name of Deal	Date of Issuance	Approximate Principal Amount of Notes	Maturity Date
Zohar I	2003	$532 million	November 2015
Zohar II	2005	$1 billion	January 2017
Zohar III	2007	$1 billion	April 2019

[4] "Patriarch," as used in testimony, may be a shorthand reference to any Patriarch entity. *See, e.g.*, Tr. 1798.

[5] Patriarch XV's registration was terminated as of March 30, 2016, following its filing Form ADV-W. *See* https://goo.gl/Aad5k4 (last visited Sept. 1, 2017), in the public official records of the Commission, of which official notice is taken, pursuant to 17 C.F.R. § 201.323. According to Patriarch XV's March 31, 2015, Form ADV, it had $4.9 billion in assets under management, including Zohar I, II, and III. *See* Form ADV Items 5.F, 7.B & Schedule D, https://goo.gl/VgUwGg (last visited Sept. 1, 2017).

Answer ¶ 16. Each Zohar deal is governed by deal documents that include the indenture[6] and the collateral management agreement (CMA). *Id*. ¶ 17. The indenture describes the terms of the offering, including the maturity date of the notes, information reporting requirements, and priority of payments, as well as the rights of the parties and responsibilities of the collateral manager. *Id*. ¶ 18. The CMA, a contract between the issuer and collateral manager, engages the collateral manager and describes its obligations and compensation. *Id*. ¶ 19. The CMA allows the collateral manager to select and manage the collateral to be held by the Fund. *Id*. ¶ 20.

Through the collateral managers, Tilton used the monies raised from investors to buy or make loans to primarily private, mid-sized distressed companies (Portfolio Companies). *Id*. ¶ 20. At times, Tilton directed more than one of the Zohar Funds to extend loans to the same Portfolio Company. *Id*. In connection with the loans, the Zohar Funds obtained equity in the Portfolio Companies. *Id*. ¶ 21. Tilton also obtained equity in some of the Portfolio Companies through other entities she owned. *Id*.

Tilton's management strategy for the Zohar Funds included improving the operations of the distressed Portfolio Companies, paying off their debt and increasing their value, and selling them. *Id*. ¶ 22. She actively managed the Portfolio Companies. *Id*. ¶ 28. She hired and fired their senior employees and provided input on their major operating decisions. *Id*. She required that the companies report regularly to her regarding their financial condition and business prospects. *Id*. Tilton was CEO of some of the Portfolio Companies. *Id*. In other instances, Tilton was the sole manager of the Portfolio Companies that are LLCs. *Id*. Tilton was a hands-on, demanding taskmaster in managing Portfolio Companies, in some instances resulting in a successful turnaround. Tr. 3061-63, 3069-88, 3108-39, 3516-59.

4. Investors

Zohar noteholders were sophisticated, institutional investors. *See, e.g.*, Tr. 91, 95-96, 98-100, 588-93, 634, 1492, 1498-99, 1672, 2379, 2415. There is no evidence in the record that any retail investors invested in the Zohar Funds. The terms of the Zohar indentures and accompanying note forms and certificates show that the notes were primarily intended for Qualified Institutional Buyers and Qualified Purchasers, and include strict restrictions on the transfer of the notes.[7] *See, e.g.*, Resp. Ex. 1 (Zohar I indenture) at 51, 73, 77-79 (of 303 .pdf

[6] The indentures for Zohar I, II, and III are in evidence as Division Exhibits 1, 2, and 3, respectively, and also as Respondents Exhibits 1, 8, and 12 (supplemented, for completeness, with additional schedules/exhibits on May 30, 2017, as 12A), respectively.

[7] "Qualified Institutional Buyer" is defined in Securities Act Rule 144A and includes specified institutions that, in the aggregate, own and invest on a discretionary basis at least $100 million in securities of issuers that are not affiliated with such institutions. 17 C.F.R. § 230.144A(a)(1). "Qualified Purchaser" is defined in Section 2(a)(51) of the Investment Company Act of 1940 and includes (i) any natural person who owns not less than $5 million in investments, (ii) a family-owned company that owns not less than $5 million in investments, (iii)

pages) & Exhibits A-1 through B-3; Resp. Ex. 8 (Zohar II indenture) at 58-59, 78-79, 83-89, 96, 97, 154 (of 447 .pdf pages) & Exhibits A-1 through B-9, I-1, I-2; Resp. Ex. 12A (Zohar III indenture) at 54, 74, 79-85, 92, 93, 146-47 (of 398 .pdf pages) & Exhibits A-1 through B-9, H-1, H-2.

The record includes evidence of the following investors:

a. Barclays Bank

Barclays Bank is a bank. Tr. 1513. Zohar I raised $532 million in notes – $350 million from Barclays and the balance from Natixis Global Asset Management[8] and MBIA Insurance Corp. Tr. 1554-55, 2207, 2258-59. MBIA (described *infra*) insured Barclays's notes through a separate contract outside of the deal. Tr. 1559, 2209, 2260. In 2010, Barclays had a position of about $300 million in Zohar I after some paydowns on its original $350 million investment. Tr. 1498. Jaime Aldama, a managing director at Barclays, began to analyze the bank's Zohar I position in 2010 and first contacted Tilton in 2011. Tr. 1496-97, 1502-03. Eventually, the Zohar investment had become unrated, triggering a requirement for Barclays to have a large amount of capital, equal to its investment, reserved against the position. Tr. 1506-14. Barclays sold its position to a Patriarch entity in 2015 for $100 million, an approximate $200 million loss to Barclays. Tr. 1522.[9] Barclays also received a payment, of undisclosed amount, from MBIA resulting from its insurance of the Barclays notes. Tr. 1723-27.

b. SEI Investments

SEI Investments Company is a global financial services NASDAQ-listed (symbol, "SEIC") company. SEI's 2016 Form 10-K at Part I, Item 1.[10] SEI purchased interests in Zohar III in the secondary market in 2010 to 2013. Tr. 95-96. Natixis was the underwriter for Zohar III. Tr. 266. The purchases, made at about $0.45, totaled $100 million face value of the A-2 tranche, and $50 million face value of the A-3 tranche. Tr. 96-99. SEI's David Aniloff

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certain trusts, and (iv) any other person that owns and invests on a discretionary basis not less than $25 million in investments. 15 U.S.C. § 80a-2(a)(51)(A).

[8] Tilton described Natixis (also referred to by a pre-merger name, CDC IXIS) as Respondents' banker. Tr. 2200, 2257, 2379, 2445, 2539.

[9] *See also* Tr. 3039-40 (testimony of Respondents' summary witness Thomas Lys that his review of Patriarch documents included confirmations from Barclays for the purchase of notes for $103,388,450); Resp. Ex. 132 (Lys's summary chart showing the March 25, 2015, purchase by Patriarch of two Zohar I notes with a face value of $350 million for $103,388,450).

[10] The Form 10-K is found in the Commission's EDGAR database, of which official notice is taken pursuant to 17 C.F.R. § 201.323. In 2016, SEI managed over $750 billion in assets, had revenues of over $1.4 billion, and had total assets of over $1.6 billion. SEI's 2016 Form 10-K at Part I, Items 1 & 6.

conducted the analysis and made the decisions to purchase. Tr. 94-95. Aniloff, whose duties included reviewing the Fund's monthly and quarterly trustee reports, did not tie the interest rate on each individual loan to interest that actually was collected on the loan – information as to both was available in the trustee reports in separate places. Tr. 119, 313-21. He acknowledged that, although Zohar III invested in distressed debt, only five loans appeared on the list of defaulted noncurrent and nonperforming loans in the June 8, 2010, note valuation report. Tr. 314-15, 321; Div. Ex. 9A at 38.

c. Värde Partners

Värde Partners is "an alternative investment manager with a focus on opportunistic credit and special situations investing." Tr. 588. That is, Värde focuses on distressed debt. Tr. 588-90, 623-24. Its co-located affiliate, Värde Management, L.P., with which it shares employees, is a Commission-registered investment adviser with more than $11 billion in assets under management. Official notice;[11] Tr. 606, 625. Värde's clients are large institutional investors. Tr. 634. Värde uses proprietary analytic models and judgment to look for and buy assets that appear cheap and eventually to profit through an exit strategy at the right time. Tr. 634-42. In 2013, Värde invested in Zohar III, purchasing $110 million face value of the A-1 tranche and $38 million face value of the A-2 tranche. Tr. 593. Matthew Mach, now a managing director of Värde Partners, was the trader who analyzed and recommended that Värde purchase the Zohar position. Tr. 587, 591, 606. Värde declined to disclose the prices it paid for the notes[12] or received on selling the notes. Tr. 644-45, 703-09, 720-21, 741. It also declined to disclose its valuation of the notes when it owned them and had access to all the reports on the trustee's website. Tr. 726-27; Resp. Ex. 1107. However, it was not a large investment for Värde. Tr. 721-22. Värde still holds $31 million face value of the A-2 notes. Tr. 617-18. Värde's due diligence prior to making the investment included studying Tilton's business successes. Tr. 661-62, 666-69.

d. MBIA[13]

MBIA Insurance Corporation is a stock insurance company incorporated under the laws of the State of New York. Resp. Ex. 1 at 8 (of 303 .pdf pages); Resp. Ex. 8 at 8 (of 447 .pdf pages). MBIA has had a relationship with Patriarch since 2001, as it "wrapped" a predecessor to

[11] *See* Värde Management, L.P., Mar. 30, 2016, Brochure at 1-2, https://goo.gl/qubMPt (last visited Sept. 1, 2017). Värde Partners, Inc., is the general partner of Värde Partners, L.P., which is the general partner of private investment funds for which Värde Management, L.P., is the investment adviser. *Id*. at 7, 44. Värde Partners, Inc., is privately owned. *Id*. at 1.

[12] In calculating the price at which it would consider purchasing the notes, Värde's due diligence indicated a recovery rate "no worse than 40%." Resp. Ex. 1099; Tr. 705.

[13] In this section, official notice is taken of related litigation and decisions and filings therein, MBIA's public filings with the Commission, a public release of the State of New York Insurance Department, and a news article regarding the Zohar I auction. *See* 17 C.F.R. § 201.323.

the Zohar Funds, the Ark II transaction.[14] Resp. Ex. 551 at 2 (of 7 .pdf pages); Tr. 2148, 2152-56. MBIA approached Tilton in early 2002 and sought a solution for its shortfall in loss reserves in seven collateralized debt obligations (CDOs) that it had insured; Zohar I was then formed, in part, to raise a separate pool of capital to cover MBIA's shortfall, and Patriarch replaced MBIA as the collateral manager of the troubled CDOs. Tr. 1913, 2175-77, 2180-85; Resp. Ex. 551 at 3, 5 (of 7 .pdf pages).

In addition to being one of the original noteholders in Zohar I, MBIA was also the credit enhancer of, or "wrapped," Zohar I and II. Resp. Ex. 1 at 1, 28-30 (of 303 .pdf pages); Resp. Ex. 8 at 1, 28-29 (of 447 .pdf pages) (both at Title Page & Section 1.1 "Credit Enhancement" through "Credit Enhancer"); Tr. 343, 2258-59. As the credit enhancer, MBIA provided a financial guaranty that it would pay certain senior classes of noteholders if the Zohar I and II Funds were unable to meet their repayment obligations. Resp. Ex. 1 at 28-30, 39 (of 303 .pdf pages); Resp. Ex. 8 at 28-29, 40 (of 447 .pdf pages) (both at Section 1.1 "Credit Enhancement" through "Credit Enhancer" & "Insured Payments"); Resp. Ex. 21 at 15 (of 64 .pdf pages). This enhanced the deals' credit ratings. MBIA wrapped the Zohar I deal exclusive of the Barclays notes; it wrapped the Barclays notes separately. Tr. 1559-64, 2186, 2209, 2260.

The relationship between MBIA and Respondents, however, began to unravel by 2006. Tr. 2412. MBIA backed out as the credit enhancer of Zohar III after Tilton refused MBIA's proposal that she raise new investor capital to partly pay off MBIA's interest in Zohar I. Tr. 2412-15. Then, in 2009, MBIA sued Patriarch in federal district court, alleging breach of contract and other claims on the purported basis that Patriarch – in contravention of a master agreement and/or the Zohar I indenture – refused to obtain ratings for, and transfer a portion of, certain Class B notes, then held by a Patriarch affiliate, to some of the troubled CDOs insured by MBIA. *See* Complaint, *MBIA Ins. Corp. v. Patriarch Partners VIII, LLC*, No. 09-cv-3255 (S.D.N.Y. Apr. 3, 2009), ECF No. 16 (unsealed version attached). Following a bench trial, the lawsuit ended in Patriarch's favor. *See MBIA Ins. Corp. v. Patriarch Partners VIII, LLC*, 950 F. Supp. 2d 568 (S.D.N.Y. 2013).

Meanwhile, Tilton offered Patriarch's resignation as collateral manager on several occasions, but MBIA – the controlling party of Zohar I and II – did not act on her offers at the time. Tr. 2181, 2224-25, 2576-77; Resp. Ex. 48A at 13; Resp. Ex. 49A at 17; Resp. Ex. 497; *see also* Resp. Ex. 1 at 27-28 (of 303 .pdf pages); Resp. Ex. 8 at 27 (of 447 .pdf pages) (both at Section 1.1 "Controlling Party"). Also, MBIA did not agree to Tilton's proposed restructuring plans for Zohar I. Tr. 1724-25, 2074, 2580; Resp. Exs. 498, 1803. After Zohar I defaulted upon maturity in late 2015, Tilton, as Patriarch's representative, filed involuntary bankruptcy petitions against Zohar I. *See* Involuntary Petitions, *In re Zohar CDO 2003-1, Ltd.*, No. 15-23680 (Bankr. S.D.N.Y. Nov. 22, 2015); *In re Zohar CDO 2003-1, Corp.*, No. 15-23681 (Bankr. S.D.N.Y. Nov. 22, 2015); *In re Zohar CDO 2003-1, LLC*, No. 15-23682 (Bankr. S.D.N.Y. Nov. 22, 2015) (collectively, Zohar Bankr. Actions), all at ECF No. 1; Tr. 2074, 2608. Also as a result of the

[14] A "wrap" is a form of financial guaranty insurance in which the insurer pledges to make interest and principal payments to noteholders or bondholders in the event the issuer defaults; in turn, the wrap enhances the quality of the issuer's credit rating, if any. *See* State of N.Y. Ins. Dep't, Circular Letter No. 19 at 2 (2008), http://goo.gl/P7NiVL; Tr. 2104-05, 2186.

default, MBIA directed Zohar I's trustee to commence an auction of the Zohar I assets, which occurred in 2016; MBIA ultimately acquired beneficial ownership of the assets. *See* MBIA Inc. (CIK No. 0000814585), Mar. 31, 2017, Form 10-Q (filed May 10, 2017) at 13, 62; Tiffany Kary & Matt Scully, *Lynn Tilton's Patriarch Faces Off With MBIA in Zohar Auction*, Bloomberg (Dec. 21, 2016), http://goo.gl/dTr7Aa. In addition to MBIA's 2009 lawsuit and the bankruptcy proceedings, Respondents and MBIA have been engaged in other litigations arising from the Zohar deals.[15]

Patriarch resigned as collateral manager of all three Zohar Funds in March 2016, as part of a bankruptcy settlement, and the bankruptcy proceedings were dismissed. Tr. 1784, 2610-11; *see* Order Dismissing the Involuntary Chapter 11 Petitions, Zohar Bankr. Actions (Bankr. S.D.N.Y. Mar. 28, 2016), filed as ECF No. 53 in No. 15-23680. MBIA selected a new collateral manager of the Zohar Funds, which has resulted in litigation between the Zohar Funds and Patriarch in various forums. Tr. 2616; *see, e.g., Zohar CDO 2003-1, LLC v. Patriarch Partners, LLC*, No. 12247-VCS, 2016 WL 6248461 (Del. Ch. Oct. 26, 2016), *am. order & judgment*, 2016 WL 6561058 (Del. Ch. Nov. 3, 2016), *aff'd*, No. 5492016, 2017 WL 2643972 (Del. June 19, 2017); *Zohar CDO 2003-1, Ltd., v. Patriarch Partners, LLC*, No. 17-cv-307 (S.D.N.Y.) (pending).

To date, MBIA has paid nearly $1 billion in aggregate claims for insured Zohar I and II notes. MBIA Inc. (CIK No. 0000814585), Dec. 31, 2016, Form 10-K (filed Mar. 1, 2017) at 26.

5. Anchin

Anchin, Block & Anchin LLP has been Respondents' one and only accounting firm since the inception of Patriarch. Tr. 2149-50. Peter Berlant, CPA, an Anchin partner, was Respondents' accountant at all relevant times. Tr. 753-1097; Div. Exs. 28, 29, 30, 34. While others at Anchin performed tax services for Respondents, only Berlant performed services concerning Respondents' financial statements. Tr. 846-47, 1118.

B. Deal Documents – Terms of the Zohar Fund Deals

The indentures for the Funds specified Patriarch as the collateral manager. Div. Exs. 1-3 [all at] Section 1.1."Collateral Manager". As discussed below, the deal documents disclosed an inherent conflict of interest in that Respondents valued the Funds' assets and determined the

[15] *See, e.g., Patriarch Partners XV, LLC v. U.S. Bank Nat'l Ass'n*, No. 16-cv-7128 (S.D.N.Y) (lawsuit by Patriarch and affiliate Octaluna against U.S. Bank National Association and MBIA to prevent them from "rigging" the sale of Zohar I assets; the parties stipulated to dismissal in January 2017); *Patriarch Partners XIV, LLC v. MBIA Ins. Corp.*, 934 N.Y.S.2d 35 (N.Y. Sup. Ct., N.Y. Cty. 2011) (lawsuit by Patriarch against MBIA seeking a declaratory judgment that Patriarch is in compliance with the Zohar II collateral management agreement; the court largely resolved the matter in Patriarch's favor); *Tilton v. MBIA Inc.*, No. 68880/2015 (N.Y. Sup. Ct., Westchester Cty.) (pending lawsuit by Tilton and Patriarch against MBIA alleging breach of contract, promissory estoppel, and fraud based on MBIA's "scheme" to induce them to buy out a third-party noteholder in negotiations to extend Zohar I's maturity date).

status however defined – performing or non-performing, defaulted or current – of the Portfolio Companies' loans and could amend the terms of the loans as well. The documents warned that the assets would consist of distressed loans and granted the collateral manager considerable flexibility in valuing and categorizing the assets. The fees that the collateral manager was to receive depended on the valuation of the assets, and a low valuation benchmark gave noteholders the right to liquidate the assets. As discussed below, during the time that Patriarch was the collateral manager for the Funds, Patriarch – with Tilton as the ultimate decision-maker – selected the collateral and valued the collateral, which as illiquid debt of distressed companies was inherently a Level 3 valuation.[16]

The deal documents also disclosed a potential conflict of interest in that Respondents might own equity in Portfolio Companies. *See also* Tr. 259-60 (testimony of David Aniloff of SEI, which invested in Zohar III in the secondary market, that he knew the collateral manager also owned the equity of the underlying companies and that this was unique), 622-23 (testimony of Matthew Mach of Värde Partners, which considered investing in Zohar II, and invested in Zohar III, in the secondary market, describing this feature as "brilliant" for Patriarch).

The indenture and CMA documents were available to noteholders prior to investing in a Zohar Fund. *See, e.g.*, Tr. 102, 158-60 (testimony of David Aniloff of SEI); 592, 594 (testimony of Matthew Mach of Värde Partners); 1500, 1526, 1534-36 (testimony of Jaime Aldama of Barclays, original noteholder in Zohar I).[17] Aniloff and Mach also had trustee reports before recommending that SEI and Värde Partners, respectively, invest in Zohar III in the secondary market.[18] Tr. 272, 592, 594; Resp. Ex. 1335 at 1, 4-52; Resp. Exs. 1336, 1336.002; Resp. Exs. 1097, 1097.006. Likewise, Aldama had trustee reports when evaluating Barclays's holdings in Zohar I and considering different strategies to deal with the holdings, including selling. Tr. 1500-02, 1523, 1597-98, 1646-49.

[16] The Financial Accounting Standards Board (FASB) establishes financial accounting and reporting standards for public and private companies that follow Generally Accepted Accounting Principles (GAAP). Financial Accounting Standard (FAS) No. 157 prioritizes the inputs used to measure fair value into three Levels: (1) Level 1 – observable, quoted prices for identical assets or liabilities in active markets; (2) Level 2 – quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; and inputs other than quoted prices such as interest rates and yield curves; (3) Level 3 – unobservable inputs for the asset or liability based on the best information available.

[17] Insofar as Aldama testified that he did not have immediate access to the documents, his involvement began several years after Zohar I was formed in a club deal that included Barclays.

[18] Neither compared the amounts of interest borrowers actually paid with the amounts due according to interest rates on their loans. Tr. 319-21, 647-51.

1. Indentures

a. Fees

The collateral manager was entitled to a Senior Collateral Management Fee of 1% of the amount of assets in the deal, paid or accrued quarterly, and a Subordinated Collateral Management Fee of 1% of assets in the deal, also paid quarterly. Answer ¶ 26. Payment or accrual of the Subordinated Fee was dependent on the performance of a test. *Id*. Entities controlled by Tilton held preference shares in the Zohar Funds. *Id*. ¶ 27. Distributions on those preference shares were also contingent on the outcome of the test. *Id*. The CMAs also disclosed the fee arrangement, *i.e.*, that the collateral manager was entitled to receive a Senior Collateral Management Fee and Subordinated Collateral Management Fee, subject to the conditions set forth in the indentures and in accordance with the priority of payments (discussed *infra*). Resp. Exs. 6, 10, 16 [all at] Section 4.1(a)-(c); Tr. 2226.

Zohar II and III paid Respondents a total of $208,415,871 in Subordinated Collateral Management Fees and Preference Share Distributions during a period starting in 2009 when the Division alleges that those Funds failed one of the tests, the Overcollateralization Ratio Test. Div. Ex. 17 at 790-97 (of 797 .pdf pages).[19] This figure breaks down as follows: (1) Zohar II (a) Subordinated Collateral Management Fees: through the quarter ended April 2010[20] - $19,768,433; thereafter - $56,243,915; (b) Preference Share Distributions - $0; (2) Zohar III (a) Subordinated Collateral Management Fees: September 2010 and thereafter - $91,403,522; (b) Preference Share Distributions: through the quarter ended March 2010 - $29,366,529; thereafter - $11,633,471. *Id*. at 793-94, 796-97.

b. Overcollateralization Ratio and Interest Coverage Ratio Tests

The indentures refer to the Overcollateralization (OC) Ratio and Interest Coverage (IC) Ratio Tests, collectively, as "Class A Coverage Tests." Div. Exs. 1-3 [all at] Section 1.1."Class A Coverage Tests". The IC Ratio is, essentially, at the measurement date, the amount of interest the Fund collected less expenses, including the Senior Collateral Management Fee, divided by the amount owed to noteholders. *Id*. Section 1.1."Class A Interest Coverage Ratio"; Section 11.1(a)(i)(A)-(E); *see, e.g.*, Div. Ex. 7A at 4 (showing calculation of numerator and of

[19] Division Exhibit 17 is the Expert Report of Michael G. Mayer, the Division's expert witness. The Division adduced his evidence in support of its argument that Respondents should disgorge $208 million in ill-gotten gains. Respondents argue that Mayer's methodology is faulty or that they are entitled to an offset, but they do not dispute that $208,415,871 was actually paid. Resp. Br. at 115-20; Resp. Opp. Br. at 52-55.

[20] Insofar as these payments are subject to the possibility of disgorgement, the five-year statute of limitations provided by 28 U.S.C. § 2462 is applicable to disgorgement and runs from the date of the OIP, March 30, 2015. *Kokesh v. SEC*, 137 S. Ct. 1635, 1644 (2017). In a letter dated June 9, 2017, the Division reduced its requested disgorgement amount by $45,447,417 in light of the U.S. Supreme Court's June 5 decision in *Kokesh*.

denominator of IC Ratio). The passing grade for the IC Ratio Test was 110% for all three Zohar Funds. Div. Exs. 1-3 [all at] Section 1.1."Class A Interest Coverage Ratio Test".

An individual OC Ratio for Zohar I, II, and III is specified in each Fund's indenture. Resp. Ex. 1 at 20 (of 303 .pdf pages); Resp. Ex. 8 at 18 (of 447 .pdf pages); Resp. Ex. 12A at 15-16 (of 398 .pdf pages) (all at Section 1.1. "Class A Overcollateralization Ratio"). The denominator is the outstanding principal balance of the notes due to the Fund's investors. *Id.*; Answer ¶ 30. The numerator is essentially the collateral balance or "carrying value" plus cash. *See* Resp. Ex. 1 at 13, 20, 68 (Section 1.1. "Adjusted Collateral Balance"; "Class A Overcollateralization Ratio"; "Unrestricted Collateral Balance"); Resp. Ex. 8 at 18, 50-51, 73 (Section 1.1. "Class A Overcollateralization Ratio"; "Net Portfolio Collateral Balance"; "Unrestricted Collateral Balance"); Resp. Ex. 12A at 15-16, 46-47 (Section 1.1. "Class A Overcollateralization Ratio"; "Net Portfolio Collateral Balance"); Tr. 1890-91, 2234-35, 2251, 2370.[21] The carrying value can be affected by how assets are categorized. For Category 3 and 4 loans in Zohar I and II and for Collateral Investments in Zohar III, the entire principal outstanding is included in the numerator calculation; for Category 1 and 2 loans in Zohar I and II and for Defaulted Investments in Zohar III, only a portion of the principal outstanding is included based on certain metrics, as specified in each indenture. *See* Resp. Ex. 1 at 13, 20, 68; Resp. Ex. 8 at 18, 50-51, 73; Resp. Ex. 12A at 15-16, 46-47. Although these metrics call for using market values in certain situations, there generally were no obtainable market values. Tr. 2245-46. Thus, for Zohar I, the carrying value was typically: par, for a Category 3 or 4 loan (i.e., $1.00, even if the loan were purchased at $0.30); the purchase price, for a Category 1 or 2 loan. *See* Resp. Ex. 1 at 13; Tr. 1891-92, 2234-36, 2246, 2330. For Zohar II and III, the carrying value was typically: par, for a Category 3 or 4 loan/Collateral Investment; a reduced portion of the principal using a recovery rate based on data from rating agencies, for a Category 1 or 2 loan/Defaulted Investment. *See* Resp. Ex. 8 at 50-51; Resp. Ex. 12A at 46-47; Tr. 1896-98, 2370, 2418-19.

Respondents argue that although the numerator is based on an understanding of the "carrying value" of the loans under the definitions set forth in the indentures, the OC Ratio does not reflect a valuation of the loan assets. *See, e.g.*, Answer ¶ 30; Tr. 1891-92; Resp. Ex. 24 at 13 n.47. Nonetheless, Tilton acknowledged that on the whole, in Zohar II and III, recategorizing an asset from a Category 4 loan/Collateral Investment to a Category 1 loan/Defaulted Investment would lower the carrying value and, in turn, could negatively impact the OC Ratio. Tr. 1897-98.

Passing grades for the OC Ratio Test were: 105% for Zohar I; from 112% to 117% for Zohar II; and 112.7% for Zohar III. Div. Ex. 1 Section 1.1."Class A Overcollateralization Ratio

[21] The term "carrying value" in this context refers primarily to the main input of the numerator – the adjusted collateral balance or net portfolio collateral balance. For Zohar I and II, another input called the unrestricted collateral balance – the principal balance of unrestricted collateral debt obligations, carried at 60% for Category 1 and 2 loans – represented a small portion of the numerator relative to the input for the adjusted collateral balance or net portfolio collateral balance. *See* Resp. Ex. 1 at 68; Resp. Ex. 8 at 73; *see, e.g.*, Resp. Ex. 18.076 (Zohar I Trustee Report as of Mar. 31, 2014) at 4; Resp. Ex. 19.071 (Zohar II Trustee Report as of Mar. 31, 2014) at 12.

Test"; Div. Ex. 2 Section 1.1."Class A Overcollateralization Ratio Test", "Ratings Matrix"; Div. Ex. 3 Section 1.1."Class A Overcollateralization Ratio Test Level".

Respondents argue that the IC Ratio is more significant than the OC Ratio because it compared available cash with current interest payments owed to noteholders. Resp. Br. at 5. The OIP does not allege any violations or errors in calculating the IC Ratio or of misrepresenting the amount of interest actually collected, included in the numerator.

c. Priority of Payments (Waterfall)

The priority of payments – referred to as the waterfall – derived from the Portfolio Companies' interest payments, to be made by the trustee on the payment dates is set forth in the indentures. Div. Exs. 1-3 [all at] Sections 1.1."Priority of Payments", Sections 11.1(a)(i) and (ii); Div. Exs. 1-2 [both at] Section 11.2(a). The trustee was to pay available monies in the following order: (1) for the Fund's operational and administrative costs; (2) to Patriarch for its Senior Collateral Management Fee; (3) interest payments to the Class A noteholders; (4) payments to a preference share account up to a certain amount; (5) to Patriarch for its Subordinated Collateral Management Fee; (6) to an account to purchase or originate more loans during the reinvestment period; and (7) after the reinvestment period,[22] principal payments to all noteholders in order of priority, and then any remainder to equity and preference shareholders. *Id*. As relevant here, if a Fund failed its OC Ratio Test (or its IC Ratio Test), the trustee was to use available monies to pay down principal, starting with the highest Class A noteholders. *Id*. The Subordinated Collateral Management Fee and preference shareholders would not be paid.

d. Event of Default by Zohar Funds

An Event of Default would be triggered if, *inter alia*, the Collateral Value Ratio fell under 102% for Zohar I, the OC Ratio fell under a certain percentage (ranging between 102% and 107%) for Zohar II, and the OC Ratio fell under 105% for Zohar III. Div. Exs. 1, 2 [both at] Section 5.1(k); Div. Ex. 2 Section 1.1 "Adjusted Event of Default Overcollateralization Ratio"; Div. Ex. 3 Section 5.1(j). It would also be triggered upon the "default in the payment of" interest on certain notes or principal on any note "when the same becomes due and payable." Div. Exs. 1-3 [all at] Section 1.1."Event of Default" and Section 5.1(a), (b). An Event of Default would empower the controlling party to liquidate the Fund's assets. Div. Exs. 1, 2 [both at] Section 1.1."Controlling Party" and Section 5.2(a); Div. Ex. 3 Section 1.1."Controlling Class" and Section 5.2(a).

e. Defaults by Portfolio Companies to which the Funds Made Loans

As relevant to the Division's claims, a Defaulted Obligation (Zohar I and II) or Defaulted Investment (Zohar III) is one in which "a default as to the payment of principal and/or interest has occurred" and not been cured. Div. Exs. 1, 2 [both at] Section 1.1."Defaulted Obligation";

[22] Each Fund had a five-year reinvestment period. Div. Exs. 1-3 [all at] "Reinvestment Period"; "Scheduled Reinvestment Period Termination Date"; Tr. 2187-88.

Div. Ex. 3 Section 1.1."Defaulted Investment". A Non-Performing Obligation (Zohar I and II) or Non-Performing Collateral Investment (Zohar III) is one in which "a default as to the payment of interest has occurred and is continuing . . . during a specified period." Div. Exs. 1, 2 [both at] Section 1.1."Non-Performing Obligation"; Div. Ex. 3 Section 1.1."Non-Performing Collateral Investment". The indentures do not define the specific facts, *e.g.*, number of overdue payments or period of delinquency, that constitute a borrower's "default" (lower case). A Non-Current Obligation (Zohar I and II) or a Non-Current Collateral Investment (Zohar III) is a Defaulted Obligation or Investment in which the issuer of, or obligor on, "has previously deferred and/or capitalized as principal any interest due thereon (unless [such] interest . . . has subsequently been paid in full . . .)." Div. Exs. 1, 2 [both at] Section 1.1."Non-Current Obligation"; Div. Ex. 3 Section 1.1."Non-Current Collateral Investment". A Current Collateral Debt Obligation is defined as "[not] a Non-Current Obligation" (Zohar I and II), and a Current Collateral Investment, as "not a Non-Current Collateral Investment" (Zohar III). Div. Exs. 1, 2 [both at] Section 1.1."Current Collateral Debt Obligation"; Div. Ex. 3 Section 1.1."Current Collateral Investment".

Where the Zohars were the sole lender or Patriarch otherwise had the ability to control the decision as to whether to consider a borrower in default, Tilton was the decision-maker, after consultation with people at Patriarch and at the Portfolio Company. Tr. 1853-54. In determining whether to continue her support for a company, she required the credit team each day to provide answers to four questions concerning the company's performance and borrowings before allowing it to draw money under a revolving credit agreement. Tr. 2474-75; Resp. Ex. 208; *see also* Resp. Ex. 210 (an October 2008 weekly update from Portfolio Company GAS regarding its sales, staff reductions, and efforts to obtain new business). The loan agreements between the Funds and their borrowers are not in evidence. The undersigned assumes, with minimal evidence, that each loan agreement would specify the facts that constitute a borrower's default or event of default, as well as the actions that the lender could take against the borrower. *See* Div. Ex. 126 (a July 1, 2008, letter from Tilton to a borrower referencing its loan agreement, as amended, and agreeing to defer interest for the coming quarter, subject to terms and conditions). Division Exhibit 126 is the only approximation to a loan agreement that is in evidence. As Tilton pointed out, the performance of the Portfolio Companies deteriorated during the financial crisis, which would have been the worst possible time to default the loans and sell the companies and/or their assets. Tr. 2462-64, 2478-80.

f. Asset Categories

For Zohar I and II, asset categories are numbered 1 through 4; Category 4 is the strongest. Div. Exs. 1, 2 [both at] Section 1.1."Category 1", "Category 2", "Category 3", "Category 4". As relevant here, a Category 4 Collateral Debt Obligation "(i) is a Current Collateral Debt Obligation, . . . (iii) with respect to [which] . . . there shall not have occurred any 'event of default' or any 'default' . . . which has not been waived . . . *and* (v) is not a Collateral Debt Obligation that has, *in the reasonable judgment of the Collateral Manager*, a significant risk of declining in credit quality or, with the passage, of time, becoming a Category 1, . . . 2 or . . . 3." *Id.* at "Category 4" (emphasis added). In practice, the assets were categorized as either 1 or 4.[23]

[23] Tilton explained:

See, e.g., Div. Ex. 7A at 9-10, 26, 37-40 (Zohar I report as of January 29, 2010, showing aggregate principal balances for all Category 1 and 4 loans, but no existing aggregate principal balance for either Category 2 or 3 loans; and categorizing loans as only Category 1 or 4 in a recovery rate test report); Div. Ex. 8, 2010.pdf at 7 (Zohar II report as of January 7, 2010, showing 119 Category 4 loans, eleven Category 1 loans, and no Category 2 or 3 loans); Tr. 2330-31, 2417-18. Category 4 assets are carried at the principal amount outstanding on the loan to the Portfolio Company. Answer ¶ 35. For Zohar III, the categories are binary:[24] Collateral Investment or Defaulted Investment. Div. Ex. 3 Section 1.1."Collateral Investment", "Defaulted Investment".

The collateral manager categorized each loan the Fund made or acquired, and the category of each asset might affect the carrying value of the asset for calculating the numerator of the OC Ratio. Answer ¶¶ 34, 55. Tilton was aware of the interest payments made by the Portfolio Companies and their financial condition. Answer ¶ 46. Tilton regularly received a quarterly interest projection, in which she was notified of the amount of interest on loans that a company expected to pay that quarter. *Id*.

g. Section 7.7(a) – Distressed Loans – Amendment, Forbearance, Waiver, or Supplement

Each of the indentures provided at Section 7.7(a):

> The Zohar Obligors (or the Collateral Manager on behalf of such Person) may, without the consent of the Holders of any Notes or the Credit Enhancer, enter into any amendment, forbearance or waiver of or supplement to any Underlying Instrument included in the Collateral, so long as such amendment, forbearance,

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> [I]f we were working up the company, we would hold it as a Category 4, amend and restructure as we saw fit to create value. If it were in a free-fall bankruptcy without a prepackaged plan, we would hold it as a Category 1. Or if it came to a point that we didn't believe by putting more money in that we could create more value than where we were today, or it was going to take too much time, too much money and too much effort, then we would hold it as a Category 1.

Tr. 2330-31 (re Zohar I); *see also* Tr. 2370-72 (applying the same reasoning to Zohar II). "Category 4 just meant that it wasn't defaulted. And if I agreed to accept less interest than the stated amount on the credit agreement, I had amended and it wasn't defaulted." Tr. 2332. "[T]he analysis [is] . . . if I'm putting [new money] in, will I get back [that sum] plus more than the liquidation value if I liquidate today? . . . [If the new] money and time is . . . just not going to make a difference[,] that's when we would decide that this should be a Category 1." Tr. 2372; *see also* Tr. 2464-68, 2477-81, 2716-21, 2727-28.

[24] This recognized that Categories 2 and 3 were rarely, if ever, used in Zohars I and II. Tr. 2418. Tilton stated that Zohar III's Collateral Investment "is equivalent to a Category 4." Tr. 2418.

> waiver or supplement does not contravene the provisions of any Transaction Document or contravene any applicable law or regulation. For the avoidance of doubt and notwithstanding anything else contained herein, the parties hereto acknowledge and agree that the Collateral Debt Obligations will consist of stressed and distressed loans that may be the subject of extensive amendment, workout, restructuring and/or other negotiations and, as a consequence thereof, the Issuer or the Zohar Subsidiary may receive by way of amendments, modifications, exchanges and/or supplements to such Collateral Debt Obligations, Equity Kickers, Equity Workout Securities and/or the relevant Underlying Instruments (i) interests in loans, debt securities, letters of credit or leases that do not satisfy the provisions of the definition of "Collateral Debt Obligation" and/or the Eligibility Criteria and/or (ii) Equity Workout Securities.

Div. Exs. 1, 2, 3;[25, 26, 27] *see also* Tr. 2210-14.

The April 4, 2007, Zohar III offering memorandum warned that the collateral "is expected to include a material amount of stressed and distressed loans that may be the subject of extensive amendment, workout, restructuring and other negotiations" and, as a result, the Fund "may . . . receive interests in loans, debt securities, letters of credit or leases that do not satisfy the provisions of the definition of 'Collateral Investment' and the Eligibility Criteria referred to

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[25] The segment quoted is from Zohar I's indenture. There are minor differences in wording in the same segment in Zohar II's and III's indentures: In both, "Collateral Debt Obligations" is replaced with "Collateral." In Zohar III's indenture, "Equity Workout Securities" is replaced with "Exchanged Securities," "Collateral Debt Obligation" is replaced with "Collateral Investment," and the numerals "(i)" and "(ii)" in the last sentence are omitted.

[26] Section 7.7(a) was not changed by supplemental indentures: (1) Zohar I: Resp. Ex. 2 (First Supplemental Indenture, dated Aug. 10, 2004); Div. Ex. 5 (Second Supplemental Indenture, dated Oct. 29, 2004); Resp. Ex. 4 (Third Supplemental Indenture, undated); Resp. Ex. 5 (Fourth Supplemental Indenture, dated Mar. 21, 2007); (2) Zohar II: Resp. Ex. 9 (First Supplemental Indenture, dated Oct. 31, 2007); (3) Zohar III: Resp. Ex. 13 (First Supplemental Indenture, dated Mar. 27, 2008); Resp. Ex. 14 (Second Supplemental Indenture, dated Apr. 4, 2008).

[27] The following additional language appears at the end of Section 7.7(a) in the Zohar II and III indentures:

> The Issuer (or the Collateral Manager on its behalf) shall notify each Rating Agency of any amendment, waiver or supplement to any Underlying Instrument included in the Collateral that is in the Collateral Manager's reasonable determination a material amendment, waiver or supplement of the related Pledged Obligation.

Div. Exs. 2, 3.

herein." Resp. Ex. 15[28] at 57, 134-35, 153-58 (of 248 .pdf pages). It further warned that the Fund "may originate or purchase loans . . . of . . . companies that are experiencing significant financial or business difficulties, including . . . bankruptcy." *Id*. at 60. Such investments "involve a substantial degree of risk. Any one or all of [them] . . . may be unsuccessful or not show any return for a considerable period of time . . . [and the Fund] may lose its entire investment." *Id*. SEI and Värde Partners had the Zohar III offering memorandum at the time they invested in the Fund in the secondary market. Resp. Exs. 1097, 1097.002, 1336, 1336.001.

Respondents referred openly to amendments in their communications with investors. Tr. 1676-78 (Tilton told Barclays's Aldama that she was amending the loan agreements); Resp. Exs. 117 (June 2011 email string in which Patriarch told Barclays: "We have recently amended many of the credit agreements to lower interest rates to allow them to pay full interest or defer current due interest"); 118 (September 2011 email string in which Natixis asks for Zohar II and III loans "that have recently changed coupon rates," and Patriarch's reply observes, "You are well aware that the ability to waive, amend or change interest rates to meet the current conditions of a company is an integral part of the business model" and advises that the reductions are temporary and will be re-evaluated within a year); 48A at 4 (transcript of December 2011 investor call in which Tilton tells Barclays, MBIA, and Natixis that the deals were constructed to provide for amendments "to be able to create the most amount of value to pay off the loans"); 48B (recording of same); 49A at 2 (December 2011 investor call with Zohar II noteholders in which Tilton says the deals look "very different than other CDOs in terms of the ability to change maturities, adjust interest rates, . . . extend, restructure"); 49B (recording of same); 50A at 15-16 (Zohar III 2011 investor call in which Tilton states that Global Automotive Systems was able to recover due to her ability to change the interest rate and maturity); 50B (recording of same).

Tilton made the ultimate decision on when to accept less than the contractual rate of interest due from the Portfolio Companies. Answer ¶¶ 48, 55; Tr. 1809. In most such instances she "deferred and accrued" interest. Tr. 1831-32, 1849.[29] Indications of "amendment by course of performance" by deferring and accruing (agreeing to accept less than the contractual rate of interest and deferring the remaining interest to a later date) appear in the trustee reports, as discussed *infra*. As Tilton aptly emphasized, "You want to collect as much as you can without throwing a company into foreclosure or liquidation. . . . Everyone knew what we were buying, and everyone knew what the strategy was." Tr. 1839. A deferral is an amendment to the loan or credit agreement under the terms of the applicable Zohar indenture. Tr. 1842. By contrast to a deferral, a permanent change of interest or maturity, for example, would be incorporated in a signed document. Tr. 1850. Tilton was the ultimate decision-maker on whether a loan would be considered as defaulted, through Section 7.7(a). Tr. 1853-54. Tilton considered that she could

[28] The Zohar III offering memorandum is also in evidence as Div. Ex. 6 and Resp. Exs. 1097.002, 1336.001.

[29] Tilton explained: "It was rare that we waived or forgave interest." Tr. 1849. By deferring and accruing unpaid interest, "if a company turned around . . . we could provide that interest to the loans . . . also . . . [if] we needed to take a company through bankruptcy, having that large accrued interest helped us keep the equity, because it became the unsecured class." *Id*.

categorize a 1 as a 4, if appropriate, using reasonable, good faith business judgment and discretion. Tr. 1863-64. As Tilton understood, categorization of a loan could have an impact on the OC Ratio. Tr. 1896-99.

When Tilton deferred interest payments, payments were deferred until she asked for payment, which could be any point in the future or never. Tr. 1836-37.

h. Financial Statements

Each Zohar Fund was required under the terms of its indenture to provide quarterly financial statements prepared in accordance with GAAP to the trustee and each noteholder, as well as to "the Preference Share Paying Agent, the Credit Enhancer,[30] [and] each Rating Agency." Answer ¶ 57; Tr. 1119; Div. Exs. 1-3 [all at] Section 7.9(a). The indentures did not require the financial statements to be audited. Div. Exs. 1-3 [all at] Section 7.9(a). The financial statements were prepared by Patriarch's accounting department, provided to Berlant, and then ultimately approved by Tilton; the statements were then provided to the trustee, which made them available to noteholders by posting them on a secure website to which they had access. Answer ¶ 57; Tr. 151-52, 1118.

i. Trustee Reports

Under the terms of the indentures, the trustee for each of the Funds was required to prepare and distribute a monthly report to noteholders containing various information about the Fund and its assets, including the outstanding balance of the notes, interest received, a description of loans in the portfolio, and the outcome of tests relating to the collateral, including the OC Ratio test. Answer ¶ 33; Div. Ex. 1 Section 10.12, Div. Ex. 2 Section 10.12, Div. Ex. 3 Section 10.09. The information in the reports was provided by the Funds. Specifically, the indentures required the issuer each month to provide monthly reports and quarterly note valuation reports "to each Rating Agency, the Trustee, the Preference Share Paying Agent, . . . the Collateral Manager, . . . and the Holders of Notes." Div. Ex. 1 Section 10.13, Div. Ex. 2 Section 10.13, Div. Ex. 3 Section 10.10. The trustee made the reports available to the noteholders on a secure website. Tr. 104, 311; Resp. Ex. 1656. The reports were confidential and not to be shared by the recipients with other parties. Tr. 274-76.

The indentures absolved the trustee of any responsibility to verify the accuracy of information it received from Respondents. Div. Ex. 1, 2, 3 [all at] Section 6.3(k).

[30] In Zohar I and II only; Zohar III did not have a Credit Enhancer. Div. Exs. 1-3 [all at] Section 7.9(a).

2. Collateral Management Agreements

a. Termination for Cause

The CMAs for each Zohar Fund required Tilton to be a principal and own a minimum percentage of the equity of the respective Patriarch collateral manager (with a provision for an approved replacement). Resp. Exs. 6, 10, 16[31] [all at] Section 1.1."Cause" (vi) and Section 5.3; Tr. 2224-25. The holder of the controlling interest in each Fund could remove the collateral manager for specified causes. Resp. Exs. 6, 10, 16 [all at] Section 1.1."Cause" and Section 5.3. In Zohar I and II, that party could then select a successor; in Zohar III, Patriarch XV could then select a successor, subject to the consent of the controlling class. Resp. Exs. 6, 10 [both at] Section 5.5; Resp. Ex. 16 Section 5.4.

b. Workouts and Restructurings

Each of the CMAs contained language that tracked the warning in Section 7.7(a) of the indentures about the assets to be held in the CLOs:

> Workouts and Restructurings. For the avoidance of doubt and notwithstanding anything else contained herein, the Company, the Zohar Subsidiary and the Collateral Manager acknowledge and agree that the Collateral Debt Obligations [and/or] Unrestricted Collateral Debt Obligations will consist of stressed and distressed loans that may be the subject of extensive amendment, workout, restructuring and/or other negotiations and, as of consequence thereof, the Company and/or the Zohar Subsidiary may receive by way of amendments, modifications, exchanges and/or supplements to such Collateral Debt Obligations, Equity Kickers, Equity Workout Securities[,] and/or the relevant Underlying Instruments (A) interests in loans, debt securities, letters of credit or leases that do not satisfy the provisions of the definition of "Collateral Debt Obligation" and/or the Eligibility Criteria and/or (B) Equity Workout Securities.

Div. Ex. 13 Section 2.2(p); Div. Ex. 14 Section 2.2(p); Div. Ex. 15 Section 2.2(m) (CMAs for Zohar I, II, and III, respectively);[32] *see also* Tr. 2219-21. The CMAs also tracked Section 7.7(a)'s disclosure regarding the collateral manager's authority to amend, modify, waive, or supplement any term or condition of any loan or investment, without the noteholders' consent. Div. Exs. 13, 14, 15 [all at] Section 2.2(c).

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[31] Resp. Exs. 6, 10, and 16 are the same as Div. Exs. 13, 14, and 15, respectively.

[32] The segment quoted is from the CMA for Zohar I. There are minor differences in punctuation and wording in the same segment among the CMAs. In particular, in the CMA for Zohar III "Collateral Debt Obligations" and "Collateral Debt Obligations [and/or] Unrestricted Collateral Debt Obligations" are replaced with "Collateral Investments," and the first instance of "Equity Workout Securities" is replaced with "Exchanged Securities."

c. Conflicts of Interest

In addition to the conflict inherent in the collateral manager's authority to categorize collateral, which in turn affected the fees it would receive, the CMAs contained a provision regarding conflicts of interest arising from the collateral manager's or its affiliates' investments in or services to other firms. Tr. 2227-28; Resp. Exs. 6, 10, 16 [all at] Section 6.2. Section 6.2 dealt with conflicts. More generally, obligations of the collateral manager provided in Section 2.6 include: "[T]he Collateral Manager shall not take any action which it knows or should be reasonably expected to know in accordance with prevailing market practices would . . . adversely affect the interest of the [noteholders] . . . in any material respect (other than as contemplated hereunder or under the Indenture," with the proviso that "the Collateral Manager does not guarantee the performance of the Collateral or any payment obligation under the Indenture)." Resp. Exs. 6, 10, 16 [all at] Section 2.6.

C. Respondents Operate the Zohars

Having become interested in distressed assets, Tilton developed a method of evaluating distressed loans – analyzing the potential cash flows and other factors; and determining on that basis whether to purchase, and an appropriate price for, each loan to make up a portfolio of varied loans that would generate sufficient cash flows to pay expenses, including interest and principal to investors in a vehicle that would hold the portfolio. Tr. 2080-98. A portion of the pool had to have a high likelihood of paying interest on a consistent basis, in order to pay investors; as Tilton explained, if all the loans were non-performing at the start, there would be no interest coming in to pay investors, while if all were higher quality, there would not be enough potential for profit because she would have to pay too much for them. Tr. 2085. In November 2003, Tilton was granted a business method patent, Patent No. US 6,654,727 B2 (Method of Securitizing a Portfolio of at Least 30% Distressed Commercial Loans), for her method. Tr. 2173-75; Resp. Ex. 65. Tilton obtained equity and became active in management of the Portfolio Companies. Tr. 2164. Since some of the Portfolio Companies were bound to fail, it was necessary for some to succeed in order to mitigate the risk of loss. Tr. 2165.

Tilton referred to her investment in, or interest in, the Zohar Funds or Portfolio Companies in general terms, but the record does not contain specifics concerning dollar amounts, her rights or obligations, or other specific details. For example, Tilton testified, "I believe I put up 5 million" for "last-out preference shares" in Zohar I. Tr. 2208; *see also* Tr. 2114. Zohar II "had $78 million of equity contribution. . . . Most of it was from me . . . part of it was from one of the funds that I wrapped." Tr. 1788. For Zohar III, "I put up $60 million of the equity." Tr. 1789.[33] For Zohar II and III and the later years of Zohar I, "much of what we had acquired was exercising our distressed private equity expertise into buying companies and loaning to [them] and giving equity upside to the fund." Tr. 1790. Tilton used the term "equity upside" some

[33] The dollar amounts in Tilton's testimony as to her investments in Zohar I, II, and III are approximately consistent with the evidence of Respondents' summary witness Thomas Lys concerning her entities' investments in the Funds' preference shares, based on his review of Patriarch documents. Tr. 3038-40, 3054; Resp. Ex. 132 (Lys's summary chart).

forty-eight times, and "upside equity" six times, in her testimony.[34] Tilton confirmed that the "equity upside" is not in the trustee reports. Tr. 2757. She testified that she allocated the upside equity to the Funds to run through the waterfall upon a sale of the companies to pay the noteholders before she would receive the rest. Tr. 1800-01. She testified that she "gifted" the equity upside to the Funds. Tr. 1934, 2261, 2596, 2687, 2756. However, there are no deeds of gift or other documents in evidence effectuating such gifts. Thus, it is found that, for the purpose of this administrative proceeding, the Zohar Funds, beyond their right to receive interest and principal payments on loans or other assets listed in the Trustee Reports,[35] had no express equity ownership or beneficial rights in the Portfolio Companies.

Tilton used her patented method in setting up Zohar I. Tr. 2175-76, 2179. The deal had a twelve-year maturity and a five-year period during which principal could be reinvested. Tr. 2187-88. It was a club deal. Tr. 2207. The three investors in the notes, totaling approximately $532 million, were Natixis, Tilton's banker; MBIA; and Barclays, which MBIA brought into the deal. Tr. 2204-05, 2207; Answer ¶ 16. Tilton herself invested in Zohar I preference shares. Tr. 2208.

Starting in 2012, Tilton had tried to restructure Zohar I, at the least, to extend its maturity from November 2015 to match the maturity of Zohar II in January 2017. Tr. 1515-21, 1695-96, 1712-19, 2561-95, 2599-611, 2701-05. In exchange, Tilton would give up any subordinated fees and dividends that would have come to her and her affiliates. Tr. 2572. Barclays and MBIA did not agree to Tilton's proposal and the restructuring did not occur. Tr. 1517-21, 1696, 2571, 2580, 2705-06. Zohar I matured in November 2015 and defaulted. Tr. 1796.

At the time of the hearing, Zohar II and III were still extant.

The allegations of wrongdoing relate to disclosures in the trustee reports – alleged miscategorization of loans and consequent effect on the OC Ratio Test – and in the financial statements. The allegations directly related to the trustee reports are discussed first.

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[34] *See, e.g.*, Tr. 2754-55 (Tilton testifying "there are multiple types of equity upside. Some are collateral to the funds, like the special lien preferreds . . . or equity kickers . . . or equity workout securities. But the common equity upside that I paid for lives in Octaluna where the preference shares and . . . the B notes also are held."); *see also* Resp. Exs. 125, 126A. Adding to the indefiniteness concerning the ownership of benefits and rights in the portfolio companies is the role of the blocker corporation (Octaluna). Tr. 2754-57, 2261 (Tilton testifying that the Zohars could not hold anything that was a U.S. taxpayer; such interests were placed in a blocker corporation). *See also* Tr. 2118, 2170 (explaining her use of a blocker corporation in connection with a previous investment vehicle).

[35] *See, e.g.*, Div. Ex. 7A at 53 (listing equity holdings of Zohar I in several companies as of Jan. 29, 2010); Div. Ex. 9A at 39 (listing an equity holding of Zohar III in one company as of June 8, 2010); Resp. Ex. 19.100 at 19 (listing an equity holding of Zohar II in one company as of Jan. 7, 2011).

1. Trustee Reports

The trustee reports provided far more information than the financial statements. *See, e.g.*, Resp. Ex. 18.108 & Div. Ex. 10A (Zohar I Aug. 10, 2010, quarterly trustee report [68 pp.] & financial statements [9 pp.]); Resp. Ex. 19.098 & Div. Ex. 11A (Zohar II Jul. 8, 2010, quarterly trustee report [48 pp.] & financial statements [10 pp.]); Resp. Ex. 20.070 & Div. Ex. 12D (Zohar III Mar. 8, 2010, quarterly trustee report [51 pp.] & financial statements [10 pp.]). Of a financial statement's nine or ten pages, two pages contained dollar values – a one-page balance sheet and a one-page income statement; the remaining pages were Tilton's certificate and the notes to the financial statements. *See, e.g.*, Div. Exs. 10A, 11A, 12D. Except for a table of contents or title page, the trustee reports were comprised largely of dollar values and several financial metrics ascribed to loans, payments, and various compilations. *See, e.g.*, Resp. Exs. 18.108, 19.098, 20.070. There is no evidence in the record that any of these dollar values were inaccurate.

The trustee reports for Zohar II and III listed, in separate places, the interest rate (and balance) of each individual loan and the interest that actually was collected on the loan.[36] For example, the Zohar III report as of June 8, 2010, showed the interest rate and the intra-period interest actually collected as to loan 855_11; the interest collected was far less than the interest due according to the interest rate. Div. Ex. 9A at 19, 31; Tr. 315-21. The report includes a list of defaulted noncurrent and nonperforming loans; loan 855_11 does not appear. Div. Ex. 9A at 38; Tr. 315-16, 321. The OC Ratio was reported as passing at 125.28%. Div. Ex. 9A at 16. Further, the Zohar II report as of January 7, 2010, showed no intra-period interest collected on loan 855_11, which had a 10% interest rate and a balance of $44,949,848.59, and showed the loan as Category 4. Div. Ex. 8, 2010.pdf at 28, 36. The OC Ratio was reported as passing at 121.66%. *Id*. at 15.

The reports for Zohar I show the total interest collected and the interest rate and balance of each loan. An example is the Zohar I report as of January 29, 2010, which showed that total interest collected was far less than interest due.[37] Div. Ex. 7A at 2, 45-48. The OC Ratio was reported as passing at 120.11%. *Id*. at 3.

[36] Zohar III investor Värde compared the interest rate and actual interest payments reported in the trustee reports only after the institution of this proceeding. Tr. 612-14, 646-51, 675-79, 690-96, 725-26. An analyst entered the data in Excel; Mach admitted that it took just "basic math to look at the actual interest rate that had been paid." Tr. 613.

[37] Zohar I investor Barclays ascertained that a Category 4 rating did not mean that the borrower was paying full interest at the original rate. Tr. 1656-61, 1678-79, 1683, 1710-11; Resp. Ex. 1079. Barclays also discerned that there was a gap between actual interest payments and interest calculations based on the weighted average spread stated in the trustee reports. Tr. 1665-68, 1674, 1701; Resp. Ex. 117.

Zohar I trustee reports do not show loan-by-loan data on interest collected.[38] *See, e.g.*, Div. Ex. 7A; *see also* Tr. 1596, 1647-48, 1738-39. They show most of the loans as Category 4. *See, e.g.*, Div. Ex. 7A; *see also* Tr. 1651. They also show Category 4 loans with interest rates declining and maturity dates extending over time. *See, e.g.*, Div. Ex. 7, 2004.pdf at 21 (Sept. 30, 2004, Trustee Report showing Bomar Industries International Inc. Tranche A Term Loan of $10 million with an interest rate of 7.75% and maturity on June 30, 2008, as Category 4); Div. Ex. 7A at 22 (Jan. 29, 2010, Trustee Report showing the same loan with an interest rate of 3.2309% and maturity on June 30, 2010, as Category 4). They also show total interest received. *See, e.g.*, Div. Ex. 7A at 2 (showing "Scheduled Distributions of Interest" as part of calculation of the numerator of the IC Ratio).

The Zohar II and III trustee reports also disclosed the Senior and Subordinated Collateral Management Fees paid. *See, e.g.*, Div. Ex. 8, 2010.pdf at 9; Div. Ex. 9A at 9. The Zohar I trustee reports disclosed the Senior Collateral Management Fee, and the income statements disclosed the total Collateral Management Fees. *See, e.g.*, Resp. Ex. 18.108 at 2 & Div. Ex. 10A at 3 (Zohar I Aug. 10, 2010, quarterly trustee report showing $1,799,826.45 Senior Collateral Management Fee & financial statements showing $3,599,653 Collateral Management Fees).

The trustee reports do not contain underlying financial information on the Portfolio Companies; Tilton considered that disclosing such information would reduce the Portfolio Companies' chances of being able to turn around.[39] Tr. 2230-32; *see also* Tr. 1502-06, 1509-12, 1517-21, 1534, 1622, 1669-70, 1707 (testimony of Jaime Aldama of Barclays regarding his unsuccessful attempt to obtain underlying financial information on Zohar I Portfolio Companies in which he acknowledges that Barclays had no right to the information), 2783-84; Div. Ex. 189 at 4.

2. Financial Statements

As found *supra*, the financial statements provided far less information than the trustee reports.[40] Over the entire time that Patriarch was the Funds' collateral manager, Tilton never

[38] There was some loan-by-loan information that noteholders could download from the trustee's website. Tr. 1695, 1759-62; *see* Resp. Exs. 18.001A, B (data associated with Resp. Ex. 18.001, Sept. 30, 2004, monthly report), 18.002A, B (data associated with Resp. Ex. 18.002, Oct. 29, 2004, monthly report), etc.

[39] Nor were the noteholders entitled to the credit agreements between the borrowers and the Funds. Tr. 2784.

[40] Indeed, after approximately February 2015, when the financial statements' disclosure regarding impairment was revised and reference to GAAP and fair value was removed, the revisions included the following addition to Note 1: "It is important that the financial statements be read in conjunction with the monthly and quarterly trustee reports, which include detailed information regarding the Collateral Debt Obligations, along with other information not included in the financial statements." *See, e.g.*, Div. Exs. 10B, 11C, 12C [all at] 4.

was asked a question about a Fund's financial statements by noteholders, rating agencies, or anyone else. Tr. 1981-82. Barclays's Aldama, who analyzed the bank's position in Zohar I, starting in 2010, never looked at the Fund's financial statements. Tr. 1496-97, 1499-1501, 1547. The representation that Zohar III's financial statements were GAAP compliant was not important to SEI's Aniloff, who conducted the analysis and made the decision to purchase interests in the Fund during 2010 to 2013 and monitored the holdings. Tr. 375. His interest in the financial statements focused on the fair value of the collateral. Tr. 152, 154-55, 345-52. Värde's Matthew Mach, who analyzed and recommended that Värde purchase the Zohar position, focused on the fair value of the collateral and the representation that the fair valuation was conducted in accordance with GAAP. Tr. 618-20.

Tilton executed the certificates as to the financial statements of the Funds. Div. Exs. 10-12, *passim*. Through 2014, the certificates stated that the financial statements complied with GAAP.[41] *Id*. After approximately February 2015, the statement of compliance with GAAP does not appear, and this statement appears: "These financial statements have been prepared under a basis of accounting in which the Company's investment in Collateral Debt Obligations ("CDOs") are recorded at cost and the company's equity interests in portfolio companies are not recorded on the consolidated balance sheet." *Compare* Div. Exs. 10A, 11A, 11B, 12A, 12B, 12D [all at] 1 *with* Div. Exs. 10B, 11C, 12C [all at] 1.[42] Respondents made this change to reduce their risk going forward when they understood that the Commission was about to issue an OIP alleging that their financial statements did not comply with GAAP.[43] Tr. 2597-98, 2738.

Respondents' outside accountant, Peter Berlant, CPA, was not consulted about the language changes concerning compliance with GAAP (or concerning impairment and fair value, referenced *infra*) and does not know who drafted the revised language. Tr. 817-27, 883. Berlant had provided the language concerning FAS 157 that had appeared in Note 3. Tr. 1008-13; Resp. Exs. 60, 60.002.

[41] Specifically, the certificates as to the financial statements through November 6, 2014, for Zohar I; January 7, 2015, for Zohar II; and December 8, 2014, for Zohar III stated that they complied with GAAP. Div. Ex. 10 (Zohar I Financials) at 293-95 (of 322 .pdf pages); Div. Ex. 11 (Zohar II Financials) at 260-62 (of 280 .pdf pages); Div. Ex. 12 (Zohar III Financials) at 266-68 (of 293 .pdf pages).

[42] The change occurs starting with the financial statements for Zohar I on February 6, 2015; for Zohar II, April 8, 2015; and for Zohar III, March 6, 2015. Div. Exs. 10B, 11C, 12C.

[43] The Division argues that the change is an acknowledgement that the prior reporting did not comply with GAAP. Div. Br. at 24-26. This argument is rejected and Respondents' common-sense explanation is accepted. There is no evidence in the record that any noteholder or other interested party asked for an explanation of the change.

3. Disclosure of Impairment and Fair Value Policies

The notes to the Zohar financial statements contained certain disclosures regarding Patriarch's accounting policies related to impairment, fair value, and interest accrual, as discussed further below. Tr. 1111-13. The policies concerning impairment and interest accrual also relate to Respondents' categorization of loans as disclosed in the trustee reports. The policies, however, were not written down in any manual specific to the Zohar Funds. Tr. 1114, 2138-39, 2749-51; *see also* Div. Exs. 127, 128; Resp. Ex. 1766.001. Respondents' current controller, Carlos Mercado, CPA, understood the policies from discussions with the former controller and understood that Respondents had a process by which the credit team monitored the borrowers on a day-to-day basis. Tr. 1099, 1102, 1117, 1172.

a. Impairment

The notes to the Zohar financial statements disclosed:

> **NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**
>
> . . .
>
> 4. Carrying Value of Collateral Debt Obligations/Collateral Investments
>
> . . . In the event the Company's expected realization of principal . . . is impaired, such that the anticipated future collections are determined to be less than the carrying value of the loan, the Company will record an impairment loss equal to the amount of the anticipated shortfall and will thereafter carry the loan at the reduced amount.[44]

[44] After approximately February 2015, Note 4 was changed, adding language indicated by underscoring as follows:

> In the event the Company's expected realization of principal . . . is impaired on a permanent basis, such that the anticipated future collections are determined to be less than the carrying value of the loan, the Company will record an impairment loss equal to the amount of the anticipated shortfall and will thereafter carry the loan at the reduced amount. A Collateral Debt Obligation is not considered impaired and the carrying value of the loans is not reduced until either an event or sale occur such and to the extent that, in the judgment of the Collateral Manager, principal losses can be conclusively determined. Pursuant to Section 7.7(a) of the Indenture, the Company, through the Collateral Manager, may defer, waive, or forgive interest otherwise payable. Accordingly, a Collateral Debt Obligation is not considered impaired on the basis that interest payments are less than the amounts that would otherwise be due.

Compare Div. Exs. 10A, 11A, 11B, 12A, 12B, 12D [all at] 5 *with* Div. Exs. 10B, 11C, 12C [all at] 5.

5. Revenue Recognition

. . .

> *Gains and Losses on the Settlement of Collateral Debt Obligations* – The Company expects that a portion of the underlying obligors of the Collateral Debt Obligations/Collateral Investments will be unable to repay the full principal outstanding under their respective credit agreements. Given such element of uncertainty with regard to future collection, the Company employs the cost-recovery basis of accounting for the recognition of capital gain or loss. To this end, the Company does not recognize gain on Collateral Debt Obligations/ Collateral Investments until the principal collected exceeds the carrying value of a respective Collateral Debt Obligation/Collateral Investment . . . .

Div. Ex. 10 at 5; Div. Ex. 11 at 5; Div. Ex. 12 at 5.[45]

According to Mercado, impairment occurs when it is expected that the full amount of principal and interest on a loan will not be collected. Tr. 1148. Respondents' policy since the inception of the Zohar Funds is that the Collateral Debt Obligations/Collateral Investments are not considered impaired unless an event or sale occurs from which a principal loss can be conclusively determined. Tr. 1117-18, 1149, 1175, 1256-57, 1973. Events leading to impairment include bankruptcy, liquidation, and restructuring of a company's debt. Tr. 1151, 1154; *see, e.g.*, Tr. 1258-62, 1267-68 (concerning recording a write-off of a portion of a borrower's loan on restructuring). If there were no "event," there would be no impairment. Tr. 1149, 1153, 1948, 1964, 1975-76. Mercado considered this to be GAAP-compliant. Tr. 1118, 1175.

Patriarch applied the impairment process to Category 1 loans; for the most part, Category 4 loans were held at cost and not impaired, unless there was a restructuring, because Respondents "believed in the future recovery"; in Tilton's words, "until you know, you don't know." Tr. 1975-76. Deferring interest in itself did not necessarily trigger an impairment analysis. Tr. 1334-35.

The Zohar accounting workpapers show losses were recognized upon impairment events. *See, e.g.*, Tr. 1258-59; *see also* Resp. Ex. 31, Payoffs 2-7-14 Tab at Column I; Resp. Ex. 32, Payoffs 4-8-14 Tab at Column H; Resp. Ex. 33, Payoffs 3-6-14 Tab at Column H. When the workpapers yielded a net loss for a given period, a corresponding loss would be recorded on the income statement under "Gain or (Loss) on Settlement of Collateral Debt Obligations" (for Zohar I and II) or "Gain or (Loss) on Settlement of Collateral Investments" (for Zohar III), would be reported in the notes to the Zohar financial statements, and would reduce the loan's carrying value – which, in turn, may affect the value of assets presented on the balance sheet. Tr. 1256-57, 1271-72, 1148-49; *see, e.g.*, Div. Ex. 10 at 74-75, 77-78 (Zohar I, Feb. 9, 2009,

[45] The quoted language is modified to reflect that, in Zohar III, the term Collateral Investments is used instead of Collateral Debt Obligations.

Financial Statement) ($2,216,388 loss tied to Resp. Ex. 31, Payoffs 2-7-14 Tab at Column I, Period Ended 2/9/09); Div. Ex. 11 at 83-84, 86-87 (Zohar II, July 8, 2009, Financial Statement) ($17,805,637 loss tied to Resp. Ex. 32, Payoffs 4-8-14 Tab at Column H, Period Ended 7/8/09); Div. Ex. 12 at 157-58, 160-61 (Zohar III, Dec. 7, 2011, Financial Statement) ($4,044,852 loss tied to Resp. Ex. 33, Payoffs 3-6-14 Tab at Column H, Period from 9/8/11 thru 12/8/11).

As Mercado testified and as Tilton expressed in an August 2010 email to Mercado, Patriarch's policy was to write off loans, not to write down. Tr. 1159-61, 1174-75, 1265; Div. Ex. 162. This policy, however, did not mean that Respondents would record an impairment loss only when writing off the entire amount of a loan; rather, it reflected Respondents' event-driven impairment policy, and losses short of a full write off were recognized in the event of loan restructuring. Tr. 1263, 1265, 1964, 2146. Indeed, the Zohar workpapers show partial write offs or write downs when Patriarch restructured loans, in which a portion of the borrower's loan that was not included in the restructuring was written off, as it was determined to be the uncollectible principal loss. Tr. 1027, 1151, 1258-62, 1267-68; *see, e.g.*, Resp. Ex. 33, Payoffs 3-6-14 Tab at Column H, Period from 12/8/08 thru 3/6/09 (reflecting a $3.7 million loss upon restructuring of an Ark II Manufacturing loan), Period from 3/6/09 thru 6/8/09 (reflecting a $1.7 million loss upon restructuring of a Zohar Waterworks loan).

Respondents' policy was consistent with a 2001 Patriarch document titled "Ark CLO 2000-1, Limited – Accounting/Tax Manual."[46] Resp. Ex. 1766.001. That manual provided:

> Under GAAP, a mere modification in terms of a loan – such as a change of interest rate, extension of maturity, release of collateral, or reduction of principal – does not, by itself, require accounting entries.
>
> If the modification results a material diminution of anticipated collections versus Loan Carrying Value, this situation may call for an Impairment Charge. However, since most of the modifications will be engineered to enhance the borrower's ability to service its debt, we expect that a modification will rarely, if ever, necessitate an Impairment Charge.

Id. at 63.[47] According to Tilton, Berlant developed the GAAP reporting portion of the manual in conjunction with a Patriarch associate and provided advice embodied in the quoted language. Tr.

[46] Respondents urge that the manual was in use in 2008, citing Respondents Exhibit 1766, a March 26, 2008, email to Patriarch accountants Chris Denune and William Plon, which forwarded a 2005 email from then-CFO Kimberly Sturkey. Tr. 2138, 2143, 2267. The subject line reads "FW: Helpful Tax Information and Guidance.zip," and the attachment is identified as "Helpful Tax Information and Guidance.zip." Resp. Ex. 1766. This identification might – or might not – contain the 2001 Patriarch document titled "Ark CLO 2000-1, Limited – Accounting/Tax Manual." Most of the sixty-five page manual was devoted to tax issues, but eight pages were devoted to GAAP reporting. Resp. Ex. 1766.001 at 58-65.

[47] The manual also provided, as to "GAAP Reporting of Loan Restructurings": "If assets received bear a material diminution of anticipated collections versus their respective Carrying

2143, 2145-46. Berlant, however, testified that he did not recall drafting the language or ever seeing the manual or the language prior to being questioned on it. Tr. 963. There is no additional evidence in the record on this, and no finding can be made as to whether Berlant drafted, reviewed, or commented on the language, based on the brief testimony of Tilton and Berlant.[48]

Patriarch's loan review process involved a team of six or more credit officers – also referred to as portfolio managers – who monitored borrowers day to day, including telephoning companies daily for financial information; the team provided monthly updates to Tilton, and she used the information in the impairment analysis. Tr. 1244-46, 1250-51, 1254-56, 2353. As an example of the type of information prepared by the credit team, Respondents introduced a credit template for American LaFrance, which included detailed financial information and analyses of the company and its loans, including a pricing sheet to predict future cash flows. Resp. Ex. 561; Tr. 1246, 1250-51, 2277-78. The final decision on impairment of a loan was Tilton's. Tr. 1152, 1164, 1171-72; *see, e.g.*, Div. Ex. 162.

b. Fair Value

The notes disclosed that the fair value of the Collateral Debt Obligations/Collateral Investments, "taken as a whole, is approximately equal to the . . . carrying value presented on the Balance Sheet";[49] the dollar amount for carrying value is included both in this fair value disclosure and as the first reported figure under assets on the balance sheet. *See, e.g.*, Div. Ex. 10 at 2, 6; Div. Ex. 11 at 2, 6; Div. Ex. 12 at 2, 6. Regarding Respondents' policy on carrying

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Values, the situation may call for an Impairment Charge. However, since most of the Restructurings will be engineered to increase the borrower's ability to service its debts, we expect such Impairments to be rare." Resp. Ex. 1766.001 at 64.

[48] The record is unclear as to whether Mercado knew of the manual. Tr. 1114 (as to accounting policies and procedures that govern loan impairments and fair value analysis of the loan assets "[t]here is no manual where that specific language is included"), 1278-79 (Denune showed him how to prepare the financial statements, and "[w]e also had an accounting manual that outlines . . . how to use the work papers in the preparation of the financial statements"); *see also* Div. Exs. 127, 128 (accounting manuals for the Zohars, which do not contain the guidance referenced in the Ark manual).

[49] After approximately February 2015, all references to fair value were removed from the financial statements. Note 3 had included a section titled "Disclosure of Fair Value of Financial Instruments" that described the GAAP framework for measuring fair value and stated that the Fund's CDOs were valued using Level 3 inputs; this section was removed from Note 3. *Compare* Div. Exs. 10A, 11A, 11B, 12A, 12B, 12D [all at] 6-7 *with* Div. Exs. 10B, 11C, 12C [all at] 6. The fair value section that was removed included the statements on fair value as quoted in the main text. A "Fair Value" column in Note 6, a chart depicting notes payable, was also removed. *Compare* Div. Exs. 10A, 11A, 11B, 12A, 12B, 12D [all at] 8 *with* Div. Exs. 10B, 11C, 12C [all at] 8.

value, the notes disclosed that: the Collateral Debt Obligations/Collateral Investments are recorded "at cost" upon acquisition or origination, which is equal to the amount of cash paid to acquire or originate them; the carrying value of the respective loan assets is reduced by principal payments received from borrowers and increased by advances to borrowers pursuant to revolving credit agreements; and loans are carried at reduced amounts when losses are recognized under Respondents' impairment policy. *See, e.g.*, Div. Ex. 10 at 5-6; Div. Ex. 11 at 5-6; Div. Ex. 12 at 5-6.

Further, the notes disclosed:

> Fair value estimates are generally subjective in nature, and are made as of a specific point in time based on the characteristics of the financial instruments and relevant market information. Where available, quoted market prices are taken into account in the determination of fair value. For substantially all of the [Collateral Debt Obligations/Collateral Investments], however, fair values are based on estimates using present value of anticipated future collections or other valuation techniques. These techniques involve uncertainties and are significantly affected by the assumptions used and judgments made regarding risk characteristics of various financial instruments, discount rates, estimates of future cash flows, future expected loss experience and other factors. Changes in assumptions could significantly affect these estimates and the resulting fair values. Derived fair value estimates cannot necessarily be substantiated by comparison to independent markets and, in many cases, could not be realized in an immediate sale of the instrument. Accordingly, the aggregate fair value amounts determined by the Company do not purport to represent, and should not be considered representative of, the underlying enterprise value of the Company. In addition, because of differences in methodologies and assumptions used to estimate fair values, the Company's estimate of fair values should not be compared to those of other financial institutions.

See, e.g., Div. Ex. 10 at 6; Div. Ex. 11 at 6; Div. Ex. 12 at 6.

Mercado believed that the notes to the Zohar financial statements gave sufficient notice of Patriarch's fair value valuation technique. Tr. 1176-83. Mercado, however, was not involved in the process of fair valuing loans. Tr. 1326, 1331. Nor was Berlant. Tr. 1081, 1331. Rather, Tilton conducted the fair value analysis along with the structured finance team and the credit officers. Tr. 1977.

Although acknowledging that cost and fair value are not necessarily the same, Mercado explained that the accounting and finance group and Tilton determined that carrying the assets at cost was the most effective way of determining the aggregate value of the assets because they are all distressed assets subject to highly subjective assumptions; Mercado considered this valuation technique to be GAAP-compliant. Tr. 1181-82.

Patriarch calculated fair value of the Collateral Debt Obligations/Collateral Investments as cost (cash paid for loans) minus or plus gains or losses recognized – in effect carrying cost.

Tr. 1177-83, 1273; *see also* Resp. Exs. 31, 32, 33 (Zohar workpapers) all at WTB tabs (reflecting calculation of the value of Collateral Debt Obligations/Collateral Investments each period, corresponding to this method). There could be a potentially different value for any particular loan, Tr. 1273, but Patriarch's fair value estimation process never arrived at a number different from the cost basis reported in the financial statements. Tr. 1275.

Tilton considered detailed financial data and cash-flow analyses about each Fund's overall performance and the Portfolio Companies to confirm that the carrying value, or cost, of the Collateral Debt Obligations/Collateral Investments was an accurate estimate of their fair value. Tr. 1273-74, 1978-79, 2280-83, 2297-98; *see, e.g.*, Resp. Exs. 487.001, 557, 1832 (compilation exhibit). Tilton explained:

> If when we conducted the fair value analysis, it came to a lower number than cost, then we would have lowered that number; but we used cost as the most conservative when we compared it to the carrying value on the trustee report and to our fair market value analysis, which also included equity upside which is not included in our holding value or carrying value here.
>
> So it always came up higher, so we chose to use the carrying value as the most conservative basis to hold the assets.

Tr. 1978.

Tilton acknowledged that, for the most part, Category 4 loans were held at cost and not impaired. Tr. 1975-76. She considered this to be the most conservative approach as it was "event-driven," rather than "a market value of subjective inputs." Tr. 1962-64. The subjective inputs included "when [Tilton] thought debt would pay down; when [she] thought there might be a sale of the company; what [she] thought would be the equity upside; what [she] thought the [earnings before interest, tax, depreciation and amortization (EBITDA)] might be at the time of the sale of the company." Tr. 1978-79.

4. Accrued Interest

Respondents' strategy of amending loans by course of performance and deferring and accruing unpaid interest might not seem entirely consistent with their treatment of accrued interest on the financial statements. However, contrary to the Division's argument, Respondents' treatment of accrued interest does not demonstrate an "inherent inconsistency" with their strategy of amending loans.

The consolidated balance sheet of each financial statement included under assets an item for "Accrued Interest and Fees Receivable," which is net of an "allowance for uncollectables." *See* Div. Exs. 10, 11, 12. Generally, accrued interest is interest that is earned but not collected at a specific point in time. Tr. 1183-84. Patriarch accrued interest based on the terms of the credit agreements of the underlying loans. Tr. 1183. Respondents' policy was to report on the balance sheet of each Zohar Fund's financial statements the amount of accrued interest that Patriarch reasonably expected to be collected in the next period, based on the amount of interest it agreed

to receive from the Portfolio Companies, taking into account any amendments or restructures. Tr. 1199-1201, 1221-22, 2023-24. The "allowance for uncollectables" was a "haircut" applied to the amount of interest that Patriarch expected to collect, as a general provision for unforeseen collection difficulties. Tr. 1185-87, 1233, 1337-38.

There was a time, before Patriarch's controller Mercado joined Patriarch in 2008, when Patriarch fully expected to collect the amounts of actual interest owed, and as a result, those were reflected on the balance sheet. Tr. 1103, 1203-05. In March 2010, Patriarch modified its methodology as to how it arrived at the accrued interest figure reported on the balance sheet. Tr. 1200. Before Zohar III's March 2010 financials were finalized, Mercado emailed Tilton and said that a 50% reduction would be applied to the unpaid current period interest of certain companies with past-due balances, whereas, in the prior three periods, the total accumulated and unpaid interest for all prior periods was reduced by specific exclusions to arrive at the accrual. Div. Ex. 218 at 1 (of 6 .pdf pages). Attached to the email are a financial statement variance analysis and an interest accrual analysis; the latter shows total accrued interest of $47.2 million and current period unpaid interest of $12.5 million. *Id*. at 2-6; Tr. 1224-25. In response to Mercado's email, Tilton said that she would prefer to discuss in person and: "We need to do this borrower by borrower based on the restructures and amendments that are in process . . . . It is more than a formula." Resp. Ex. 1775. Ultimately though, Tilton had no changes to the interest accrual. Resp. Ex. 1776.

In implementing the modified methodology, Zohar III's March 2010 balance sheet showed "Accrued Interest and Fees Receivable (net of $0.9 million allowance for uncollectables)" of $6,907,911. Div. Ex. 12D at 2; Tr. 1233-35. That is the amount Patriarch agreed to collect from the Portfolio Companies and for which it had a reasonable expectation of collectability. Tr. 1359. Under the prior methodology, the accrual would have shown a $4.1 million increase from the prior period. Div. Ex. 218 at 1; Tr. 1352. As a result of the change, Zohar III's March 2010 balance sheet showed an amount of accrued interest that was relatively consistent with the amounts reported in 2009. Tr. 1354-55; Div. Ex. 218 at 3; *compare* Div. Ex. 12D at 2 *with* Div. Ex. 12 at 47, 57, 67, 77 (of 293 .pdf pages) (March, June, September, and December 2009 balance sheets showing accrued interest of $6.31 million, $6.35 million, $6.57 million, and $6.91 million, respectively).

The goal behind the methodology change was to consistently show the amount that Patriarch expected to collect. Tr. 1355. Mercado testified that the accounting and finance group discussed the methodology change with Tilton: "The objective was not so much to keep things in line, but to be able to reflect what we expected to collect on a consistent basis."[50] Tr. 1201-02. Although the amount of interest that Patriarch expected to collect did not change, there was an "uptick" in the amount of unpaid interest, and more interest payments were being deferred in the post-financial crisis era. Tr. 1201, 1203, 1350-51, 2025. Tilton would defer and accrue interest

[50] Mercado also discussed Zohar III's draft March 2010 financial statements with Berlant, but the evidence does not establish whether or not their discussion addressed the methodology change. Tr. 1236; Resp. Ex. 1776.

for the purpose of keeping Portfolio Companies alive; she did not, however, consider such interest "due and owing." Tr. 2047-49, 2056.

The total accrued interest of $47.2 million was not shown on Zohar III's March 2010 balance sheet because, according to Mercado and Tilton, Patriarch did not want to overestimate or inflate the amount it expected to collect. Tr. 1189-91, 1197, 1359, 2023-24; *compare* Div. Ex. 218 at 5-6 *with* Div. Ex. 12D. The Patriarch team considered the amount of accrued interest that Patriarch expected to collect as "more meaningful" for investors to see on the balance sheet, as opposed to the total accrued interest. Tr. 1187-91, 1207, 1221, 1347-48, 1357. Tilton made the final decision on what to show on the financial statements. Tr. 1207. As Mercado testified, the total accrued interest of $47.2 million could have been ascertained from the trustee's quarterly note valuation report reflecting the cash activity, loan by loan, for principal and interest. Tr. 1340-41, 1348, 1357-60. However, the report does not express total accrued interest in a single-sum figure. Tr. 1355-56; *see* Resp. Ex. 20.070 (Zohar III, March 8, 2010, note valuation report).

Despite Respondents' methodology change in 2010, the policy disclosure in the notes to the financial statements did not change as to interest and fee income; the disclosure stated that such income would be recognized "on an accrual basis with respect to assets for which there exists reasonable certainty that such accrued interest and fee income will be collected in the future," and "doubtful" amounts are recognized when received.[51] Div. Exs. 10, 11, 12 [all at] Note 2(5) – Revenue Recognition, Interest and Fee Income; Tr. 1238-39. The methodology change, however, does not necessarily conflict with the stated policy.

The financial statements could have been presented differently to show the total accrued interest and/or the amount of accrued interest not expected to be collected while still reporting under assets the lower amount of accrued interest that Patriarch expected to collect in a given period; and it would have been easier for investors to ascertain the total accrued interest had it been reported on the balance sheet (with an allowance for the amount of accrued interest that Patriarch did not expect to collect). Tr. 1205-07, 1344-46, 1355-56. Nonetheless, the Division's argument that Respondents' accrued interest methodology was part of an effort to "actively conceal" an increase in missed interest payments is unpersuasive. As discussed elsewhere, the sophisticated, institutional investors that owned the Zohar notes could have reviewed the trustee reports and understood the actual cash activity of the distressed loans. Moreover, uncertainty regarding the collection of accrued interest at a specific point in time does not necessarily mean

[51] In 2015, the following language was added:

> For this reason, the Accrued Interest and Fees Receivable on the Balance Sheet presents accrued interest for which collection at the date of accrual is considered reasonably certain. The Collateral Manager and the Trustee maintain historical data relating to interest accruals, including interest accruals that the Company has considered uncertain.

Div. Ex. 10 at 307 (of 322 .pdf pages) (Zohar I, Feb. 6, 2015, Financial Statement); Div. Ex. 11 at 264 (of 280 .pdf pages) (Zohar II, Jan. 7, 2015, Financial Statement); Div. Ex. 12 at 280 (of 293 .pdf pages) (Zohar III, Mar. 6, 2015, Financial Statement).

that a loan must be deemed impaired under GAAP, and does not necessarily mean that a loan is in default or non-current for purposes of calculating the OC Ratio.

5. Accounting

The Zohar indentures represented that financial statements were to be prepared in accordance with GAAP. Tr. 1119; Div. Exs. 1-3 [all at] Section 7.9(a). Mercado testified that, when Patriarch personnel prepared the financial statements, "We've always relied on Peter Berlant . . . to provide us with some guidance [on GAAP]." Tr. 1280. Berlant did provide advice. Tr. 1292-1309 (*passim*); Div. Ex. 151; Resp. Exs. 61, 64, 107, 1777.

a. Patriarch Prepared Financial Statements

Mercado, now controller, joined Patriarch in October 2008 as assistant controller. Tr. 1102-06, 1278. In those capacities, he prepared the Zohar Funds' quarterly financial statements from workpapers. Tr. 1106-11, 1278-80. Mercado considered that the financial statements complied with GAAP. Tr. 1144, 1356. The workpapers were Excel spreadsheets that had various tabs and had the information necessary to roll up to financial statements. Tr. 1108; *see also* Resp. Exs. 31-33. The workpapers were populated from the following sources: cash sheets that the trustee submitted to Patriarch; a daily extract, which was an Excel spreadsheet showing all the loans outstanding on the trustee's records; information from Patriarch's loan administration group as to all outstanding interest due on the CDO balances; and input from the structured finance group confirming the par value of the outstanding CDO balances. Tr. 1290. Typically there were about ten tabs in each workpaper for every quarter, and each tab had a certain amount of information that ultimately flowed up to the eventual financial statement – balance sheet and income statement – being prepared. Tr. 1110. All the tabs led up to the working trial balance tab which was compared to the general ledger for the various accounts that were on the financial statements. Tr. 1290-91. That flowed into a balance sheet and an income statement, and these were transferred into a Word document that reflected the full financial statements with notes included. Tr. 1291. The Word document and workpapers were then sent to Berlant. Tr. 1291-92. After Berlant's feedback, Tilton signed the officer certificate for the financial statements. Tr. 1107, 1292; Div. Exs. 10-12 (*passim*); Resp. Exs. 28.022 at 1, 29.004 at 1, 30.009 at 1, 30.013 at 1. Each Fund had a payment date (specified in the indenture). Tr. 1121; Div. Exs. 1-3 [all at] Section 1.1. "Payment Date". The cutoff date for the financial statements was eight business days before the payment date; and the financial statements had to be submitted to the trustee three days before the payment date. Tr. 1121; Div. Exs. 1-3 [all at] Section 1.1. "Determination Date", "Due Period"; Section 7.9(a). The financial statements were sent to Berlant within those five days. Tr. 1121.

b. Berlant provided agreed-upon procedures only

As discussed below, Berlant did not provide "audit," "review," or "compilation" services with respect to the Zohar Funds. He provided "agreed-upon procedures" that included looking over and commenting on each Fund's quarterly financial statements. These comments included guidance on GAAP.

Berlant performed "agreed-upon procedures" for Respondents with respect to the Zohar Funds from 2003 to January 2016. Tr. 757-60, 765, 889; Div. Ex. 34.[52] He started performing these services in regard to Tilton's previous investment vehicles, the Ark funds and, starting in 2003, in regard to the Zohar Funds. Tr. 757-59. He did not provide "audit," "review," or "compilation" services for them. Tr. 761-65, 1125. Nor did he draft Zohar financial statements. Tr. 762. He spent an hour or two each quarter reading, footing, and commenting on Zohar financial statements. Tr. 757, 759-62, 775-76, 778-82, 846, 928. Berlant summarized the services that he performed as "reading of the quarterly financial statements, commenting on the clerical accuracies, the ministerial agreed-upon procedures on an annual basis for each [Zohar Fund], and response to the occasional question." Tr. 928. Typically, he had twenty-four to forty-eight hours from the time he received the financial statements to do this and telephone his contact at Patriarch to convey his comments. Tr. 780-82, 932-34, 1121.

The word "review" appears in the hearing testimony and exhibits that are emails among Zohar-related participants;[53] in those instances "review" was used as a colloquial term to mean "look over," not to indicate review services as defined in accounting literature. Mercado, Respondents' controller, confirmed that Berlant did not provide "review" services as defined in accounting literature. Tr. 1124-26. Rather, he was checking that the financial statements were consistent with the workpapers and providing any comments he felt necessary, including, to some degree, guidance concerning GAAP. Tr. 1128-37.

Respondents paid Anchin approximately $17 million over fifteen years. Tr. 1958. More was for tax services than for Berlant's services. Tr. 846, 897, 1959. There is no evidence in the record as to the specific amounts paid for Berlant's services. *See* Tr. 2150.

c. Berlant's Role

Berlant's role is addressed in detail because: (1) part of Respondents' defense to the charge that the financial statements did not comply with GAAP is that they relied on him to

[52] Division Exhibit 34 is an engagement letter dated July 1, 2007, signed by Berlant and Tilton, describing the scope of services to be provided by Anchin. There is no other general engagement letter in the record. *See also* Tr. 770-71. However, there are a number of engagement letters, between Berlant on behalf of Anchin and Tilton on behalf of Zohar, describing specific "agreed-upon procedures" services to be performed in specified periods for Zohar I, II, and III. Resp. Exs. 52.001-.005, .007-.011. The copies of the letters that are in the record all have signature blocks for Berlant and Tilton; some also have their signatures. Div. Ex. 34; Resp. Exs. 52.001-005, .007-011. The earliest date on any of the engagement letters in the record is January 1, 2006. Div. Ex. 34; Resp. Exs. 52.001-005, .007-011. However, all are consistent with Berlant's testimony that he performed such limited agreed-upon procedures for the Zohar Funds from 2003 onward. Tr. 757-62, 769, 928.

[53] *See, e.g.*, Tr. 976-92; Resp. Exs. 34, 1257, 1258, 1753. Berlant himself used "review" in the non-technical sense. *See, e.g.*, Tr. 941; *but see* Tr. 946-47 (Berlant objecting to such use by counsel of "review," saying he "read" materials).

interpret GAAP; and (2) the Division failed to disclose timely Anchin's concurrent engagement by the Commission in a case pending in U.S. District Court, discussed *infra*. Berlant described his role as mostly clerical and ministerial. Tr. 758-62, 778-80. These tasks would take "[a]n hour, maybe two." Tr. 780. Then he would call the person who had sent him the draft – the controller or CFO – and provide his comments; the calls would last fifteen minutes or perhaps longer. Tr. 780-81.

Berlant denied ever discussing loan impairment or the need to reduce – write-down – the carrying value of loan assets under GAAP with anyone at Patriarch or telling anyone at Patriarch that he was evaluating Zohar loan assets for impairment. Tr. 787-95. He also denied discussing fair valuation of the assets with Tilton or anyone at Patriarch or telling her or anyone else at Patriarch that he was evaluating the fair value of the assets. Tr. 796-98. He also denied being asked to opine on compliance with FAS 157. Tr. 798-801. He also denied being asked to opine on language changes that removed reference to GAAP in the financial statements. Tr. 802-27. He conceded that there were isolated requests for advice relating to the interpretation of accounting issues. Tr. 893. He denied ever being asked to consider whether the financial statements complied with GAAP. Tr. 894. Mercado confirmed that Patriarch's expectation was that Berlant was checking accuracy – that what was in the workpapers was reflected in financial statements – and providing any commentary with respect to accounting issues that he felt were relevant to the financial statements. Tr. 1125-26. He also confirmed that, with reference to GAAP, Berlant was to advise whether there was an issue that Patriarch should consider to be included in the financial statements. Tr. 1128-29, 1131-32. Mercado confirmed that Berlant conveyed his comments, usually, in a telephone call and sometimes in an email. Tr. 1136.

Insofar as the foregoing suggests that Berlant's role was limited to clerical and ministerial activities, that is not entirely consistent with other record evidence of his providing accounting guidance. Tr. 1002-1013; Resp. Exs. 60, 60.001, 60.002 (February 16, 2009, email enclosing draft financial statement Notes concerning newly applicable accounting standards that Patriarch included in its financial statements; Berlant claims the draft Notes were Anchin stock language that he provided for Patriarch's determination as to whether to include them); Tr. 1013-15; Resp. Ex. 64 (November 17, 2009, email from Berlant providing language for a Note based on FAS 165 that "I recommend . . . be added to the Zohar report (and all reports that you issue from here on out)"); Tr. 1016-19; Resp. Ex. 1741 (January 23, 2004, email string in which Patriarch poses various accounting questions concerning Zohar workpapers; Berlant proposes to "look at this over the weekend" unless "an answer [is needed] sooner"); Tr. 1019-21; Resp. Ex. 1263 (December 14, 2009, email asking Berlant for "guidance" on an accounting issue presented by the financial statements); Tr. 1022-24; Resp. Ex. 1260 (December 15, 2008, email notifying Berlant of a change in interest accruals in the draft financial statements "in the event you had any questions"); *see also* Tr. 1131-32 (Mercado: Berlant "would make comments whether or not we needed to include something that he felt was GAAP appropriate, such as adjustments to the notes to the financial statements"), 1135-36 (Mercado: Patriarch expected Berlant would advise Patriarch of "any GAAP information that he felt should be included in the footnotes [and] [h]e, in fact, provided . . . guidance on the footnotes").

Berlant conceded that if there were a change in the standards that might have affected the financial statements, he would have advised Patriarch to take a look at it. Tr. 959. When Zohar I

was created, Berlant conceded that he "read sections of" the key transaction documents before they were finalized and "may have had comments on them." Tr. 969. In fact, the evidence shows that he *did* read and comment substantively on them. Tr. 971-74; Resp. Exs. 1196, 1259.

Several emails to which Berlant was a party refer to Berlant's approval of financial statements. Tr. 975-94; Resp. Exs. 1257, 1258, 1753, 1760, 1761. Berlant confirmed that he performed the same work from 2001 onward. Tr. 994-95.

Numerous emails in 2005-2008 from Patriarch employees forwarding Zohar I, II, or III financial statements to Tilton for her approval stated "Peter has reviewed and approved the Zohar Financials" or similar phraseology. Resp. Exs. 40, 41, 1257, 1768. This included an instance where Berlant was temporarily unavailable and it was feared that, as a result, Patriarch would miss a deadline for producing Zohar III's financial statements. Resp. Ex. 1768 at 20-26. *See also* Resp. Ex. 42 (forwarding Zohar I financial statements to Tilton for approval, noting that Berlant "has reviewed and approved the financials with only one question," and stating that the balance in an account had been adjusted in line with Berlant's explanation); Div. Ex. 136 (informed that Berlant "will review Zohar III this afternoon," Tilton replied that she "will just need to review his chnages (sic)").

Berlant testified about his February 16, 2009, email to Chris Denune[54] at Patriarch attaching draft notes concerning Financial Interpretation (FIN) No. 48 (regarding uncertainty in income taxes) and FAS No. 157 (regarding fair value measurements). Tr. 1002-13; Resp. Ex. 60. He testified that he advised Denune to consider including the language in the Zohar financial statements, but that it was up to Denune/Patriarch whether to include the language; he further testified that the FIN 48 language was a generic draft authored by Anchin's quality control or technical department but conceded that he slightly edited the FAS 157 language provided by Anchin's quality control or technical people. Tr. 1002-13. The evidence of record contains additional examples of Berlant's providing, or Patriarch's soliciting from him, advice concerning accounting issues. Tr. 1013-23; Resp. Exs. 64 (regarding FAS 165), 1256 (regarding FAS 150), 1741 at 2 (regarding accrual of a fee), 1263 (regarding accounting treatment of credit and debit entries for a cash account), 1260 (regarding accrual of interest). To the extent that Berlant's testimony could be construed as evidence that he never provided advice to Patriarch, such a construction is not entirely consistent with the other evidence in the record, including the referenced emails. Berlant never advised Respondents that he could not advise them and that they should engage another accounting firm for advice on accounting issues. Tr. 1023-26.

D. Expert Testimony[55]

Michael G. Mayer, CFA, CFE, testified for the Division. Div. Exs. 17, 20. He is a vice president of Charles River Associates, a global consulting firm, and has extensive experience as an expert witness or consultant in securities disputes, including matters involving structured

[54] Denune was Patriarch's controller at the time. Tr. 1105.

[55] To the extent that the expert's evidence does not lead to findings of fact, it will be summarized here and referred to as appropriate in the Conclusions of Law section of this Initial Decision.

products and CDOs. Div. Ex. 17 at 3 & Ex. 1; Tr. 389-90. He was accepted as an expert in the topics on which he opined. Tr. 423-24. He opined that Zohar II and III: (1) failed their monthly OC Ratio Tests starting in July 2009 and June 2009, respectively; and (2) as a result, improperly paid $208 million in Subordinated Collateral Management Fees and preference share distributions to Respondents during the periods in which Zohar II and III failed their OC Ratio Tests – as those monies should have been paid as additional principal to investors under the "priority of payments" or "waterfall" per the Zohar governing documents. Div. Ex. 17 at 3-4, 8-9, 16-19, 62-72; Div. Ex. 20 at 2-4; Tr. 391-94. He further opined that investors could not replicate the OC Ratio Tests solely by using data available in the trustee reports but rather would have to maintain, update, and analyze over a thousand pieces of data each month to replicate the tests. Div. Ex. 17 at 4, 57; Tr. 392.

Ira Wagner testified for the Division. Div. Exs. 16, 19A. He is an independent consultant; has extensive experience in structured finance, including CDOs of all asset classes; and previously served as the head of the CDO group at Bear, Stearns & Co. Tr. 2839-41; Div. Ex. 16 at 7-9 & App. 2. He was accepted as an expert in the structure and operation of CLOs, including categorizations of assets within CLOs and the duties and responsibilities of CLO collateral managers. Tr. 2834, 2837-38, 2850, 2863. In general, Wagner opined that Tilton's approach to categorizing assets of the Zohar Funds was inconsistent with the methodology required by the governing documents of each Fund, and her purported failure to properly categorize assets was adverse to the interests of the Funds and investors – but beneficial to Tilton. Div. Ex. 16 at 2, 4-5. He also opined that investors were harmed by Tilton's approach because payments that should have been paid as principal to Zohar investors when the OC Ratio Tests failed were instead improperly paid to Respondents in Subordinated Collateral Management Fees and equity distributions, investors were denied information they regularly utilize to analyze investment performance, and Respondents breached standards of care and fiduciary duties. Div. Ex. 16 at 5-6, 43-50.

Wagner further opined that – contrary to Tilton's approach – a loan that has not made its current, required interest payment must be categorized as a defaulted asset (i.e., placed in Category 1 for Zohar I and II or categorized as a Default Investment for Zohar III) under the governing documents, and Tilton had no discretion to treat a loan that had not paid its contractual payments as anything other than a defaulted asset. Div. Ex. 16 at 27, 30-34, 36, 38; Div. Ex. 19A at 8. Responding to Tilton's defense theory, Wagner opined that Tilton was not "amending" the loans when accepting less than the contractual amount of interest due. Div. Ex. 19A at 3, 10-34; Tr. 2842-47.

Steven L. Henning, Ph.D., CPA, testified for the Division. Div. Exs. 18, 21. He is a partner at Marks Paneth LLP, a public accounting and business consulting firm, and has an extensive background in accounting and teaching the subject. Div. Ex. 18 at 2-3 & Ex. A; Tr. 1404-06. He was accepted as an expert in the topics on which he opined, namely GAAP and financial reporting. Tr. 1407, 1412-13; Div. Ex. 18 at 4. He opined that the financial statements of the Zohar Funds departed from GAAP and were false and misleading because, contrary to certain representations in the statements, GAAP-compliant impairment and fair-value analyses were not performed by Respondents. Div. Ex. 18 at 2, 4, 13-19, 22-24; Div. Ex. 21 at 2; Tr. 1407-11. He further opined that the fact that the Funds' financial statements and accompanying

certifications eliminated references to GAAP compliance in 2015 was an acknowledgement by Respondents that their prior reporting departed from GAAP. Div. Ex. 18 at 4, 24-26; Div. Ex. 21 at 2; Tr. 1411.

Charles R. Lundelius, Jr., CPA, CFF, testified for Respondents and adopted the report of J. Richard Dietrich, Ph.D., who did not testify at the hearing. Resp. Exs. 22, 27, 27A; Tr. 3145-46, 3164. He is the managing director of the Capital Markets Group at Berkeley Research Group, LLC, and has extensive experience in public and forensic accounting. Resp. Ex. 27A; Tr. 3276-78. He was accepted as an expert in the topics on which he opined, which included responding to certain opinions of Division expert Henning. Tr. 3143-44, 3147. In general, he opined that Henning did not consider certain accounting guidance in reaching his conclusions, and Respondents' policies as to impairment and fair value were consistent with GAAP. Resp. Ex. 27; *see*, *e.g.*, Tr. 3151-52, 3311. He also opined that, contrary to the Division's theory, Respondents' policy as to accrued interest was consistent with GAAP. Tr. 3150, 3162-63.

Mark Froeba testified for Respondents. Resp. Ex. 21. He is an independent consultant in CDOs; he previously worked in private law practice and then at Moody's Derivatives Group, where he focused exclusively on the analysis and ratings of all types of CDOs, including CLOs, and was the legal analyst on the Zohar II and Zohar III deals. Resp. Ex. 21 at 9-12 (of 64 .pdf pages); Tr. 3326-28. He was accepted as an expert on interpreting indentures in general and in interpreting the Zohar indentures in particular, and he responded to related issues raised by Division experts Wagner and Mayer. Tr. 3331-32; Resp. Ex. 21 at 4 (of 64 .pdf pages). He opined that the Zohar indentures categorize loans based upon their current terms, giving effect to all amendments, even those intended to avoid payment default; thus, a loan amended to avoid default is not a defaulted security. Resp. Ex. 21 at 4-8, 20 (of 64 .pdf pages); Tr. 3332-33. He further opined that the Zohar indentures reflect an investment strategy that gives Respondents broad discretion, such as the capacity to negotiate amendments to a loan that avoids a default. Resp. Ex. 21 at 8-9, 37 (of 64 .pdf pages); Tr. 3333-34.

Peter U. Vinella testified for Respondents and adopted certain opinions of Marti P. Murray, who did not testify at the hearing. Resp. Exs. 25, 25A. He is the managing director of PVA Toucan International LLC, a financial consulting firm; has extensive financial-industry experience; and previously served the CEO and president of an entity that provided trustee and collateral administration services. Resp. Ex. 25A; Tr. 3439-40. He was accepted as an expert in the topics on which he opined, which included responding to certain opinions of Division expert Wagner. Tr. 3440-42; Resp. Ex. 25. He opined that the Zohar governing documents gave Patriarch broad authority over the management and disposition of the underlying loans, including, without limitation, the ability to modify loans for any reason at its sole discretion. Resp. Ex. 25; Tr. 3443. He also opined that Patriarch's approach should be evaluated from the perspective of what a manager of a distressed debt turnaround strategy would have reasonably done operating within a CLO that provides the same level of constraints and discretion as the Zohar Funds under the circumstances that Patriarch faced – rather than the benchmark of a typical CLO manager. Resp. Ex. 25; Tr. 3445-46.

John H. Dolan testified for Respondents. Resp. Ex. 23. He is an independent consultant in risk management and other subjects; has extensive prior experience trading in, investing in,

and valuing structured products, including CDOs; and has held executive and senior-level positions at large portfolio managers and investment banks. Resp. Ex. 23 at 3-5, 75-76 (of 99 .pdf pages); Tr. 3463-67. He was accepted as an expert in the topics on which he opined, which included responding to the Division's allegation that Zohar investors were not informed about the decline in value of the Zohar Funds' assets and to certain opinions of Division experts Mayer and Wagner. Tr. 3468; Resp. Ex. 23 at 6 (of 99 .pdf pages). He opined that the OC Ratio is but one of many metrics available to investors to analyze the risks of their Zohar investments and any decline in value; such metrics include publicly available economic indicators and credit ratings, disclosures regarding the underlying debt collateral, and detailed information on individual loans from the trustee reports and accompanying electronic data files. Resp. Ex. 23 at 7-9 (of 99 .pdf pages); *see, e.g.*, Tr. 3469-71. He also opined that some investors developed independent valuation models of the Zohar notes, confirming that ongoing surveillance of the Zohar notes was within the capabilities of investors. Resp. Ex. 23 at 30 (of 99 .pdf pages).

Steven L. Schwarcz testified for Respondents and adopted a specific opinion of Murray. Resp. Exs. 26, 26A; Tr. 3506. He is a law professor at Duke University School of Law, where his teaching and research concentrates in structured finance, securitization, bankruptcies, and workouts; and he previously was a corporate partner at major law firms. Tr. 3505; Resp. Ex. 26A. He was accepted as an expert in the workout of distressed companies and the area of structured finance. Tr. 3507-08. He noted that Murray had opined that the Zohar governing documents provided Patriarch with the ability to modify loans to avert default, and he opined that successful execution of the Zohar Funds' investment strategy in distressed companies required flexibility in managing the investments; for example, he noted that Patriarch might choose to allow a Portfolio Company to delay payment of interest or principal on its debt, enabling the company to use the cash for other purposes that could assist with its successful turnaround. Resp. Ex. 26; Tr. 3509-10.

Robert Glenn Hubbard, Ph.D., testified for Respondents. Resp. Ex. 24. He is a professor at and dean of the Columbia University Graduate School of Business, is an adviser to the president of the Federal Reserve Bank of New York, and has an extensive background in economics and finance, including a term as chairman of the President's Council of Economic Advisers. Tr. 3560-63; Resp. Ex. 24 at 3-4, 31-33 (of 58 .pdf pages). He was accepted as an expert in the topics on which he opined, which included responding to certain opinions of Division experts Wagner and Mayer. Tr. 3564; Resp. Ex. 24 at 4 (of 58 .pdf pages). He rendered four principal opinions: (1) the economic characteristics of the Zohar Funds are not similar to those of typical CLOs, but follow Tilton's distinct business strategy; (2) from an economic perspective, Tilton's approach was consistent with the Funds' disclosed strategy; (3) Mayer's calculations are incomplete and therefore unreliable, as they do not take into account how purported OC Ratio Test failures would change waterfall distributions in subsequent periods or impact subsequent investment decisions, operating decisions, or cash flows; and (4) contrary to Mayer's opinion, adjusted OC Ratios may be approximated with simple calculations based on the Funds' quarterly note valuation reports. Tr. 3564-65; Resp. Ex. 24 at 4-6, 14, 17, 19, 25 (of 58 .pdf pages).

III. THE DIVISION'S DISCLOSURE OBLIGATIONS AND ALLEGED MISCONDUCT

Respondents allege that the undersigned has interpreted in overly narrow terms the Division's obligation to turn over exculpatory and impeachment materials as required by the *Brady* doctrine, the Jencks Act, and 17 C.F.R. §§ 201.230, .231. Resp. Concl. at 26-27; Resp. Br. at 47, 109-10. Respondents also contend that the Division engaged in misconduct that warrants dismissal of this proceeding. Resp. Concl. at 22-24; Resp. Br. at 110-12.

A. Rule 230/Brady

Pursuant to 17 C.F.R. § 201.230 (Rule 230), the Division "shall make available for inspection and copying by any party documents obtained by the Division prior to the institution of proceedings, in connection with the investigation leading to the Division's recommendation to institute proceedings." Rule 230(b) describes documents that may be withheld and provides: "Nothing in this paragraph (b) authorizes the Division of Enforcement in connection with an enforcement or disciplinary proceeding to withhold, contrary to the doctrine of *Brady v. Maryland*, 373 U.S. 83, 87 (1963), documents that contain material exculpatory evidence." Rule 230(b)(2).[56] Neither the Commission nor the courts have interpreted *Brady* expansively. *See, e.g.*, *Weatherford*, 429 U.S. at 559; *Pennsylvania v. Ritchie*, 480 U.S. 39, 59 (1987); *Orlando Joseph Jett*, Admin. Proc. Rulings Release No. 514, 1996 SEC LEXIS 1683 (June 17, 1996). Insofar as Respondents seek to reargue their *Brady* motions, they are again denied. *See, e.g.*, *Lynn Tilton*, Admin. Proc. Rulings Release No. 4162, 2016 SEC LEXIS 3487 (A.L.J. Sept. 16, 2016); Oct. 19, 2016, Prehr'g Tr. 32-33; Tr. 447, 455, 1366-70, 1467-68, 1481-82, 1990, 1992.

Two of Respondents' *Brady* claims warrant further discussion. First, Respondents argue that the Division improperly withheld information relating to the pre-OIP roles of its three experts. Resp. Br. at 111; Resp. Concl. at 23. On cross-examination, the experts testified that they were retained by the Division before the institution of this proceeding; one expert, Michael G. Mayer, CFA, testified that he had assisted the Division in developing its theory; another expert, Ira Wagner, testified that he had provided his views to the Division about certain evidence. Tr. 438-40, 1393-98, 2822-26. Respondents cite *Schledwitz v. United States*, 169 F.3d 1003, 1015 (6th Cir. 1999), in which the court held that "if a witness has been extensively involved in a criminal investigation against a defendant, and is presented at trial as a neutral, detached expert against that defendant, then the witness's previous involvement qualifies as 'bias,' and the defendant is entitled to expose such bias." Unlike *Schledwitz*, however, the Division's experts did not take part in the formal investigation of gathering evidence or conducting interviews. *See id.* at 1014 (government expert "had been actively and intimately involved in the investigation against" the defendant, "was present during the FBI's interview with" one witness, and "himself conducted the interviews with" two other witnesses). Rather, they evaluated the evidence and the Division's potential theories. Also unlike *Schledwitz*, this is

[56] Under the Commission's 2016 amendments to its rules of practice, this disclosure requirement is now codified under Rule 230(b)(3). *See* Amendments to the Commission's Rules of Practice, Exchange Act Release No. 78319, 81 Fed. Reg. 50,212, 50,235 (July 29, 2016) (codified at 17 C.F.R. § 201.230).

not the case where a jury could be easily misled. The undersigned has taken into consideration the experts' potential biases, including the fact that they were paid. Tr. 460, 464-65.

Second, Respondents argue that the Division improperly failed to disclose prior to Berlant's testimony its concurrent engagement with Anchin in another matter. Resp. Br. at 111; Resp. Concl. at 23. Berlant testified as a witness in the Division's case on October 26 and 27, 2016. Tr. 753-1097. On October 30, 2016, Division counsel advised Respondents' counsel that they had previously engaged the Anchin firm in a matter pending in the U.S. District Court for the District of Connecticut and paid $366,000 for forensic accounting services performed by individuals other than Berlant.[57] Tr. 1444-91; Division's Oct. 30, 2016, Letter to the undersigned and Respondents' counsel (Oct. 30 letter). The Division also represented that: Berlant had performed no work related to that Connecticut matter and would not receive direct compensation for his firm's work on that matter; Anchin expected less than $100,000 in profits from the engagement; and, as an Anchin partner, Berlant might indirectly receive a portion of that sum derived from the Connecticut matter.[58] Oct. 30 letter. In response, Respondents' counsel stated that it had independently identified the Connecticut matter in question (the name and case number were not disclosed by the Division) and discovered that two of the Division attorneys in the present matter were representing the Commission in the Connecticut matter. Respondents' Oct. 31, 2016, Letter to the undersigned. Respondents' counsel also discovered that – in an October 4, 2016, witness disclosure – the two Division attorneys had disclosed to the defendant in the Connecticut matter that certain individuals from Anchin may be used to support the Commission's claims. *Id*. at 4 & Ex. A.

Respondents urged the undersigned to dismiss the proceeding based on prosecutorial misconduct or, at least, to strike Berlant's testimony. Tr. 1443-67. The undersigned denied the request.[59] Tr. 1467-68, 1481. However, the undersigned issued a subpoena *duces tecum*, as requested by Respondents, directed to Anchin concerning its involvement since 2006 with the Division, including, but not limited to the Connecticut matter; on November 9, 2016, Respondents reported that they had received a document response from Anchin that they believed could have been used for cross-examination of Berlant, but that they had decided not to recall him only for that purpose. Tr. 1482-86, 3625. In light of the foregoing, even though the Division made a belated disclosure, no prejudice has been shown, and no further remedial action is warranted.

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[57] Official notice pursuant to 17 C.F.R. § 201.323 is taken of the fact that two of the attorneys who represent the Division in this proceeding are among the attorneys who represent the Commission in *SEC v. Ahmed*, No. 3:15-cv-675 (D. Conn.) (pending).

[58] Division counsel apologized at the hearing for the belated disclosure. Tr. 1456-59.

[59] The denial was one of the forty-one Key Erroneous Rulings on Respondents' motions that Respondents incorporated by reference and reiterated in their post-hearing briefing. *See* Resp. Br. at 46, 110 & App. B at 3-4.

B. Rule 231/Jencks

Pursuant to 17 C.F.R. § 201.231(a), a respondent may move that the Division "produce for inspection and copying any statement of any person called or to be called as a witness by [the Division] that pertains, or is expected to pertain, to his or her direct testimony and that would be required to be produced pursuant to the Jencks Act, 18 U.S.C. 3500." The term "statement" is defined under the Jencks Act as:

> (1) a written statement made by said witness and signed or otherwise adopted or approved by him;
>
> (2) a stenographic, mechanical, electrical, or other recording, or a transcription thereof, which is a substantially verbatim recital of an oral statement made by said witness and recorded contemporaneously with the making of such oral statement; or
>
> (3) a statement, however taken or recorded, or a transcription thereof, if any, made by said witness to a grand jury.

18 U.S.C. § 3500(e). Only those statements which can properly be called the witness's own words are required to be produced. *Palermo v. United States*, 360 U.S. 343, 352-53 (1959); *see also United States v. Sasso*, 59 F.3d 341, 351 (2d Cir. 1995) ("The statute does not . . . require the government to divulge even verbatim statements by the witness if the writer 'merely select[ed] portions, albeit accurately, from a lengthy oral recital.'" (quoting *Palermo*, 360 U.S. at 352) (alteration in original)).

Respondents maintain that the Division has improperly withheld "interview notes from its interviews with witnesses reflecting those witnesses' statements and bearing on their likely direct testimony." Resp. Concl. at 24; *see* Resp. Br. at 111. Essentially, Respondents seek to reargue their Jencks motions, which are again denied. *See, e.g.*, *Lynn Tilton*, Admin. Proc. Rulings Release No. 4137, 2016 SEC LEXIS 3366 (A.L.J. Sept. 8, 2016); Oct. 19, 2016, Prehr'g Tr. at 32-33; Tr. 300-01, 534, 901-06. Respondents' attempted analogy to *Goldberg v. United States*, 425 U.S. 94 (1976), is misplaced. Unlike *Goldberg*, none of the witnesses suggested that they had "adopted or approved" anything written in interview notes. Mere speculation that the Division's interview notes might contain Jencks material does not suffice to require the Division to produce the notes or to submit them for *in camera* review. Respondents have not shown that their requests are anything other than a fishing expedition, which the Commission and the courts frown upon. *See, e.g.*, *United States v. Delgado*, 56 F.3d 1357, 1364 (11th Cir. 1995); *United States v. Boyd*, 53 F.3d 631, 634-35 (4th Cir. 1995); *United States v. Nickell*, 552 F.2d 684, 689-90 (6th Cir. 1977); *United States v. Graves*, 428 F.2d 196, 199 (5th Cir. 1970); *Orlando Joseph Jett*, 1996 SEC LEXIS 1683, at *1-2 (frowning on "fishing expeditions" in the context of *Brady* material).

Respondents also maintain that the Division improperly conducted interviews with certain witnesses off-the-record and has been "unwilling[] to create and provide [an] investigative record" of those interviews. Resp. Br. at 111. But the Division does not have a

general duty to create potential Jencks material by recording witness interviews or taking notes during such interviews. *See United States v. Houlihan*, 92 F.3d 1271, 1288-89 (1st Cir. 1996) (collecting case law).

C. Anchin Emails

Respondents aver that the Division failed to disclose Anchin emails it had received as a result of an investigative subpoena. Respondents' counsel represents that the Division produced only two Anchin emails to Respondents, whereas the Division subpoena sought seven years of Zohar-related emails and Berlant testified that "likely, yes" he had provided more than just two emails. Resp. Br. at 111. Even accepting that representation as true, there has been no showing that any purported failure by the Division was not harmless error. *See* 17 C.F.R. § 201.230(h); *James. S. Tagliaferri*, Securities Act Release No. 10308, 2017 SEC LEXIS 481, at *38 (Feb. 15, 2017). At the hearing, Respondents offered into evidence numerous exhibits reflecting Berlant's emails sent or related to Respondents. Resp. Exs. 60, 1191, 1194, 1195, 1196, 1247, 1271, 1776, 1777.

D. Alleged Collusion with MBIA

Throughout this proceeding, Respondents have claimed that the Division improperly colluded with MBIA by providing MBIA confidential information produced by Respondents to the Division during the investigation and allowing MBIA to use such information in civil proceedings against Tilton. *See, e.g.*, Resp. Br. at 29-30, 111. It appears that the Division agreed to share certain documents with MBIA in December 2013, Resp. Ex. 515, but the exact nature of those documents is unclear. Even if the Division's information sharing breached "'legal or ethical rules governing [Commission] investigations' [it is] 'not, without more, a defense to the SEC's suit.'" *Kevin Hall, CPA*, Exchange Act Release No. 61662, 2009 SEC LEXIS 4165, at *86 n.115 (Dec. 14, 2009) (quoting *Buntrock v. SEC*, 347 F.3d 995, 998 (7th Cir. 2003)) (first alteration in original); *see also Mabry v. Johnson*, 467 U.S. 504, 511 (1984) ("The Due Process Clause is not a code of ethics for prosecutors.").

IV. CONCLUSIONS OF LAW

The OIP charges that Respondents willfully violated Advisers Act Sections 206(1), 206(2), and 206(4) and Rule 206(4)-8 thereunder, or, alternatively, that Patriarch Partners, LLC, willfully aided and abetted and caused violations of those provisions by the other Respondents. The OIP charges that these violations were committed in that: (1) Tilton improperly categorized and overvalued loans, such that Zohar II and III never failed their OC Ratio Tests, enabling Respondents to collect Subordinated Collateral Management Fees and other payments; and that these alleged departures from the provisions of the indentures were not disclosed to investors;[60]

[60] The OIP also charged that Respondents failed to disclose their conflict of interest. To the extent that this is not covered in item (1), as found above, the deal documents disclosed an inherent conflict of interest in that Respondents valued the Funds' assets, categorized the loans, could amend the terms of the loans, and were to receive fees dependent on their own valuation of the assets.

and (2) the Funds' financial statements were false and misleading and did not comply with GAAP, in respect to impairment and fair valuing of assets.

As discussed below, it is concluded that the violations are unproven.

A. Antifraud Provisions

Advisers Act Sections 206(1), 206(2), and 206(4) make it unlawful for any investment adviser, by jurisdictional means, respectively:

> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client; . . . or
> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative [as defined by Commission rule].

Rule 206(4)-8 applies specifically to "any investment adviser to a pooled investment vehicle":

> It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of [Advisers Act Section 206(4)] for any investment adviser to a pooled investment vehicle to:
> (1) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or
> (2) Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

1. Materiality

The standard of materiality is whether or not a reasonable investor or prospective investor would have considered the information important in making an investment decision. *See Basic Inc. v. Levinson*, 485 U.S. 224, 231-32, 240 (1988); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). "[T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Basic Inc.*, 485 U.S. at 231-32 (quoting *TSC Indus., Inc.*, 426 U.S. at 449); *accord Matrixx Initiatives., Inc. v. Siracusano*, 563 U.S. 27, 38 (2011); *SEC v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992).

Investor sophistication may influence whether an allegedly misleading or omitted fact would have assumed actual significance in the deliberations of the reasonable investor. *See McGonigle v. Combs*, 968 F.2d 810, 817 (9th Cir. 1992). Moreover, investor sophistication is a relevant consideration in assessing the adequacy of a defendant's disclosure. *United States v. Litvak*, 808 F.3d 160, 185 (2d Cir. 2015).

2. Scienter

Scienter is required to establish violations of Advisers Act Section 206(1). *Aaron v. SEC*, 446 U.S. 680, 695-97 (1980); *SEC v. Steadman*, 967 F.2d at 641 & n.3. It is "a mental state embracing intent to deceive, manipulate, or defraud." *Aaron*, 446 U.S. at 686 n.5; *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976); *SEC v. Steadman*, 967 F.2d at 641. Recklessness can satisfy the scienter requirement. *See SEC v. Steadman*, 967 F.2d at 641-42; *David Disner*, Exchange Act Release No. 38234, 1997 SEC LEXIS 258, at *15 & n.20 (Feb. 4, 1997). Reckless conduct is "conduct which is 'highly unreasonable' and which represents 'an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978) (quoting *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977)).

Scienter is not required to establish a violation of Advisers Act Section 206(2) or 206(4) and Rule 206(4)-8 thereunder; a showing of negligence is adequate. *See SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963); *SEC v. Steadman*, 967 F.2d at 643 & n.5; *Steadman v. SEC*, 603 F.2d 1126, 1132-34 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981). Negligence is the failure to exercise reasonable care. *IFG Network Secs., Inc.*, Exchange Act Release No. 54127, 2006 SEC LEXIS 1600, at *37 (July 11, 2006).

The Patriarch entities are responsible for the actions of their responsible principal, Tilton. *See C.E. Carlson, Inc. v. SEC*, 859 F.2d 1429, 1435 (10th Cir. 1988) (citing *A.J. White & Co. v. SEC*, 556 F.2d 619, 624 (1st Cir. 1977)). A company's scienter is imputed from that of the individuals controlling it. *See SEC v. Blinder, Robinson & Co.*, 542 F. Supp. 468, 476 n.3 (D. Colo. 1982) (citing *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1096-97 nn. 16-18 (2d Cir. 1972)), *aff'd*, No. 82-1954, 1983 WL 20181 (10th Cir. Sept. 19, 1983).

3. Willfulness

Respondents are charged with *willful* primary or secondary violations of Advisers Act Sections 206(1), 206(2), and 206(4) and Rule 206(4)-8. A finding of willfulness does not require an intent to violate the law, but merely an intent to do the act which constitutes a violation. *See Steadman v. SEC*, 603 F.2d at 1135; *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965).

4. Fiduciary Standard

Patriarch Partners VIII, XIV, and XV were registered investment advisers during part of the time at issue. As owners of, and the parties who controlled, those entities, Tilton and Patriarch Partners, LLC, were associated persons of an investment adviser. *See* Advisers Act Sections 202(a)(17), 203(f). All Respondents were also investment advisers within the meaning of Advisers Act Section 202(11) in that they "for compensation, engage[d] in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities." Investment advisers and their associated persons are fiduciaries. *Fundamental Portfolio Advisors, Inc.*, Advisers Act Release No. 2146, 2003 SEC LEXIS 1654, at *54 (July 15, 2003), *pet. denied sub nom. Brofman v. SEC*, 167 F. App'x 836

(2d Cir. 2006); *see Capital Gains Research Bureau*, 375 U.S. at 191-92, 194, 201; *see also Transamerica Mortg. Advisors, Inc. v. Lewis*, 444 U.S. 11, 17 (1979). An investment adviser owes a duty to act "in a manner consistent with the best interest of [her] client and . . . not subrogate client interests to [her] own." *James C. Dawson*, Advisers Act Release No. 3057, 2010 SEC LEXIS 2561, at *8 (July 23, 2010).

The Zohar Funds (not the noteholders) were Respondents' clients within the meaning of Advisers Act Sections 206(1) and 206(2), and, thus, Respondents' fiduciary duty was owed to the Funds. *Goldstein v. SEC*, 451 F.3d 873, 881-82 (D.C. Cir. 2006). Advisers Act Section 206(4) prohibits fraud by an investment adviser without reference to "any client or prospective client," and Rule 206(4)-8(a) thereunder specifically prohibits fraud by an investment adviser to a pooled investment vehicle as to "any investor or prospective investor." *See id.* at 881 n.6. The Funds were pooled investment vehicles. *See* Rule 206(4)-8(b).

5. Primary Liability

An associated person may be charged as a primary violator where the investment adviser is an alter ego of the associated person. *John J. Kenny*, Securities Act Release No. 8234, 2003 SEC LEXIS 1170, at *63 n.54 (May 14, 2003), *pet. denied*, 87 F. App'x 608 (8th Cir. 2004). Accordingly, since, as found above, Tilton was the decision-maker in the events at issue as well as the direct or indirect owner of the other Respondents, including Patriarch Partners, LLC, it is unnecessary to address its secondary liability for any violations.

6. Reliance on Accountants

Respondents raise an affirmative defense of reliance on accountants. Resp. Br. at 95-104. To the extent that Respondents argue that the involvement of Berlant or Mercado and other Patriarch accountants in the preparation of the financial statements is a defense, it fails. In considering whether to credit a claim of reliance on advice of counsel or other professional, the Commission considers four elements: "that the person made complete disclosure to counsel, sought advice on the legality of the intended conduct, received advice that the intended conduct was legal, and relied in good faith on counsel's advice." *Howard Brett Berger*, Exchange Act Release No. 58950, 2008 SEC LEXIS 3141, at *38 (Nov. 14, 2008), *pet. denied*, 347 F. App'x 692 (2d Cir. 2009); *see also SEC. v. Caserta*, 75 F. Supp. 2d 79, 94-95 (E.D.N.Y. 1999) (articulating similar standard for reliance on accountants defense). The professional must also be independent. *C.E. Carlson, Inc.*, 859 F.2d at 1436; *Arthur Lipper Corp.*, 547 F.2d 171, 181-82 (2d Cir. 1976). There is no evidence in the record that Berlant was asked by anyone associated with Respondents whether Tilton's impairment procedures or fair value procedures complied with GAAP. Rather, the record shows that he responded to specific accounting questions on various topics and looked over the draft financial statements, raising questions that occurred to him related to GAAP compliance as well as checking administrative errors.

Likewise, Mercado denied involvement in Respondents' impairment and fair value policies. There is no evidence in the record that shows that Mercado was asked to opine on these questions; rather, he followed Respondents' historic accounting practices, learned from other

employees, and was not involved in impairing or fair valuing loans. In addition, as a Patriarch employee, he is not independent of Respondents.

Although any reliance on the advice of accountants defense fails, the fact that Tilton employed accountants and engaged an outside accountant is relevant to Respondents' degree of culpability for any violations. Berlant was given the opportunity – albeit within a short time period of about two days – to raise questions about the Funds' financial statements. There is no indication in the record that Respondents affirmatively rejected any particular advice from Berlant (or from Mercado) concerning the compliance of any course of action with GAAP.

B. Alleged Violations

In applying the law to the facts of the instant case, it must be emphasized that the trustee reports and financial statements were not publicly available, unlike financial statements of a public issuer in the issuer's periodic reports published on the Commission's website. Rather, pursuant to the Funds' indentures, they were made available to the noteholders, the trustee, and a limited group of entities. The investors and potential investors in the Funds were Qualified Institutional Buyers and Qualified Purchasers, such as Barclays, SEI Investments, Värde Partners, and MBIA; not, in the words of Commission Chairman Jay Clayton, "Mr. and Ms. 401(k)."[61] While there may have been an information asymmetry between Tilton and the noteholders, there was not a power asymmetry.[62] While Respondents did not maximize the ease of finding it, they also did not conceal – omit to state – material information such as the amount of interest actually being paid and the interest rate and principal on the Portfolio Companies' loans. This material information underlies the alleged miscategorization of loans and consequent OC Ratio Test in the trustee reports and is related to the alleged improper valuation of assets in the financial statements.

1. Categorization of Assets and OC Ratio Test

The Division argues that Tilton improperly categorized the Funds' loan assets in the strongest category when many, if not most, of the loans should have been Category 1 (Zohar I and II) or Defaulted Investments (Zohar III), and that, as a result of the improper categorization, Zohar II and III never failed their OC Ratio Tests, enabling Respondents to collect Subordinated Collateral Management Fees and other payments; and that these alleged departures from the provisions of the indentures were material and not disclosed to investors. The Division does not allege that Zohar I ever "failed the OC Ratio test even if the collateral had been categorized correctly." Div. Br. at 20 n.10. It does argue that Respondents' categorization of the assets misled investors about their performance. However, it is concluded that Respondents' approach

[61] *See* Commission Chairman Jay Clayton, Remarks at the Economic Club of New York (July 12, 2017).

[62] Zohar I was a club deal; the original noteholders actually participated in negotiating the deal documents.

was disclosed in the trustee reports, which disclosed adequate information to determine that Category 4/Collateral Investment included loans that did not make full stated interest payments.

There is no dispute that many borrowers paid less interest than the original coupon rate on their loans. Tilton presented evidence that she amended loan agreements, as permitted by the indentures, by "course of performance" to allow interest payments to be deferred and accrued or otherwise to change the terms – interest rates and maturities – of loans.[63] There is no affirmative evidence that she did not amend the loan agreements. In light of the Division's burden of proof and the undisputed fact that she did accept the lesser payments or nonpayments on loans, it must be concluded that she did "amend" the loan agreements. Section 7.7(a) of the indentures effectively gave Respondents wide discretion to amend the terms of the underlying instruments. Further, as found above, the evidence does not establish the specific facts that would constitute a borrower's "default." However, assuming *arguendo* that asset categorizations and consequent OC Ratio computations were not in accord with the provisions of the indentures, this disparity was disclosed to the investors.

The investors knew that the Funds' business model was to lend to a number of distressed companies with the idea that, while some would succeed, enabling the Funds' investors to be paid, others would fail. Thus, it would be unreasonable to expect that all the borrowers would make 100% of their interest payments. Indeed, an assumption that borrowers' not making 100% of their interest payments would trigger a Fund's Event of Default – due to a failed OC Ratio Test – could result in returning the investors' funds to them soon after they invested, thus defeating the purpose of investing. The trustee reports disclosed that the interest payments received from the Portfolio Companies were far below the amounts due based on the loans' stated interest rates, yet almost no loans were Category 1 or Defaulted Investments. Noting that investors had to glean these facts from different pages of the trustee reports, the Division points to *ZPR Investment Management, Inc.*, Advisers Act Release No. 4417, 2016 SEC LEXIS 2074 (June 9, 2016),[64] in which an investment adviser distributed to the public advertisements and promotional materials containing misrepresentations concerning the adviser's past performance, and *SEC v. Nutmeg Group, LLC*, 162 F. Supp. 3d 754 (N.D. Ill. 2016), *recon. denied*, 2016 U.S. Dist. LEXIS 68176 (N.D. Ill. May 24, 2016),[65] in which an investment adviser inappropriately commingled retail investors' funds and reported this in a misleading way on account statements. These cases are inapplicable to the instant case, in which there was no affirmative misrepresentation of the interest payments collected and in which the investors – large financial institutions – could ascertain the difference between the total interest payable based on the

[63] Under New York law, "any written agreement, even one which provides that it cannot be modified except by a writing signed by the parties, can be effectively modified by a course of actual performance." *Gaia House Mezz LLC v. State St. Bank & Tr. Co.*, 720 F.3d 84, 90-91 (2d Cir. 2013) (quoting *Harold J. Rosen Tr. v. Rosen*, 386 N.Y.S.2d 491, 499 (N.Y. App. Div. 1976), *aff'd*, 371 N.E.2d 828 (N.Y. 1977)).

[64] *Pet. granted in part on other grounds and denied in part*, 861 F.3d 1239 (11th Cir. 2017).

[65] A two-week jury trial in this long-running case is currently set for January 16, 2018. Order, *SEC v. Nutmeg Grp., LLC*, No. 09-cv-1775 (N.D. Ill. May 15, 2017), ECF No. 883.

interest rates of the loans and the total actually collected by comparing information disclosed in the same document.[66] Not only were these large financial institutions able to obtain the information from the trustee reports, it would have been unreasonable for them to expect all of the companies to pay all of their interest according to the interest rates on their loans, given the business model of loaning to distressed companies.

The Subordinated Collateral Management Fee payments to Respondents resulting from the Funds' passing the OC Ratio Test are disclosed in the Zohar II and III trustee reports, and the Division does not allege that Zohar I ever failed the OC Ratio Test.[67] Whether or not Tilton "amended" the loan agreements, the amount of interest actually collected is disclosed in the trustee reports. The total mix of information available to the investors was such that there was no omission to state a material fact or misrepresentation of a material fact.

2. Financial Statements

As found above, each Fund's indenture required it to provide quarterly financial statements prepared in accordance with GAAP to its trustee and noteholders. GAAP "are the conventions, rules, and procedures that define accepted accounting practices." *United States v. Arthur Young & Co.*, 465 U.S. 805, 811 n.7 (1984). GAAP include a hierarchy of statements published by the Financial Accounting Standards Board (FASB) and other sources.[68] *Wendy McNeeley, CPA*, Exchange Act Release No. 68431, 2012 SEC LEXIS 3880, at *49 n.42 (Dec. 13, 2012). FASB's Accounting Standards Codification (ASC) has been considered the authoritative source of GAAP for nongovernmental entities since 2009. *Id.*; ASC 105-10-05-1. "[F]ar from being a canonical set of rules," however, GAAP "tolerate a range of 'reasonable' treatments, leaving the choice among alternatives to management." *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 544 (1979).

a. Impairment

As a general concept, FASB's guidance provides:

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[66] Division expert witness Mayer opined that such research and calculation would be burdensome. However, the burden must be viewed in light of the noteholders' resources.

[67] The Senior Collateral Management Fees are disclosed in Zohar I's trustee reports and can be compared with the total Collateral Management Fees disclosed in the financial statements; the Subordinated Collateral Management Fee, paid only if the Fund passes the OC Ratio Test, is the difference between the two.

[68] The American Institute of Certified Public Accountants (AICPA), a private professional association, designated FASB as the body primarily responsible for setting accounting standards. The Commission treats FASB's standards as authoritative. *See Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 160 n.4 (2d Cir. 2000); Statement of Policy on the Establishment and Improvement of Accounting Principles and Standards, Accounting Series Release No. 150, 1973 SEC LEXIS 2259 (Dec. 20, 1973).

> It is usually difficult, even with hindsight, to identify any single event that made a particular loan uncollectible. However, the concept in GAAP is that impairment of receivables shall be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and conditions existing at the date of the financial statements.

ASC 310-10-35-4(a). FASB's "guidance does not specify how a creditor should identify loans that are to be evaluated for collectability," but rather states that "[a] creditor shall apply its normal loan review procedures in making that judgment" and lists "[s]ources of information useful in identifying loans for evaluation." ASC 310-10-35-14.

An entity shall disclose, as of the date of each statement of financial position presented, its recorded investment in impaired loans. ASC 310-10-50-15(a)(3). "A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due [of both principal and interest payments] according to the contractual terms of the loan agreement." ASC 310-10-35-16. Probable means "[t]he future event or events are likely to occur." ASC 310-10-35-18. It "does not mean virtually certain." ASC 310-10-35-19.

FASB's guidance "does not specify how a creditor should determine that it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan." ASC 310-10-35-17. Instead,

> [a] creditor shall apply its normal loan review procedures in making that judgment. An insignificant delay or insignificant shortfall in amount of payments does not require application of this guidance. A loan is not impaired during a period of delay in payment if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate for the period of delay.

ASC 310-10-35-17.

ASC 310-10-35-16 references subtopic 310-40 for specific application of its guidance to loans restructured in a troubled debt restructuring. Generally, "[a] restructuring of a debt constitutes a troubled debt restructuring if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider." ASC 310-40-20. "A loan restructured in a troubled debt restructuring is an impaired loan."[69] ASC 310-40-35-10. "For a loan that has been restructured in a troubled debt

[69] "Usually, a loan whose terms are modified in a troubled debt restructuring already will be identified as impaired. However, if the creditor has written down a loan and the measure of the restructured loan is equal to or greater than the recorded investment, no impairment would be recognized . . . ." ASC 310-40-50-4. In this circumstance, "[t]he creditor is required to disclose the amount of the write-down and the recorded investment in the year of the write-down but is not required to disclose the recorded investment in that loan in later years if . . . two criteria . . . are met": (1) "[t]he restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of the restructuring for a new loan with

restructuring, the contractual terms of the loan agreement [for purposes of ASC 310-10-35-16] refers to the contractual terms specified by the original loan agreement, not the contractual terms specified by the restructuring agreement." ASC 310-40-35-8. However, a debt restructuring is not a troubled debt restructuring if "[t]he fair value of cash, other assets, or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor's recorded investment in the receivable." ASC 310-40-15-12(a).

Patriarch employed its normal loan review procedures – credit officers monitored the borrowers on a daily basis and reported to Tilton, who used the information in her impairment analysis. According to ASC 310-40, some of the amended loans were loans restructured in a troubled debt restructuring – Tilton "for economic or legal reasons related to the debtor's financial difficulties grant[ed] a concession to the debtor that [she] would not otherwise consider" – and impaired with reference to the "contractual terms [of] the original loan agreement." ASC 310-40-20, -35-10, -35-8. The impairment loss of Zohar restructured loans appeared on the "Gain or (Loss) on Settlement of Collateral Debt Obligations" (for Zohar I and II) or "Gain or (Loss) on Settlement of Collateral Investments" (for Zohar III) line in the income statements and was reflected in the asset value on the balance sheet. Tilton's "event-driven" impairment process was an attempt to introduce a degree of objectivity into impairment.

Loans were typically held at cost and not impaired unless there was a triggering event, such as a restructuring, because Respondents continued to support the future recovery of the underlying Portfolio Companies. That Tilton's support for the Portfolio Companies played an important, if not decisive, role in their future recovery was not a hidden fact. Given the distressed nature of the loans and unique context of Tilton's business model, determining probability of loss might not have been practical without reference to events from which losses could be conclusively determined. An alternative process to recognizing impairment losses may have involved amorphous tests – or impairing many loans simply due to the nonpayment of full interest, which would have been nonsensical in this context. The notion that impairment losses should have been recognized in a manner inconsistent with Tilton's business model is unproven.

b. Fair Value

"A reporting entity shall disclose . . . [,] [e]ither in the body of the financial statements or in the accompanying notes, the fair value of financial instruments for which it is practicable to estimate that value."[70] ASC 825-10-50-10(a). Fair value is "[t]he price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants

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comparable risk"; and (2) "[t]he loan is not impaired based on the terms specified by the restructuring agreement." ASC 310-40-50-2, -4.

[70] A reporting entity is "[a]n entity or group whose financial statements are being referred to." FASB, Master Glossary. "[P]racticable means that an estimate of fair value can be made without incurring excessive costs. It is a dynamic concept: what is practicable for one entity might not be for another; what is not practicable in one year might be in another." ASC 825-10-50-17.

at the measurement date."[71] ASC 825-10-20. An orderly transaction is "[a] transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale)." FASB, Master Glossary; FAS 157-8.

FASB's standard FAS 157 prioritizes the inputs used to measure fair value into three Levels: (1) Level 1 – observable, quoted prices for identical assets or liabilities in active markets; (2) Level 2 – quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; and inputs other than quoted prices such as interest rates and yield curves; (3) Level 3 – unobservable inputs for the asset or liability based on the best information available.

As illiquid debt of distressed companies, the loans were inherently Level 3 assets. As found above, the notes to the financial statements disclosed that the fair value estimates were subjective and that "fair values are based on estimates using present value of anticipated future collections or other valuation techniques . . . [that] involve uncertainties and are significantly affected by the assumptions used and judgments made regarding risk characteristics of various financial instruments, discount rates, estimates of future cash flows, future expected loss experience and other factors." Tilton's testimony that such estimates fell below the carrying value of the loans was not disproved. The financial statements disclosed the subjective and uncertain nature of the fair valuation techniques, and in light of the Division's burden of proof, it is concluded that violation of GAAP is unproven with reference to fair value.

c. Noncompliance with GAAP is Insufficient to Prove Fraud

Even if the financial statements did not comply with GAAP, "a violation of GAAP provisions . . . without corresponding fraudulent intent [is] not sufficient to state a securities fraud claim." *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 270 (2d Cir. 1996); *accord Stevelman v. Alias Research, Inc.*, 174 F.3d 79, 84-85 (2d Cir. 1999). In the instant case, evidence of scienter or reckless conduct is lacking, and, accordingly, it is concluded that, even if their treatment of impairment or fair value on the financial statements did not comply with GAAP, Respondents did not violate Advisers Act Section 206(1). Further, assuming that their treatment of impairment or fair value on the financial statements did not comply with GAAP, this did not alter the total mix of information available to Zohar investors in light of the more comprehensive information in the trustee reports, so that the misrepresentation or omission was not material and

[71] Before 2007, FASB's guidance stated: "Quoted market prices, if available, are the best evidence of the fair value of financial instruments. If quoted market prices are not available, management's best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques." Statement of Financial Accounting Standards No. (FAS) 107 ¶ 11 (FASB 1991). FAS 157 deleted this guidance, effective November 15, 2007. *See* FAS 157-1, -4, -68 (FASB 2006). Under FAS 157, "a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability." FAS 157-3.

Respondents did not violate any of the charged Advisers Act provisions – Sections 206(1), 206(2), and 206(4) and Rule 206(4)-8.

V. ULTIMATE CONCLUSIONS

It is concluded that the violations alleged in the OIP are unproven. Thus, this proceeding will be dismissed.

VI. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), it is certified that the record includes the items set forth in the revised record index issued by the Secretary of the Commission on September 27, 2017.[72]

VII. ORDER

IT IS ORDERED that this administrative proceeding IS DISMISSED.

IT IS FURTHER ORDERED THAT reconsideration of the forty-one "Key Erroneous Rulings" on Respondents' motions that Respondents incorporated by reference and reiterated in their post-hearing briefing IS DENIED.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then a party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct a manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or motion to correct a manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

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Carol Fox Foelak
Administrative Law Judge

[72] The revised record index implements changes ordered on September 26, 2017. *See Lynn Tilton*, Admin. Proc. Rulings Release No. 5096, 2017 SEC LEXIS 3018 (A.L.J. September 26, 2017). Additionally, Respondents' Exhibit 12, the Zohar III indenture, was supplemented, for completeness, by Respondents' May 30, 2017, submission of Exhibit 12A, which has additional exhibits included within the indenture. Exhibit 12A is admitted into evidence.