UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING
File No. 3-16293

In the Matter of

LAURIE BEBO, and
JOHN BUONO, CPA

Respondents.

RESPONDENT LAURIE BEBO'S OPENING BRIEF IN SUPPORT OF HER APPEAL TO THE COMMISSION

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INTRODUCTION

Bad facts make bad law. And so it is with the Division's case. Having only belatedly realized that it possessed no evidence to establish that the eight words it challenges in the mountain of Assisted Living Concepts, Inc.'s ("ALC") Commission filings were material to investors, the Division has pushed the securities laws beyond their limits in the areas of materiality, scheme liability, falsity, and scienter. The ALJ's adoption of such strained and unwarranted extensions of the law should be rejected. Moreover, these administrative proceedings were unconstitutional from the outset, and since the Supreme Court's 2018 *Lucia* decision, their unconstitutionality has become even clearer. The case against Laurie Bebo should be dismissed.

VIOLATIONS FOUND AND SANCTIONS IMPOSED WERE IMPROPER

STATEMENT OF FACTS

ALC And Ventas

From November 2006 to July 2013, ALC was a publicly-traded company, with shares traded on the New York Stock Exchange. Respondent Laurie Bebo was ALC's CEO for most of that time, and Respondent John Buono was ALC's CFO. ALC's business was owning and operating senior living facilities in various regions throughout the United States. At the end of 2009, ALC owned and/or operated 215 assisted and independent living residences in 20 states totaling 9,398 units. (Ex. 5 at 3.)[1] ALC operated about the same number of facilities and units throughout the relevant time period, with 211 facilities as of the end of 2011. (Ex. 13 at 3.)

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[1] Citations to pages of the record exhibits are to the page of the pdf unless otherwise indicated. The record in these proceedings is immense and the factual disputes are many. This overview is meant only to provide just that—a high-level brief of the facts necessary to put the legal and factual matters discussed below in their proper context. For a complete recitation of the facts, *see* Bebo's Post-Hearing Brief at pp. 26-174.

ALC preferred to own most of its facilities—161 of the 211 it operated as of the end of 2011. It leased the other 50 facilities. (Ex. 13 at 4-5; Tr. 2856, 3876-77, 3879-87, 4600-01.) From 2009 to 2011, ALC generated revenues of approximately $230 million, net income of $16-$24 million, and cash flows from operating activities of approximately $44-$55 million. (Ex. 377 at 6-7, n.6.)

ALC's financial performance was largely driven by company-wide private pay occupancy. (*See* Tr. 2570-71, 3834; Ex. 13 at 20-21, 24.) ALC tracked occupancy in its facilities based on the number of units occupied, even if more than one person occupied the unit. (Tr. 4105-06.) ALC never tracked whether a resident was actually living in or staying at its facilities for occupancy purposes, but counted it as "occupied" as long as there was a commitment to pay for the unit. (*See* Tr. 512-13, 1482-83, 2414, 4105-06.)

Every night, senior management, divisional personnel, regional personnel, and others would receive a nightly occupancy snapshot, broken out by region and facility, for the entire Company. (Tr. 2959-61; Ex. 2133.) They were passed out at Board meetings. (Tr. 2868-70, 2959-61.) None of the data included units related to employee-leasing.[2] (*Id.*; Tr. 1484.)

At all times relevant, Ventas, Inc. was a large, publicly-traded healthcare real estate investment trust based in Chicago, Illinois. In 2008, at the time the Lease (defined below) with ALC was executed, Ventas owned a portfolio of 513 senior housing and healthcare-related properties. (Ex. 2106 at 83.) These included 440 "senior housing communities" and skilled nursing facilities. (*Id.*) A number of these properties were in the same markets as ALC facilities, making Ventas a direct competitor to ALC. (*See*, *e.g.*, Tr. 299-300.) As Ventas grew

[2] As used herein, reference to "employee-leasing" or similar language refers to the practice whereby ALC paid for units at the CaraVita Facilities for employees with a reason to go to those Facilities. It also includes the circumstance of ALC paying for rooms in those few situations where units were used or available to family members of employees or other contractors who were performing services in furtherance of the operations of the Facilities.

between 2008 and 2012, the number of markets where it competed with ALC also grew. (*See* Tr. 261-62, 2831, 4138-39.)

Ventas had an acquisitions group that worked hand-in-hand with its asset management group. Joe Solari was the Managing Director-Acquisitions at Ventas, and he negotiated the terms of the Lease with ALC. He later became ALC's principal contact and relationship manager for all things related to the Lease. (Tr. 399-400, 444-45.) Solari was a senior executive of Ventas who reported directly to Ray Lewis, Ventas' Chief Investment Officer. Lewis reported directly to Ventas' CEO Debbie Cafaro. (Tr. 442-43.) In a December 2008 meeting, Cafaro told Bebo, and Buono, that Solari should be their point of contact for "everything" important regarding the relationship between the two companies, including issues pertaining to the Lease. (Tr. 2741-42; *see also* Tr. 3992.)

The Challenged "Boilerplate" Language In ALC's Commission Filings

There is no dispute in this case that ALC's periodic filings with the Commission accurately stated the Company's overall occupancy, or that ALC accurately stated the Company's revenue, expenses, profits, EBITDA, and other financial metrics in all of its filings with the Commission. (Dec. 77, 99.)[3] Rather, the Decision concluded that ALC misrepresented that it was in compliance with a January 1, 2008 operating lease with Ventas (the "Lease") governing eight of the over 200 facilities that ALC owned or operated located in several states in the Southeast United States (the "CaraVita Facilities").

The Division challenges ALC's disclosure pertaining to the Lease beginning with the first quarter 10-Q for 2009. From then through its 2011 annual report on Form 10-K, ALC included a disclosure in its periodic filings with the Commission about the possible unfavorable impact of a

[3] The ALJ's Initial Decision (the "Decision") is cited in this brief as "Dec. __."

provision of the Lease. (*See* Dec. 91-92.) This disclosure appeared under the caption "Future Liquidity and Capital Resources," and imbedded within a full-page, 332-word disclosure about ALC's revolving credit facility was the following challenged statement about the Lease:

> In addition, the failure to meet certain operating and occupancy covenants in the CaraVita operating lease could give the lessor the right to accelerate the lease obligations and terminate our right to operate all or some of those properties. We were in compliance with all such covenants as of March 31, 2009, but declining economic conditions could constrain our ability to remain in compliance in the future.

(*See, e.g.*, Ex. 2 at 30.)[4]

Beginning with its 10-Q for the second quarter of 2011, ALC added the following sentence to the end of the disclosure: "Based upon current and reasonably foreseeable events and conditions, ALC does not believe that there is a reasonably likely degree of risk of breach of the CaraVita covenants." (Dec. 49; Ex. 11 at 36.) Otherwise, ALC's disclosure remained unchanged throughout the entire time period.

One of Bebo's experts to testify at trial, Professor David Smith, stated that in his vast experience analyzing public company filings related to covenant violations, the disclosure at issue here was "boilerplate language that's in a lot of 10-Ks of firms that have financial covenants." (Tr. 3631.) Other hearing evidence demonstrated this statement was universally overlooked for the insignificant boilerplate language that it is.

It was so inconsequential that ALC's general counsel at the time, Eric Fonstad, could not recall at trial any discussion about it at the disclosure committee meetings he chaired and could not recall any legal advice that he provided with respect to the disclosure (though it was indisputable that he did approve the affirmation of compliance in February 2009). (Tr. 1569-71, 1593, 1597, 1603.) Similarly, ALC's general counsel who succeeded Fonstad has no recollection

[4] "Occupancy" and "occupancy rate" were ambiguous, undefined terms in the Lease.

of the discussions at the disclosure committee about it and the additional sentence added to the second quarter 2011 filing. (Tr. 4379-81.) Nor could she recall a single detail about discussions of this disclosure at a Board meeting in July 2011. (Tr. 4378-79.)

At trial, ALC's director of financial reporting, John Lucey, and ALC's director of Internal Audit, David Hokeness, could not recall any specifics with respect to discussions of the disclosure at ALC's disclosure committee meetings other than what was contained in the minutes. (Tr. 3708, 3712-13, 3082-87.) Even a Ventas witness testified that she never noticed whether ALC's filings mentioned the Lease or covenant compliance in her review of them. (Tr. 951.)

Moreover, ALC's stock was covered by several stock market analysts who prepared periodic reports about the Company (*see* Ex. 2186 at 18-23; Tr. 3645-47), and the Division did not present any evidence that analysts believed the Lease or compliance with the occupancy covenant (or the other unspecified covenants contained in the challenged disclosure) was material or important. Therefore, it can be inferred that no questions were asked about the Lease covenants on any ALC earnings calls with investors and analysts.

Events Prompting The Phone Call With Solari On January 20, 2009 (The "Solari Call")

A declining economy and resulting drops in occupancy at the CaraVita Facilities resulted in discussions at ALC board meetings in late 2008 about the implications of non-compliance with the Lease's financial covenants (Ex. 1204), and a meeting among Bebo, Buono, Cafaro, and Solari in December 2008 to discuss how ALC and Ventas might work together through the Great Recession.

Around the same time, Bebo learned that ALC actually had a handful of employees living at the CaraVita Facilities, as hold-overs from the predecessor operator of the Facilities. ALC did

not realize this until it terminated one of them in late 2008, and needed to determine whether it was necessary to evict the employee. (Tr. 1883, 3993-94.)

ALC and Bebo also believed that these employees were included in ALC's occupancy and coverage ratio covenant calculations for 2008 and in reporting by the prior operator. (Tr. 1884-86.) Consequently, in December 2008 or January 2009, Bebo, Buono and Hokeness met with ALC's general counsel, Fonstad, to discuss more generally the permissibility of the inclusion of units rented to employees in the covenant calculations. (Tr. 1307, 1888-89, 3046-47.)

ALC also had a policy of having employees stay at ALC's facilities (including Ventas') when they travelled to them on business. (Tr. 1551, 2966-67.) This included regional management staff, facilities management staff, and marketing, information technology, and finance personnel. (Tr. 1306, 1551.) To save costs, these employees would stay in a vacant room at the facility instead of a hotel.

On The Solari Call , Ventas And ALC Reach An Understanding Regarding An Interpretation Of Ambiguous Lease Terms

Bebo's Testimony. After discussions internally about how to proceed in light of employee units previously being included in the covenant calculations, ALC decided to discuss two principal matters during the Solari Call: increasing the performance of the Facilities by (a) partnering with a hospice company, and (b) ALC paying for apartments for employees or others with a reason to go to the Facilities. (Tr. 3997-99.) As described below, Bebo was the only witness with a specific recollection of what occurred on the 30 minute call, which took place on speakerphone in Bebo's office. (Tr. 4002.) Bebo, Buono and Fonstad participated from Bebo's office. (Tr. 1902.) Solari was the only announced participant from Ventas. (*Id.*)

During the call, Bebo told Solari that ALC had identified a few employees who had been renting units at the CaraVita Facilities that carried over from the prior operator. (Tr. 1903.) Solari indicated he was not aware these employees had been living at the Facilities and included in the covenant calculations, but did not think it was a problem. (Tr. 1903-04.)

At that point, Bebo described ALC's desire to initiate a broader employee-leasing arrangement whereby ALC would pay for units available in the CaraVita Facilities for employees or others who would have reason to go there to assist in the operations. (Tr. 1904-05, 1907-08.) Bebo made clear that ALC would not be tracking the whereabouts of the employees. (Tr. 1907-08.) On the call, Solari agreed that these units could be included in the covenant calculations for both occupancy and coverage ratio purposes. (Tr. 1908.)

Bebo asked Solari a question to the effect of, "Do you care how many?" Solari stated he did not care. (Tr. 1909.) Bebo's missing hand-written notes of the call confirm this, according to witness testimony. (Tr. 3273-74.) They discussed the rate at which ALC should pay for the apartments, and Solari told Bebo "that it should be, like, an arm's-length, third-party transaction, and it would be at the market rate." (Tr. 1908-09.)

<u>Buono corroborates Bebo</u>. Both in his testimony at trial and in his recorded statements prior to trial, Buono corroborated numerous aspects of Bebo's account of the call. One of the hotly contested factual issues has been whether the Lease covenant calculations were mentioned during the Solari Call. The memorandum of Buono's interview with the Milbank law firm in connection with its 2012 internal investigation (described below), which occurred closer in time to the events at issue and before the distorting involvement of the Division, provided highly

relevant new information *confirming Lease covenants were discussed*.[5] According to Buono, covenant calculations came up *twice* during the call. First, the interview memorandum states:

> Buono's recollection was that Bebo informed Solari that the prior operator had used employee leases *in its covenant calculations* and that ALC intended to do the same thing.

(*Id.* at MB_BEBO_0000060 (emphasis added).) Second, Bebo told Solari ALC's own covenant calculations were "getting tight" (i.e. ALC was close to breaching them), although he did not recall her also specifically saying ALC intended to use the rentals for employees in the covenant calculations. (*Id.* at MB_BEBO_0000064.) However, in the context of the discussion about the prior operator leasing units to employees, *and including them in the covenant calculations*, this would have been obvious.

At trial, Buono refused to acknowledge covenant calculations were discussed, but he testified Solari agreed that ALC could pay for apartments to be used by its employees, and Solari expressed no concern about that practice. (Tr. 4656-59.) Buono further testified to the understanding reached with Solari: "In 2009, my understanding was that Ventas was aware we were going to put employees into the--into the properties, and it was my interpretation of that that--those employees, we would only do that--a reasonable person would only think we'd do that in order to meet covenants." (Tr. 2489-90.)

This is consistent with his statements to Milbank that ALC had an "arrangement" with Ventas through the Solari Call and follow-up correspondence where "ALC could keep employees in a unit at one of the Ventas facilities so long as the lease arrangements were on an arms-length basis," that ALC's conduct thereafter "had been done with the full knowledge of

[5] The first ALJ assigned to this case prevented Bebo from obtaining the Milbank interview memoranda. The second ALJ assigned, Judge Foelak, denied Milbank's motion to quash Bebo's subpoena seeking the same in the proceedings following the *Lucia* decision.

Ventas," and that Ventas had "ok'd" employee-leasing. (Jt. Supp. Ex. 1, MB_BEBO_0000058-59.)

However, Buono's version of the call and events generally changed as he spent more time with Division lawyers (about 60 hours altogether), who inappropriately told Buono that Bebo had "thrown him under the bus" while simultaneously depriving him of the ability to review her transcript.[6] (*See*, *e.g.*, Tr. 2434-35, 2490-91.) Thus, he testified that "there's been additional information after that time [May 8, 2012] that would lead me to believe that maybe this [Solari Email] *wasn't as good of an agreement as we would have hoped*." (Tr. 4645.) Even then, he recognized there was an agreement reached.

Moreover, Buono's testimony elicited by the Division on direct examination was wholly inconsistent with how he acted from 2009 through 2013. Throughout that time period he acted consistent with the belief that there was an agreement with Ventas to count rooms in the covenant calculations that ALC paid for employees and others to use in assisting with facility operations. (*See generally* Tr. 2390-2545, 2667-2756.)

Solari Has No Recollection of the Call. On several occasions prior to the Division's investigation, Solari told others he had no recollection of the call and could not dispute Bebo's version of it. (Tr. 449-52; Tr. 3480; Ex. 1879 at 4 ("He was unable to deny the Bebo representation of his approval.").) His trial testimony about the 30-minute call was general and non-specific. (Tr. 414, 450.) In light of Solari's failed memory of this telephone conversation and virtually every other pertinent discussion with ALC personnel (Tr. 413, 446-51, 456-59), his recitation of the denials scripted by the Division with respect to various aspects of Bebo's

[6] Buono had also entered the SEC cooperation program, where he understood he would answer the Division's questions and "offer things to help them." (Tr. 2432-33.)

recollection of the call regarding what he "would" have done or said was speculative and should have been given no weight.

ALC's General Counsel, Eric Fonstad, Attended the Call. Three witnesses besides Bebo place Fonstad in Bebo's office during the call. (Tr. 2343, 2781-82, 2939-40, 3217-18.) Even Division witness Buono testified under oath during his investigative testimony that Fonstad was present for the Solari call; although, he conveniently could not recall that fact at the hearing. (Tr. 2343, 2781-82.)[7]

Bebo Sent A February 4, 2009 Confirmatory Email To Solari (The "Solari Email")

After hanging up with Solari, Fonstad agreed with Bebo and Buono that the parties had come to an understanding of ambiguous Lease terms and that no formal notice or modification was required. (Tr. 1924-25, 1936.) In Buono's words, Fonstad agreed that including employees in the covenant calculations was "kosher." (Tr. 4651-53.) They then left Bebo's office and discussed the call with ALC's head of sales and marketing, Kathy Bucholtz. She testified they informed her that Solari had agreed that ALC could "count employees in the occupancy," (Tr. 2940-41), and later discussed the belief that Solari agreed that units used for "a person that had a reason to go to the property" could be included in the covenant calculations (Tr. 2952-53).

Buono and Fonstad then took the lead in preparing a follow-up email to Solari. (Tr. 1931-32, 2354, 2468, 2756-57; Ex. 1320 and 1320A.) Consistent with the Solari Call, the Solari Email mostly covered the hospice proposal. (*See* Tr. 1914; Ex. 1334.) One paragraph addressed employee-leasing. (Ex. 1334.) It stated that ALC was "confirming our notification of our rental of rooms to employees. We confirm that all rentals related to employees are in the

[7] Buono also told the Division during an interview that "[he] was with Bebo on the Call and Eric [Fonstad] was in the room during the call." (Ex. 2122 at 2.) Emblematic of Buono's molded testimony in favor of the Division, in response to questioning on cross-examination about this point, he stated, "No matter what you do or say, I'm not going to remember if Eric [Fonstad] was in that room." (Tr. 2182.)

ordinary course of business and on terms no less favorable than would be obtained in a comparable arms-length transaction with an unrelated third party." (*Id.*)

Ventas responded to the Solari Email twice, at no point objecting to ALC's confirmation it was renting units at the CaraVita Facilities related to employees. Ventas' asset manager asked to set up a phone call to discuss the hospice *proposal*, but his response was silent with respect to ALC's *confirmation* of its rentals of rooms related to employees. (Exs. 1343, 3377.) He copied numerous other Ventas executives. (*Id.*)

Based on these two responses, Bebo was aware that *every senior executive and key Ventas employee with direct responsibility for the CaraVita Facilities and the Lease (who were copied on the emails) was aware of ALC's confirmation of the company renting rooms related to employees*. (Exs. 1335, 3376; Tr. 191-92, 452-53 (describing roles and responsibilities).) No one from Ventas ever asked any questions or raised any concerns about the employee-leasing arrangement described in the Solari Email. (Tr. 255-56, 352-54, 427-29.)

Fonstad's Further Involvement In Approving ALC's Practice And Disclosure

The day before the Solari Call, Fonstad provided a preliminary analysis of issues pertaining to ALC's rental of units for employees or family members under the Lease in a January 19, 2009 email. At its base, he advised that ALC could conduct employee-leasing if Ventas approved. (*See* Ex. 1152.)

Moreover, the undue importance placed on the template appended to the email by the Division and ALJ is a strawman because:

- Fonstad never advised that the then-contemplated arrangement of renting units for employees would require a formal modification. Both his email and the template letter accompanying it advised Bebo that ALC seek "confirmation of [ALC's] interpretation of the lease" or send a letter "confirm[ing] the understanding we reached about the interpretation of certain terms of the [Lease]." (Ex. 1046.)

- Fonstad never advised a formal notice under Section 33 of the Lease was required. (*Id.*)

In the end, the Solari Email confirmation and acknowledgement of its receipt by Ventas—in writing—achieved the same result as the contemplated template letter (as Fonstad no doubt agreed since Bebo sent him both the Solari Email and Ventas' response). Indeed, Buono stated he spoke to Fonstad, and "*Fonstad did not express any reservations regarding the quality of the notice as reflected in the [Solari Email]*." (Jt. Supp. Ex. 1, MB_BEBO_0000065.) And Fonstad admitted that Bebo and/or Buono briefed him on the Solari Call: "Fonstad later heard that a conversation between Bebo and Buono and Ventas had gone well." (*Id.* at MB_BEBO_0000081.)

It is indisputable that Fonstad continued to be involved in every step of ALC's decision to pursue employee-leasing and, more importantly, *the disclosure regarding Lease covenant compliance*. Contrary to testimony elicited from Fonstad by the Division on direct examination, where he denied knowing ALC had ever included rooms related to employees in the covenant calculations (Tr. 1508), Fonstad himself told Milbank that he knew ALC was meeting the Lease covenants by including room rentals related to employees. According to Milbank, Fonstad's "general recollection is that if ALC sent employees to work at a facility and those employees stayed at the facility during their visit, *they could be included in the occupancy count*." (Jt. Supp. Ex. 1, MB_BEBO_0000080 (emphasis added).) Fonstad told Milbank that he thought this was an "aggressive" position, but it was the position the company took (implicitly with his knowledge and approval). (*Id.*)

When pressed on whether he was aware at the time whether ALC was simply seeking approval for employees to stay at the Ventas facilities, or stay and be included in the covenant calcuations, Fonstad said that if employees were leasing units, the company should be allowed to

count them *in the occupancy covenant calculations*. (Jt. Supp. Ex. 1, MB_BEBO_0000081.) He said this issue first arose when the company decided to send employees to the properties to shore up operations. According to Milbank, Fonstad told them, "He believed the *company included these employees in the covenant calculations* for the period in which they stayed." (*Id.*)

In addition, the day after Bebo sent the Solari Email she forwarded to Fonstad both that email and Ventas' response to it. Fonstad evaluated both emails, printed them, and put them in his file of important materials.[8] (Ex. 1171; Tr. 1529-31, 1558-59.) On February 9, Fonstad likely received a memorandum from ALC's internal auditor outlining the agreement and that ALC had "increased the census" (occupancy) by "using available units to house certain ALC employees on site specifically to assist the local team," and the accounting processes and journal entries for it. (Ex. 1129.) Then a few days later, on February 13, Fonstad chaired the disclosure committee meeting described below where employee-leasing was discussed.

Finally, on February 19, 2009—two weeks after the Solari Email and six days after the disclosure committee meeting where it was discussed—Fonstad *approved ALC's affirmation of compliance, the same disclosure that the Division and the ALJ contends constituted a misrepresentation*. (Ex. 1057; Tr. 1580-82; *see also* Tr. 1929-30.) Bebo relied on his approval. (Tr. 1929-30.)

ALC's Disclosure Committee Considered Employee-Leasing And Determined ALC's Statement Of Lease Compliance Was Appropriate

At all relevant times, ALC had a disclosure committee tasked with reviewing ALC's periodic filings (and drafts) and making recommendations to senior officers like Bebo, regarding

[8] Yet, on direct examination Fonstad incredibly testified that he had no idea whether the Solari Call ever occurred. (Tr. 1507, 1555-56.)

changes or additions. (Ex. 1919 at 3; Tr. 1567-68.) Although she relied on its deliberations, Bebo was not a member and did not influence the committee's deliberations. (Tr. 3704-05.)

Beginning with the February 13, 2009 meeting—nine days after the Solari Email—and at each quarterly meeting in 2009 thereafter, the disclosure committee discussed how ALC was meeting the financial covenants, which had been "clarified" through the Solari Email so that ALC could include rooms related to employees in the covenant calculations. (Tr. 3702; Exs. 124 at 3; 125 at 4; 126 at 4; 1159B at 4.) The minutes of two 2009 meetings indicate Fonstad and the others discussed "[a]djustments to [covenant] calculations" ALC was making and "correspondence between ALC and Ventas has occurred whereby the covenant calculations have been clarified as to census." (Exs. 126 at 4; 1159B at 4.)

Although at trial, the Division worked with the disclosure committee witnesses to not remember what specifically occurred,[9] ALC's director of financial reporting, John Lucey, provided key details to Milbank. He said:

> [T]he employee leasing arrangement came up at quarterly Disclosure Committee meetings… He recalled that *Buono on one occasion (probably 2009) advised the Committee that the company was using employee leases to meet the occupancy covenants*.

(Jt. Supp. Ex. 1, MB_BEBO_0000053 (emphasis added).)

No one associated with the committee, including Fonstad, raised a concern about the practice or a need to modify ALC's disclosure about the Ventas Lease in its Commission filings.[10] (Tr. 1592-95, 3100-04, 3699-3704, 3707, 3711.)

[9] For example, when asked at trial whether "the disclosure committee ever discuss[ed] the inclusion of employees in the covenant calculations," Lucey stated "never in detail" and it was mainly "you know, are we in compliance. And Mr. Buono would say, yes, we're in compliance." (Tr. 3706.) Despite being a witness for Bebo, Lucey met with the Division to go over his cross-examination. (Tr. 3676-77.) He refused to meet with Bebo's counsel. (Tr. 1344-45.)

[10] Similarly, in late April 2012, after Ventas sued ALC and ALC discussed the employee-leasing arrangement with its securities disclosure counsel, Quarles & Brady, in April 2012, neither Quarles nor any other third-party recommended that ALC modify its Lease compliance disclosure in its soon-to-be-filed 10-Q. (Tr. 4483-84, 3723-26;

Bebo Understood ALC Disclosed The Basic, Key Facts To ALC's Outside Auditors

ALC's outside auditors, Grant Thornton ("GT") and its engagement partners were aware of the basic, important facts surrounding the employee-leasing arrangement from the outset:

- GT knew employee-leasing was premised on a conversation with Ventas followed by a confirmatory email. When GT asked for documentation of the agreement with Ventas, ALC provided it, and GT was satisfied. (Exs. 1379, 1379A.)

- Upon GT's request, ALC provided GT lists of names for the covenant calculations, and part of GT's general practice was to review the details and look for unusual items. (Tr. 3341-42.) Many of those lists included the same employees at multiple locations for the same quarter and GT did not find that troublesome. (*See* Ex. 3315; Tr. 3398, 3404 (stating he understood employees "may have needed to have rooms available to them at various locations.").)

- GT understood that ALC, not employees, paid rent. (Tr. 3404-05.)

- GT knew that ALC would have failed the covenants without the employee units. (Tr. 3514.)

- GT made site visits to several of the CaraVita properties for audits, including in 2010. (Tr. 3338-40.)

- GT tested the journal entries associated with employee-leasing; the engagement team knew the purpose of and tested "the 997 activity in the elimination of intercompany revenue." (Tr. 3351-53; Ex. 1679.)

- By the 2011 audit, GT knew that Ventas was not receiving the occupancy reconciliations setting forth the rooms related to employees. (Tr. 3406-07, 3418-20; Exs. 1824, 1824A.)

As importantly, GT acknowledged that ALC provided all of the information about the employee-leasing practice that it asked for, that nothing was withheld from them, and Bebo never refused to provide information or answer questions about the employee leasing program. (*See* Koeppel, Tr. 3360-61.)

Ex. 2058, 2058A at 18.) By this time, *Quarles lawyers were aware that 70 to 90 units for employees were being utilized for the covenant calculations and that ALC was paying for them through intercompany revenue*. (Ex. 3684.)

Bebo Disclosed The Basic, Key Facts About Employee-Leasing To ALC's Board

As the ALJ found, some or all of the board members knew ALC was meeting the Lease covenants by counting employee-related units ALC itself was paying for. (Dec. 51, 85.) But the evidence showed board members knew much more detail; they even affirmatively approved employee-leasing. (Tr. 1372, 1452-54, 2023-26, 2108, 2417-18, 2816-17, 2392-93, 4246, 4249-52, 4629-31; Exs. 86 at 46, 1048, 2117 at 6, 2122 at 7.) For example, Buono confirmed Bebo's account of the board instructing management to meet the covenants through employee-leasing in February 2009. (Tr. 1958-66, 2393-96, 4029-32, 4204; Exs. 2092, 2094, 2117 at 1.) He confirmed Bebo's specific recollection of a meeting with Vice Chairman Mel Rhinelander and another ALC employee following the Solari Call where Rhinelander said "we'll just add employees now." (Jt. Supp. Ex. 1, MB_BEBO_000062.)

GT's engagement partners testified they made presentations to the board and audit committee about ALC's practice of renting rooms for employee use to meet the covenants. (Tr. 3328-30, 3335-38, 3430-31, 3440, 3435-36, 3514-17, Exs. 1913, 1913A.) Buono recalled Melissa Koeppel presented a detailed analysis of the Ventas properties, which showed the company was satisfying the occupancy covenants by putting employees in units at the facilities. (Jt. Supp. Ex. 1, MB_BEBO_60-61, 66.)

Moreover, there is documentary proof that ALC audit committee chair Malen Ng knew by late 2009—at the height of ALC's use of employee-leasing—that ALC was meeting the covenants because ALC was "mak[ing] adjustments top side to pay for our employee rooms." (Ex. 1115; *see also* Tr. 2523-24; Ex. 1115.) Consistent with this testimony, Buono provided Milbank with additional details about how Bebo and Buono walked the Audit Committee through the facility occupancy without the employee-leasing adjustments:

> Information regarding the performance rankings of the various ALC facilities was presented at Audit Committee meetings. At one point, the Chair of the Audit Committee was looking at one of the Ventas properties and asked why the Ventas properties were far down the list. Buono recalls advising the Audit Committee Chair that the reason the Ventas properties were further down on the list than usual was that the list did not include the intercompany transfers associated with employee leases.

(Jt. Supp. Ex. 1, MB_BEBO_0000067.)

Ventas Sues ALC Regarding Alleged Resident Care Deficiencies, But Never Sues ALC Regarding Financial Covenant Violations

On April 26, 2012, Ventas filed a lawsuit against ALC (Ex. 2075) alleging that state regulatory notices identified numerous deficiencies with the respective CaraVita Facility's operations which were "jeopardizing the health, safety, and welfare of the residents." (Ex. 2186 at 9.) It contained no allegation related to financial covenant violations. (Dec. 55, 61.) The next day, ALC sent a settlement proposal to Ventas that included a statement in the release that Ventas was specifically releasing claims "based upon [ALC] renting rooms on the Properties to certain of its employees and including those employees in certificates and covenant calculations…" (Dec. 55.)

On May 9, 2012 Ventas sent another default notice to ALC alleging additional licensing-related defaults, failure to provide notice of a fire, and other allegations. (Dec. 56.) Separately, Ventas asserted ALC committed fraud related to "treating units leased to employees as bona fide rentals by third parties" in the covenant calculations. (*Id*.) The next day, Ventas filed a motion to amend its complaint against ALC. (Dec. 57.) Ventas included all of the allegations from the May 9 default notice, *except* for the financial covenant allegation. (*Id*.)

Nonetheless, on May 14, ALC filed an 8-K publicly disclosing the Ventas allegation that ALC "submitted fraudulent information [to Ventas] by treating units leased to employees as bona fide rentals by third parties and, therefore, may not have been in compliance with the minimum

occupancy covenant and coverage ratio covenants." (*Id.* quoting Ex. 2076 at 2.) This is the first time that investors learned ALC may not have been in compliance with the Lease because of employee-leasing. (Dec. 57.) ALC's stock price did not decline in a statistically significant way. (Dec. 63.)

Milbank's Internal Investigation Resulted In The Board Taking No Action

After a thorough internal investigation, where Milbank collected documents and emails from approximately 23 company personnel and interviewed approximately 16 witnesses (Ex. 1873, pp. 4-5; 1879), Milbank concluded Bebo was "open and transparent" and possessed "no ill intent." (Tr. 3483-84; Ex. 1879 at 6.) Milbank further concluded that Bebo acted reasonably in relying on Ventas' silence in response to the Solari Email and that no formal modification of the Lease was necessary. (Tr. 3481; Ex. 1879 at 4-5.)

Based on Milbank's findings, ALC and the board took no action. They did not restate ALC's financial statements. (*See* Roadman, Tr. 2623.) ALC did not disclose a material weakness in its internal controls during 2012 or prior periods. It did not terminate Buono, who was the person primarily responsible for the Ventas covenant calculation process. (Roadman, Tr. 2619-20.) Rather, in subsequent representations to GT, board members affirmed that they were not aware of *any* "indications of fraudulent activities" at any time during 2012 and affirmed the appropriateness of ALC's internal controls for that time period. (Tr. 3467-71; Exs. 1035 at 3, 1701.)

ARGUMENT

I. The Section 10(b) Claim Should Be Dismissed Because The ALJ Erred As A Matter Of Law And Fact In Finding Material Misstatements.

It has long been established that to fulfill Section 10(b)'s materiality requirement "there must be a substantial likelihood" a misrepresentation or omission was "viewed by the reasonable

investor as having significantly altered the 'total mix' of information made available." *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.,* 426 U.S. 438, 448 (1976)).

A. The ALJ erred as a matter of law when it failed to accord substantial weight to the best evidence of materiality, Professor Smith's event study.

The ALJ acknowledged "the market is the most accurate and unbiased measure of whether reasonable investors found the information to be material." (Dec. 104, citing cases.) In fact, it is the *best* way to determine whether undisclosed information is material is to assess the effect disclosure of the information has on the company's share price. *See United States v. Schiff*, 602 F.3d 152, 171-72 (3d Cir. 2010). Even the accounting literature addressing materiality that was relied upon by the Division's own expert witness confirmed this. (*See* Ex. 377 at 16 n.61; RDX 2-9.) The ALJ further correctly concluded: "Indeed [m]any courts have held that information may be deemed immaterial as a matter of law when the public disclosure of such information has a negligible effect on the price of a stock." (Dec. 104, citing cases.)

Thus, under the law, Bebo's expert, Smith, undoubtedly provided the key evidence related to materiality in the case. His event study confirmed that, the first time investors learned about Ventas' allegations of financial covenant violations and fraud, they did not react negatively. (Ex. 2186 at 16.) Smith concluded that the May 14, 2012 disclosure of allegations that ALC breached the Lease because it fraudulently calculated occupancy rates and coverage ratios under the Lease did not cause a statistically significant change in ALC's stock price after accounting for market and industry factors through his event study. (*Id.* at 16.) Consequently, "the lack of a statistically significant price impact is inconsistent with the market interpreting the Financial Covenant Allegations as negative news."[11] (*Id.*)

[11] The Division elected not to perform this kind of analysis, or ignored the unfavorable results if it did.

The ALJ acknowledged the importance of this evidence under the law and appropriately rejected the Division's improper attempt to twist the findings of Smith's event study. (Dec. 104.) However, the ALJ inexplicably concluded that Smith's event study and testimony "does not weigh against materiality of the actionable misrepresentations and omissions." (Dec. 103.) And contrary to the same law it cited, however, the court gave the study *no weight*. The ALJ compounded this error by ignoring the lack of any evidence that *any other market participant*, such as the analysts that covered ALC's stock, ascribed any importance to the Lease compliance disclosure or the Lease generally. *See Flannery v. SEC*, 810 F.3d 1, 11-12, 14 (1st Cir. 2015).

The ALJ erred by concluding, without any legal or evidentiary support, that the lack of statistically-significant share price movement in response to the May 14 disclosure that Ventas alleged ALC committed fraud was not significant because the disclosure did not provide additional details about the purported scheme. (Dec. 105.) But to constitute a corrective disclosure for materiality purposes, it must simply "reveal to the market in some sense the fraudulent nature of the practices about which a plaintiff complains." *Katyle v. Penn Nat'l Gaming, Inc.*, 637 F.3d 462, 473 (4th Cir. 2011); *see also Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 175 n.4 (2d Cir. 2005). The disclosure corrects the exact misrepresentation allegedly contained in ALC's Commission filings—that ALC was in compliance with the occupancy and other financial covenants in the Lease.

On the other hand, the ALJ acknowledges—as he must—that the market reaction "shows that the average investor did not consider Ventas's assertion and ALC's possible failure to comply with covenants to have been material." (Dec. 105.) Under the relevant legal precedents this finding ought to be dispositive of the lack of materiality to ALC's compliance statement. If the average investor did not consider Ventas's assertion that ALC committed fraud in the

reporting of financial covenants material, then *it must also be true* a reasonable investor could not have deemed that the assertion that ALC was in compliance with the Lease was a material representation. Nor could the non-disclosure of details of the purported "scheme" constitute material omissions, if investors did not find the assertion that ALC was providing fraudulent covenant reporting materials due to *employee leasing* in the first place.

Similarly, if the average investor did not consider the consequences of ALC being in non-compliance as material, it means they were not concerned at all about the potential financial impacts of a default. Thus, the worst-case scenario that could result from non-compliance—one known to investors at all times relevant—could not weigh in favor of materiality at all. This renders the Division's expert's materiality report irrelevant and the ALJ's findings that it could provide some weight in favor of materiality erroneous. The ALJ clearly erred in concluding Smith's event study was merely "useful" and only marginally supported a finding that the challenged disclosure was immaterial. Rather the findings regarding the same dispose of the Division's disclosure case.

B. Bebo's direct involvement cannot convert an otherwise immaterial statement into a material one.

The ALJ could only discard Smith's testimony by relying on an improper application of the nebulous concept of "qualitative materiality." The ALJ's mis-application of these legal principles and focus on "management integrity" effectively converts the securities laws into a general prohibition on corporate misconduct and eliminates the materiality requirement altogether.

1. The ALJ's focus on "management integrity" effectively eliminates the materiality element.

As demonstrated by Bebo's event study and acknowledged by the ALJ, the actual statement of "fact" at issue here—that ALC was in compliance with the financial covenants and

the Lease generally—was not material to investors. Similarly, the omitted fact that ALC was also meeting the covenants by "fraudulently" counting employees as bona fide rentals under the lease was also immaterial. Despite the immateriality of these facts, the ALJ concluded that "Bebo's direction of and ongoing involvement" in the purported scheme (Dec. 97), magically transforms them into material misrepresentations. There is no precedent for such alchemy.

The cases from which the ALJ plucks quotes about "management integrity" or involvement each concerned extensive misstatements of the financial condition of the company or direct self-dealing by the executive. *See, e.g. In re Kidder Peabody Sec. Litig.*, 10 F.Supp.2d 398, 410-11 (S.D.N.Y. 1998) (finding $338 million in fictitious profits at a key operating division could be material even if not quantitatively material to the entire global conglomerate); *In re Comverse Tech., Inc. Sec. Litig.*, 543 F.Supp.2d 134, 138-40 (E.D.N.Y. 2008) (involving executive self-dealing in stock options, creation of "hidden 'slush fund' CEO could provide to favored employees, and additional accounting improprieties); *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 829-30 (8th Cir. 2003) (defendants significantly overstated $287 million in revenue at key subsidiary and overstated reporting company's earnings by 8% over two years); *In re Franchard Corp.*, Rel. No. 33-4710, 1964 WL 67454 (July 31,1964) (self-dealing transactions).

The reasoning of the Fourth Circuit's decision in *Greenhouse v. MCG Capital Corp.*, 392 F.3d 650 (4th Cir. 2004) demonstrates the fallacy of the ALJ's findings. In that case, a company's Commission filings were financially accurate, but misrepresented the CEO's educational background. The court acknowledged that the CEO's intentional lie about his education would cause investors to question management integrity, but found "this is only a distraction from the real issue: whether the actual fact misrepresented—that is the basis for this

suit and that caused investors to question management's integrity—was, in and of itself, material." *Id.* at 659.

The court distinguished the cases such as those relied on by the ALJ, including specifically *Gebhardt* and *Franchard*, and reasoned that:

> [I]n each of these 'integrity' cases, and unlike this case, a real, live, material *fact* was at issue…. Of course, to some extent, 'management integrity' will *always* be implicated in *any* falsehoods. But as this Circuit and the [Supreme] Court in *Basic* noted, not all lies are actionable; the securities laws are only concerned with lies about *material facts*. Reading the law otherwise, as Appellants would have us do, simply reads materiality out of the statute. Under their theory, almost *any* misrepresentation by a CEO—including, perhaps, one about his or her marital fidelity, political persuasion, or golf handicap—that might cause investors to question management's integrity could, as such, serve as a basis for a securities-fraud [claim].

Id. at 660; *see also SEC v. Reyes*, 491 F.Supp.2d 906, 912 n.6 (N.D. Cal. 2007) (rejecting SEC suggestion that improper expenses were material simply because the company's "executives had lied").

The reasoning from *Greenhouse* applies equally here. There is no evidence that *any market participant*—whether it be analysts, investors, or even Ventas—placed *any* significance on the boilerplate disclosure about the Lease covenants in ALC's periodic filings. Smith's event study confirmed this anecdotal evidence. Put simply, as in *Greenhouse* the alleged misstatement of *fact* was immaterial, and falling back on "management integrity" cannot save the Division's case from dismissal.

2. The ALJ's focus on an accounting standard in a case not involving an alleged accounting misstatement was error.

The ALJ also improperly relied on SEC Staff Accounting Bulletin No. 99 (SAB-99), 64 Fed. Reg. 45,150 (Aug. 19, 1990), as a proxy for the legal standard of materiality in this case. (Dec. 98-99.) SAB-99 is Commission guidance for accountants and auditors in determining when misrepresentations of *financial results* could be material. It was issued primarily to

address concerns about companies "managing earnings" through small, but intentional quantitative misstatements. *The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws*, 62 Bus. Law. 317, 336 (2007).

SAB-99 is inapposite because a precondition to applying its analysis is a quantitative financial misstatement. Indeed, this is acknowledged in a footnote in SAB-99 itself: "Whether events may be material to investors for non-financial reasons is a matter not addressed by this SAB." 64 Fed. Reg. at 45,151 n.5. However, the Decision acknowledges, as it must, that ALC's profitability, earnings, and occupancy were all accurately reported to investors—ALC's financials contained no quantitative misstatement at all. (Dec. 77, 99.) No case cited by the Division or the ALJ has applied SAB-99 without the prerequisite of a quantitative financial misstatement.[12]

Moreover, the ALJ even mis-applied SAB-99. The quantitatively immaterial "misstatements" referred to in SAB-99 relate to the misstatements contained in the financials reported to investors in Commission filings. However, the ALJ transposed SAB-99 on to the purported "misstatements" *provided to Ventas*. Only through this slight-of-hand, can the Decision reach the conclusion that the misstatements "masked a trend of decreasing occupancy and revenue at the Ventas facilities." (Dec. 98-99.) Or that the Ventas reporting was susceptible to "precise measurement." (Dec. 98.) The focus on whether financial reporting provided to Ventas was materially misstated says nothing about whether ALC's representations about the Lease to *its own investors* were material.

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[12] Nor is there authority that SAB-99 should constitute the *primary* legal authority in any case. At most, a few courts have recognized that SAB-99 can provide "persuasive guidance" in evaluating *financial* misstatements, although they also explicitly recognize it "does not carry with it the force of law." *Ganino v. Citizens Util. Co.*, 228 F. 3d 154, 163 (2d Cir. 2000).

II. The ALJ's Novel Application Of Scheme Liability Is Erroneous As A Matter Of Law.

The Division should not be able to back-fill its lack of materiality evidence with a novel and unduly broad application of "scheme" liability under subsections (a) and (c) of Rule 10b-5. ALJ's adoption of this expanded version of "scheme" liability, which is contrary to the purpose and language of Section 10(b) as interpreted by the Supreme Court, would improperly convert the securities laws into a general prohibition on corporate misconduct of all kinds. The ALJ thus erred as a matter of law in two principle ways. First, the court held that the objective standard of materiality set forth in *Basic, Inc. v. Levinson* and its progeny did not apply to scheme liability. This is contrary to the plain language of *Basic* itself, which held that objective materiality applied to all Section 10(b) claims. Second, the court effectively eliminated the requirement that any deception or manipulative device be "in connection with the purchase or sale" of securities. This exposes public companies, their executives, and any other actor in the securities industry to liability for a host of "schemes" that have no direct purpose or effect on investors or the securities markets generally.

A. Because Bebo was the "maker" of the alleged misstatements, scheme liability does not apply.

Under the Supreme Court's recent decision *Lorenzo v. SEC*, 139 S.Ct. 1094 (2019), scheme liability exposes to securities fraud liability those who did not "make" the statement at issue. It does not impose *additional* liability on a maker of the statement; such additional "scheme" liability could be imposed in virtually every "maker" case. *See id.* The *Lorenzo* decision provides no support for such a complete merging of the three subsections of Rule 10b-5.

B. No subsection of Rule 10b-5 can expand the scope of Section 10(b).

The purpose of Section 10(b) and Rule 10b-5 is to protect investors, not to deter or punish all forms of corporate misconduct. *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982)

("Congress in enacting the securities laws, did not intend to provide a broad remedy for all fraud."). Overly broad application of the securities laws to management conduct "excessively interferes with the conduct of corporate affairs or the regulation of corporate mismanagement under state law." *Warner Comm's, Inc. v. Murdoch*, 581 F.Supp. 1482, 1491-92 (D. Del. 1984) (citations omitted). Section 10(b) prohibits "(1) using any deceptive device (2) in connection with the purchase or sale of securities," and Rule 10b-5 cannot expand its scope. *United States v. O'Hagan*, 521 U.S. 642, 651 (1997); *Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040, 1046 (9th Cir. 2006)*, vacated on other grounds, Simpson v. Homestore.com, Inc*., 519 F.3d 1041 (9th Cir. 2008).

To keep scheme liability claims within the ambit of the statute, courts enforce the same threshold requirements as Section 10(b) requires—defendants must have created a false appearance of *material* fact, related to a securities transaction. *See id.*; *see also Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 472-73 (1977). In *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 153 (2008), investors brought an action against vendors who participated in transactions that artificially inflated a cable company's revenues. The plaintiffs could not show they had relied on the vendors' statements, as Section 10(b) demands in private material misstatement claims. To get around this deficiency, the plaintiff's argued that the vendors' conduct fell under scheme liability, because they participated in transactions that were *reflected* in public statements that the plaintiffs relied on. *Id*. at 159. But the Court found this reasoning would open up liability to acts that were "too remote" to satisfy the statute. *Id.* at 161. To allow plaintiffs to skirt the reliance requirement—which the Court specifically analogized to the "in connection with" requirement," *id.* at 160—by asserting scheme liability

would stretch the meaning of Section 10(b) "beyond the securities market…to…the realm of ordinary business operations." *Id.* at 161.

The Court's observation in *Stoneridge* shows why the traditional elements of Section 10(b) *must* apply to all subsections of Rule 10b-5. Without these guardrails, scheme liability could serve as a backdoor to liability for allegations that could not survive a "material misstatements" or "in connection with" analysis, transforming the statute into a remedy for all forms of fraud. *Marine Bank,* 455 U.S. at 556. Courts have repeatedly blocked plaintiffs from using scheme liability this way. *See, e.g., SEC v. Kelly*, 817 F.Supp.2d 340, 342 (S.D.N.Y. 2011); *In re Dynegy, Inc. v. Sec. Litig.,* 339 F.Supp.2d 804, 916 (S.D. Tex. 2004).

The Division, unlike the private plaintiffs in *Stoneridge*, does not have to prove that it relied on Bebo's actions to succeed on a Section 10(b) claim. It does, however, have to meet the baseline requirements assigned to all actions brought under this statute, including (1) that the fraud would be material to a reasonable investor; and (2) a sufficient connection to securities.[13] *See O'Hagan*, 521 U.S. at 651-52. In arguing for scheme liability, the Division can no more avoid these elements than the *Stoneridge* plaintiffs could avoid showing reliance.

C. Liability under Rule 10b-5(a) and (c) still requires a showing of traditional materiality.

In concluding Bebo violated Rule 10b-5(a) and (c), the ALJ avoided the traditional "reasonable investor" standard for materiality—which cannot be met in this case—and instead adopted an alternative, subjective test, that has never been applied in a case under Section 10(b) or any subsection of Rule 10b-5. The ALJ suggested that because subsections (a) and (c) do not contain an express materiality requirement, it was questionable whether there was any

[13] The Supreme Court's most recent case addressing scheme liability, *Lorenzo v. SEC*, 139 S. Ct. 1094 (2019), did not find otherwise. This is because it was undisputed the materiality, in-connection-with, and scienter elements were met in that case. *Id.* at 1100 (intentional dissemination of false statements to investors could give rise to scheme liability "assuming other here-irrelevant legal requirements are met.").

materiality requirement at all. (Dec. 87-88.) However, the ALJ noted that in *Neder v. United States*, 527 U.S. 1 (1999) the Supreme Court found that there was a materiality element to criminal mail and wire fraud statutes even though those statutes did not specifically include the words "material" or "materiality." But instead of applying the traditional standard of materiality applied to *all Section 10(b)* claims, the ALJ erroneously selected the subjective standard from Restatement (Second) of Torts § 538(2)(b) as a new materiality standard for Rule 10b-5(a) and (c).

However, the Supreme Court in *Basic* expressly adopted the objective standard for *all* Rule 10b-5 claims: "[w]e now expressly adopt the *TSC Industries* standard of materiality for the §10(b) and Rule 10b-5 context." 485 U.S. at 232. Notably, the case to which it was referring, *TSC Industries*, relied on Section 538(2)(a) of the Restatement in adopting the "reasonable investor" standard for Section 10(b)—the same standard that the ALJ *rejected* for purposes of scheme liability. The *TSC Industries* Court wrote, "The question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor." 426 U.S. at 445. In relying on Section 538(2)(a) for the objective materiality standard and rejecting a standard lower than that contained therein, *id.*, the Supreme Court also implicitly rejected Section 538(2)(b) subjective materiality under the securities laws.

Moreover, the Supreme Court has already adopted the "reasonable investor" standard for materiality in the scheme liability context.[14] The quintessential application of Rule10b-5(a) and (c) is in the insider trading context, which prohibits trading on "material, non-public information." *O'Hagan*, 521 U.S. at 650-52. Materiality, in turn, has been defined for this Rule

[14] This makes sense. Any fraud claim, whether founded on a misstatement or a scheme, necessarily entails the creation of a "false appearance of fact"—some fact that is misrepresented or not disclosed. *Simpson*, 452 F.3d at 1048. That fact must be material to a reasonable investor. *See also Malouf v. SEC*, 933 F.3d 1248, 1259 (9th Cir. 2019) (scheme "failed to correct *material* misstatements…." (emphasis added)).

10b-5(a)/(c) claim in the same way as any other Section 10(b) case—the reasonable investor standard—since the seminal case of *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968).

In addition, the Decision itself establishes the problematic nature of this new standard, which effectively eliminates the materiality requirement altogether. The ALJ states "*nor ... does it matter* under the applicable subjective materiality standard whether reasonable investors would alter their investment decisions based on the misrepresentations." (Dec. 90.) This reflects how untethered the Decision and the Division's case has become from securities fraud and Section 10(b) purpose of protecting *investors*. Now, the Division need only establish the existence of a scheme directed at anyone besides investors, such as a contractual counterparty, in order to establish materiality. This is wrong.

Finally, it would be illogical and improper to have different materiality standards apply to the different subsections of the rule, particularly since the ALJ and the Division suggest that *Lorenzo* permits a "maker" of a false statement to be charged with scheme liability as an alternative or in addition to Rule 10b-5(b). Adopting a different materiality standard effectively eliminates the "reasonable investor" standard altogether, since the same conduct can be pursued under the lower threshold for scheme liability. For these reasons, and because the Division cannot establish that the alleged misstatements were material under *Basic*, the case against Bebo should be dismissed.

D. The Division's scheme liability theory does not satisfy the "in connection with" element under Section 10(b).

The ALJ compounded the erroneous application of scheme liability under sections (a) and (c) of Rule 10b-5 by interpreting the "in connection with" element so broadly as to encompass all manner of corporate misconduct that has nothing to do with the market in

securities for public companies. The ALJ's lengthy description of the purported "scheme [that] operated as an intentional fraud on Ventas" (Dec. 88), demonstrates the improper application of securities laws to govern the relationship between ALC and its larger contractual counter-party and competitor. Ventas had the opportunity to vindicate any rights it had through state law breach of contract, or the assertion of common law fraud claims against ALC and Bebo. Even if the Division had proven that ALC committed fraud against Ventas (it did not), that fraud had no independent relationship to the securities markets. This stretches the "in connection with" element beyond its breaking point.

In *SEC v. Zandford*, 535 U.S. 813, 820 (2002), the Supreme Court found the "in connection with" requirement of Rule 10b-5 must be interpreted flexibly, but not so broadly as to provide a general remedy for all fraud. There, a stockbroker defrauded a customer by selling their securities in a discretionary account and misappropriating the proceeds. *Id*. at 816. The Court rejected the broker's argument that his actions did not fall under Rule 10b-5(a) and (c) because he was not manipulating the value of specific securities. *Id.* at 820. The Court concluded that although the stock sales themselves were real, his customers "were injured *as investors*," and the injury "coincided" with the sales. *Id.* at 822 (emphasis added). This reasoning does not mean that any scheme with a remote connection to securities can be found to coincide with securities, as the ALJ suggests (Dec. 87). On the contrary, the *Zandford* Court reiterated that Section 10(b) "must not be construed so broadly as to convert every common-law fraud that happens to involve securities into a violation of 10(b)." *Id.* at 819–20.

Interpreting *Zandford*, the Ninth Circuit has held that scheme liability may only attach to actions that have (a) the principal purpose and (b) the effect of misleading investors. *Simpson*, 452 F.3d at 1051. The defendants in *Simpson*, a case relied on by the ALJ (Dec. 87), were

accused of taking part in sham transactions with an internet company, with the purpose of artificially inflating the internet company's reported revenue. Thus, the specific purpose of the scheme was to materially misrepresent public company revenue and could only become complete when the fraudulent information was introduced into the securities market. *Id.* at 1051.

Regarding the effect of the purported scheme, courts have focused on whether there is a "causal connection" or "sufficient nexus" between the scheme and the actual harm to investors. *Westinghouse Credit Corp. v. Bader & Dufty*, 627 F.2d 221, 223 (10th Cir. 1980); *In re Parmalat Sec. Litig*., 376 F.Supp.2d 472, 492-93 (S.D.N.Y. 2005). In *Parmalat*, also cited by the ALJ (Dec. 88), the scheme's effect (as in *Simpson*) was to manipulate the financial metrics—revenue and assets—of a public company. *Id.* at 506.

Here, the Division cannot demonstrate any such purpose or effect.

No effect on investors. As to the effect, unlike the customer in *Zanford*, Ventas was not injured or harmed as a securities investor by Bebo's actions. Ventas did not become involved with ALC as an investor, but as a counterparty to a lease agreement. When implementing employee-leasing, Bebo sought to substantially meet the terms of the Lease, while serving ALC's best interests. Her statements were not intended to mislead Ventas as an investor (or at all), nor did they mislead the public about the value of ALC's stock.

Similarly, and in contrast to *Parmalat*, the Division cannot show that Bebo's actions had any effect on securities, or causal connection to harm incurred by investors. The financial statements that ALC released during the relevant time period contained no material misstatements about the company's value. And as Smith's event study demonstrated, the disclosure of Ventas' allegation that ALC was fraudulently using rooms related to employees to

meet the covenants did not affect ALC's stock price in a statistically significant way. So the Division cannot point to any causal link between Bebo's actions and harm to securities.

No principal purpose to mislead investors. The definition of "coincides" cannot be extended haphazardly to conduct involving no purchase or sale of securities that does not injure investors in any way. Nor can it support the notion that statements to a contractual counterparty may "become" connected to securities when the same party is briefly considered a potential acquirer in merger. Yet, that is what the ALJ somehow found. (Dec. 89.) But the focus on a few select emails regarding Bebo's competitive concerns and where she deferred entirely to Rhinelander regarding the disclosure of information to Ventas, was improper. Bebo chose to withhold sensitive information in all circumstances because Ventas was also a competitor of ALC, and made a point of doing so since long before ALC's controlling shareholder (David Hennigar) considered putting ALC up for sale. (Exs. 1254, 1118; Tr. 2742, 4146-47.) And when Ventas did become a potential bidder, *Rhinelander* decided not to share certain aspects of ALC's operations, including the details of the occupancy covenants. (Tr. 2830-31, 2903-04, 4434.) This decision was not aimed at manipulating securities—there is no evidence it had any material effect on the sale procees—but at protecting ALC from competitive harm.

Nor could the Division satisfy the "ultimate purpose" test with conduct directed at Ventas because the alleged scheme was not made complete by information being introduced to the market. The defendants in *Simpson* and *Parmalat* entered transactions with the specific goal of artificially inflating public company assets or revenue, and the full scheme was not realized until the misinformation was released to the market. By contrast, the specific purpose of employee-leasing was to maintain compliance with Lease covenants—not to misrepresent ALC's financial

condition to *investors*. Indeed, Bebo and ALC took specific steps (via the 997 account) to *avoid* misstating ALC's occupancy, revenue, and profitability.

To extend Rule 10b-5 to the present circumstances—conduct that was not calculated to influence investors and had no intended or actual effect on the market—would improperly extend the securities laws to all manner of corporate conduct unrelated to investors or the markets.

III. The ALJ's Finding That ALC's Disclosures Contained A Misstatement Of Fact Was Erroneous As A Matter Of Law.

A. The ALJ Misapplied The *Omnicare* Standard For Proving The Falsity Of Opinion Statements.

Section 10(b) prohibits the making of an untrue or misleading statement of material *fact*. Statements of opinion—such as the statement that asserted ALC's compliance with the Lease covenants—are only actionable under limited circumstances. *See Omnicare, Inc. v. Laborers Dist. Council Contr. Indus. Pension Fund,* 575 U.S. 175, 185 (2015); *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1095-96 (1991). Because a claim based on an opinion turning out to be incorrect would be impermissibly based on hindsight, the Division was required to prove both that (1) the opinion stated was unreasonable; and (2) the speaker of the opinion knew that the opinion was incorrect or did not believe it was accurate herself. *See Omnicare*, 575 U.S. at 185. The securities laws do not permit "second-guess[ing] inherently subjective and uncertain assessments" *even if the opinion ultimately proves to be incorrect*. *Id.* at 186.

The ALJ found ALC's statement that it "believe[d]" it would not default under the Lease in the foreseeable future, which was only included in the last three challenged filings, was an opinion statement subject to *Omnicare*. However, he erroneously concluded that the statement in each filing that ALC was in compliance with covenants was not subject to *Omnicare*. (Dec. 92-93.)

If evaluating the truth of statement is subjective or involves judgment, it is an opinion statement. *Omnicare*, 575 U.S. at 183. It does *not* need to be preceded by "I believe" or similar language, as several courts have since found. *In re Merck & Co., Inc. Sec., Derivative & "ERISA" Litig.*, 2015 WL 2250472, **19-20 (D.N.J. May 13, 2015); *Corban v. Sarepta Therapeutics, Inc.*, 2015 WL 1505693, *6 (D. Mass. Mar. 31, 2015); *City of Westland Police & Fire Ret. Sys. v. MetLife, Inc.*, 2015 WL 5311196, *10 (S.D.N.Y. Sept. 11, 2015).

In this case, the ALJ erred in focusing exclusively on the lack of such signaling language. A statement of legal compliance with a complex lease, containing numerous irrelevant and inapplicable provisions, and containing significant ambiguity (as to occupancy) and discretion (as to coverage ratios) in how covenants are to be calculated, undeniably involves a "matter of judgment." Restatement (Second) of Torts § 538A (1977) (a statement of opinion includes those regarding "matters of judgment."). It therefore falls within the ambit of *Omnicare*.

As a result of this erroneous legal judgment, the ALJ never assessed whether there was evidence that Bebo did not subjectively believe that ALC was in compliance with the covenants based on the Solari Call and Email such that she could be charged with affirmatively misrepresenting the same. This can be established by specific statements to others recognizing the falsity of the stated opinion or specific conduct (such as an insider sale of significant stock holdings) that would be inconsistent with the stated opinion. But general assertions of wrongdoing, of "an overarching fraudulent scheme or corrupt environment," or "sharp [business] practices" will *not* suffice. *See Podany v. Robertson Stephens, Inc.*, 318 F.Supp.2d 146, 154-55 (S.D.N.Y. 2004); *In re Credit Suisse First Bos. Corp.*, 431 F.3d 36, 46-47 (1st Cir. 2005), *overruled on other grounds by Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007).

In this case, Bebo consistently expressed to others that ALC had an agreement with Ventas for ALC to pay for units for people with a reason to go there, and include those rentals in the covenant calculations. She consistently, repeatedly explained to internal accounting staff, to the board members, to GT, and others that the basis by which ALC was meeting the covenants was based on the Solari Call and Email. When Buono supposedly raised concerns about the practice (testimony which is of, at best, questionable veracity), he testified that Bebo never expressed concern about the validity of the agreement and whether ALC's actions were consistent with it. (Tr. 2366.) When others questioned the nature of the agreement, Bebo again explained her sincere belief that ALC was in compliance with the Lease covenants. (Tr. 1155-57, 1161-62.)

At most, the Division established that ALC and Bebo, in their interactions with Ventas, acted with ordinary advocacy in business practices between two sophisticated companies and competitors. ALC obtained a very favorable and flexible understanding in meeting the Lease covenants. ALC had no obligation to revisit the agreement. Two major law firms, Quarles and Milbank, concluded ALC could effectively defend against any default assertion by Ventas when they reviewed the matter in 2012. As in the *Credit Suisse* decision, establishing sharp business practices is insufficient to demonstrate subjective falsity.

B. ALC Had No Obligation To Disclose How It Was Meeting The Lease Covenants.

In addition to improperly concluding the compliance opinions was an affirmative misrepresentation of fact, the ALJ also concluded that ALC had a duty to disclose the manner in which ALC was meeting the covenants. However, the law does not require companies to disclose every basis for a stated compliance judgment or information that may contradict the assertion of compliance. *Williams v. Globus Med., Inc.*, 869 F.3d 235, 243 (3d Cir. 2017);

Zaluski v. United Am. Healthcare Corp., 527 F.3d 564, 572 (6th Cir. 2008); *Gallagher v. Abbott Labs.*, 269 F.3d 806 (7th Cir. 2001). *Globus* and *Zaluski* are on point, but the Decision fails to mention either case. Instead it relies on a case involving one of the worst bribery scandals in history, which the court described as "not the ordinary case." (Dec. 94 citing *EIG Energy Fund XIV, L.P. v. Petroleo Brasileiro S.A.*, 246 F.Supp.3d 52, 85-87 (D.D.C. 2017).

For example, in *Globus*, a medical device company (Globus) told investors that its sales "*could* be adversely affected" if it lost any of its key independent distributors. 869 F.3d at 238 (emphasis added). At the same time, and unknown to investors, Globus already made the decision to terminate one of its key independent distributors. *Id.* at 239. Later, Globus disclosed that its financial performance had declined due in large part to its decision to terminate the distributor. *Id.*

The Third Circuit held, as a matter of law, there was no duty to disclose the contract termination despite the risk disclosure. The court reasoned that the "risk actually warned of is the risk of adverse effects on sales—not simply the loss of independent distributors generally. Accordingly, the risk at issue only materialized … if sales were adversely affected at the time the risk disclosures were made." *Id.* at 242.

Importantly, the court also held there was no actionable misstatement because the allegations did not establish that the drop in sales as a result of the contract termination was "inevitable." *Id.* at 243. Unless the "risk about which Globus warned—the risk of adverse effects on sales as a result of the loss of a single independent distributor—had actually materialized at the time of either the 2013 10-K or the 2014 1Q 10-Q, Globus had no duty to disclose its decision to determinate its relationship with [the distributor], and the risk disclosures

were not materially misleading." *Id.* at 243; *see also In re Plains All Am. Pipeline, L.P. Sec. Litig.*, 245 F.Supp.3d 870, 909-10 (S.D. Tex. 2017).

The analysis is the same in this case. As in *Globus*, ALC warned investors of a risk to "Future Liquidity and Capital Resources" if (a) it breached "certain operating and occupancy covenants"; and (b) Ventas exercised its remedies under the lease, including acceleration of rent. Just like Globus, ALC emphasized that a breach of the covenants *could* result in the financial consequences disclosed. And as in *Globus*, at no time during the period ALC issued the challenged statements was ALC realizing the potential consequences of a covenant breach. Nor were such consequences "inevitable." Indeed, in 2009 the Alabama regulators acted to revoke the license of one of the CaraVita Facilities. When Ventas learned of this default—which is far more serious than a financial covenant violation—it took no action under the Lease. (Tr. 295-96, 375-76; Exs. 1169, 2034.) In 2010, Ventas issued a notice of default for alleged reporting violations (Ex. 1231), and nothing happened. And as the ALJ found, various witnesses testified that market participants knew that breaches of financial covenants almost always get resolved with minimal economic consequences. (Dec. 100-02.) Thus, a reasonable investor, having knowledge of the terms of the Lease, would expect that ALC could trip some of the numerous operating covenants, that a dialogue would ensue with Ventas, and resolution would be reached with little financial impact. Consequently, just as Globus was not required to make a disclosure of the contract termination until the financial consequences of it materialized, it is also the case that ALC was not required to disclose immaterial information about its dealings with its contractual counterparty unless and until the potential financial consequences of an "operating or occupancy covenant" breach materialized.

IV. Bebo Did Not Act With Intent To Deceive Investors.

A. The ALJ ignored the effect of the context in which the Solari Call and Email occurred on Bebo's state of mind.

The ALJ appears to have concluded it was unreasonable for ALC and Bebo to rely on the Solari Call and Email because the terms of the Lease required formal notices and covenant waivers to be in writing. (e.g., Dec. 23, 81.) Although legally incorrect, this conclusion is also contradicted by the undisputed facts regarding the parties' course of dealing under the Lease prior to that time:

- In 2008, ALC and Ventas reached informal agreements about the interpretation of ambiguity in the occupancy and coverage ratio covenant definitions. These were reached without formal lease modifications, and Ventas acknowledged that none was required. (Tr. 325, 329-30, 336-37, 341-46, 3984-85; Exs. 1986 at 130, 1988-89, 1992-94, 2002, 2002A.) Resolution of the 2009 default related to Alabama regulators revoking a license was also handled through an email and a phone call. (Tr. 295-96, 375-76; Exs. 1169, 1231, 2034.)
- In 2009, Ventas' business was severely affected by the Great Recession and Ventas told Bebo and the public at large that its primary goal, and the purpose of the financial covenants, was to maintain its stream of rental payments. (Tr. 285-94, 311-14, 460-61, 4047-49; Exs. 2109 at 4, 7, 2106 at 32-33, 40, 2069, 2070.) Because ALC never presented a risk of non-payment, Bebo reasonably construed silence as agreement under the circumstances. (*Id.*; Tr. 315, 459, 950, 3957-58, 3961-63, 3985-87.)
- The informal and flexible approach to covenant compliance was consistent with industry practice during that time period; lessors almost never took actions to enforce remedies for financial covenant defaults. (Ex. 2185 at 11; 3322 at 11; Tr. 3567-69, 3574, 3634-35.)

In addition, Ventas never defaulted a tenant under any lease on the basis of violations of the financial covenants alone, and Bebo was not aware of *any* instance where *any* landlord pursued a default and remedies solely as a result of a financial covenant violation. (Tr. 379-81, 4047-51.) When covenants were breached (prior to 2012), Ventas just "monitored" them until ALC was "out of the woods." (Tr. 282.)

B. The ALJ erred regarding the Solari Call.

First, the ALJ's ultimate finding of what was discussed on the Solari Call is illogical. Contrary to the evidence presented at trial, the ALJ determined that the participants discussed two topics: the subleasing of units to a hospice company, and whether ALC corporate employees traveling to the facilities could overnight there instead of a hotel. And that's it. (Dec. 32.) However, it was undisputed that, *prior to the call,* ALC already had employees staying at facilities when they traveled to the area. The only inference to be drawn from that fact is that ALC did not believe that approval from Ventas was necessary for merely having employees stay at the facilities.

Rather, the impetus for having the Solari Call was to discuss whether Ventas objected to the historical inclusion of employees living in the facilities in the covenant calculations and whether ALC could pursue broader employee-leasing. Indeed, the very purpose of Fonstad's January 19 email was to assess whether this type of practice could be permissible under the Lease. (Ex. 1046; Ex. 174.) *Not* whether employees could use the facilities like a hotel.

The Decision leaves a host of basic questions unanswered, because it is inconsistent with what actually happened. Why would ALC contact Ventas about an established company-wide practice that no one believed Ventas had to approve? Why would Bebo depart from the pre-determined plan of asking Ventas if ALC could include individuals in the covenant calculations, as the prior owner had? Why involve Buono and Fonstad on the call if she intended to proceed differently than planned?

Second, the ALJ's reliance on Solari's trial testimony was erroneous. Solari had virtually no recollection of the substance of the January 20 call, at the trial or otherwise. Despite this, the ALJ erroneously adopted Solari's two-sentence recollection of the call combined with the speculative testimony of what he "would have" done or said in its entirety. (Dec. 32.) And

although he credits Solari's testimony because he had the opportunity to have his memory refreshed, he discredits Bebo's testimony because it is more detailed than the Milbank interview memorandum, which does not record whether covenant calculations were specifically discussed. (Dec. 33.) This is inconsistent and seems outcome-driven.

The ALJ's reliance on what Solari "would have" done, said, or remembered was similarly impermissible. (Dec. 32.) In light of Solari's failed memory of this telephone conversation and virtually every other pertinent discussion with ALC personnel (Tr. 413, 446-51, 456-59), his recitation of the denials scripted by the Division with respect to various aspects of Bebo's recollection of the call regarding what he "would" have done or said was speculative and should have been given no weight rather than the dispositive weight the ALJ afforded it. The ALJ claims there is "no evidence that the Division wrote Solari's testimony for him" (Dec. 35), but the memorized, repeated statement (over 10 times, Tr. 416-23) speaks for itself. What he "would" have done based on Ventas' routine practice and his position in the organization is irrelevant, as two ALJs established as law of the case when they quashed Bebo's subpoena to Ventas seeking evidence of its routine and practice.

Finally, the ALJ failed to recognize evidence of Solari's bias toward Bebo and in favor of Ventas and the Division, including testimony that Solari and Ventas discussed conspiring to terminate the Lease with ALC so that Solari's new employer could take over the operations of the CaraVita Facilities. (Tr. 368; Ex. 258.)

Third, the ALJ found Buono's testimony at trial about the Call to be credible, even though Buono made numerous inconsistent statements about the Call itself. For example, the ALJ posits that Buono testified there was *no agreement whatsoever* reached with Solari, but he clearly testified that his understanding in 2009 "was that Ventas was aware we were going to put

employees into the—into the properties" (Tr. 2489-90), and after entering the Division's cooperation program that maybe the Solari Call and Email "wasn't as good of an agreement as we would have hoped." (Tr. 4645.) Despite this clear statement that there was some kind of an agreement, the ALJ concluded "[a]t best, Buono's testimony demonstrates the absence of any agreement by Solari." (Dec. 34.) And the finding ignores Buono's other pre-trial statements confirming an agreement consistent with Bebo's recollection.

Moreover, the ALJ rejected Buono's trial testimony as *not* credible on critical issues favorable to Bebo without any reasonable basis. For example, in sworn testimony and other occasions during the investigation, Buono stated Fonstad attended the Solari Call. (Tr. 2343, 2781-82; Ex. 2122 at 2.) Yet, the ALJ in this instance does not credit Buono.[15] (Dec. 35.) Similarly, Buono testified at trial that Fonstad was present when he drafted the Solari Email, but the ALJ rejects this testimony because Fonstad was not copied on the draft he sent to Bebo. (Dec. 36.)

C. The ALJ erred regarding the Solari Email.

The ALJ erred in concluding there was no understanding about the interpretation of ambiguous terms in the Lease based on the Solari Call and the Email, and that it simply constituted a proposal that Ventas appropriately ignored (without telling anyone at ALC). (Dec. 37-38.) Moreover, the ALJ's discussion of the Email—emblematic of the entire scienter analysis—assesses the "trial within the trial" of whether ALC could prove a contractual

[15] Instead the ALJ credited the self-serving testimony that Fonstad had a practice of taking notes of meeting in which he participated, but there were not any related to the Solari Call. (Dec. 35.) By this same logic, Bebo did not participate in the call either, since she had a proven practice of taking notes and her notes of the call do not exist (likely because they were destroyed by one of ALC's directors). Moreover, if Fonstad's practice was as testified, where are his notes from board meetings and disclosure committee meetings for which he was the secretary and chair, respectively? They do not exist.

agreement rather than whether, from Bebo's perspective it was reasonable to believe in good faith that Ventas was aware of ALC's use of room rentals for employees and did not object. (*Id.*)

First, the ALJ asserted that Bebo did not understand the Solari Email to convey an agreement to include room rentals related to employees in the covenant calculations, but rather conveyed a mere proposal. This is belied by the text of the email itself, which discusses a "confirmation" of employee-leasing, contrasted with the "potential" hospice proposal which is described as an "exciting opportunity." (Ex. 184.)

The ALJ also focused on the absence of specific reference to the financial covenants in the Solari Email. (Dec. 37.) But even Buono testified, "there would be no other reason to put them in the houses other than to put them in the calculations," and he "made that assumption from the -- from the call [with Solari], that they wouldn't -- why would we do it otherwise is the question." (Tr. 2487-88.) *He also confirmed the covenants were discussed on the Solari Call.* (Jt. Supp. Ex. 1, MB_BEBO_0000060, 64.) And the Ventas witnesses *did not* testify they failed to respond to the email because it did not refer to the covenant calculations. Timothy Doman, head of asset management, testified Ventas disregarded the email because it was not a "formal request," not because he could not tell from the email whether those rentals would be included in the covenant calculations. (Tr. 252-56.)

Similarly, the ALJ erroneously found that Bebo could have been more articulate about including employees in the covenant calculations, contrasting the additional specificity set forth in the email related to the hospice proposal. (Dec. 37.) However, the same hospice language the ALJ cites does not reference covenant calculations, even though ALC indisputably was making that proposal to increase occupancy and cash flow of the facilities for covenant calculation purposes.

Second, the ALJ determined that the email does not mean what it says because Ventas did not view it as confirming ALC's intent to include employees in the covenant calculations. This is flawed for two reasons. What Ventas subjectively believed or internally discussed is irrelevant to the analysis. Only what Ventas conveyed (or did not convey) to Bebo is significant. And Ventas conveyed agreement to ALC's confirmation of room rentals to employees through its words and conduct in the days following their receipt of the Email. Bebo honestly and in good faith believed that ALC had an agreement with Ventas to use employee-leasing to meet the covenants based on Ventas' lack of objection in two written responses to the Solari Email as well as in subsequent discussions. (Tr. 4044-45; 1937-38.)

D. No scienter where Bebo consulted with and relied on the advice of counsel and the disclosure process and committee Fonstad ran.

Generally, disclosing pertinent facts to legal counsel negates an inference of scienter. *Howard v. SEC*, 376 F.3d 1136, 1147-49 (D.C. Cir. 2004). Moreover, relying on the advice of counsel as to whether a contemplated course of action is legal can be a complete defense. *See United States v. Benson*, 941 F.2d 598, 614 (7th Cir. 1991); *SEC v. e-Smart Techs., Inc.*, 2015 WL 583931, *6 (D.D.C. Feb. 12, 2015); *SEC v. Harwyn Indus. Corp.*, 326 F. Supp. 943, 955 (S.D.N.Y. 1971).

In this disclosure fraud case, the advice of counsel question is whether Fonstad or other ALC counsel possessed facts sufficient to advise whether ALC's *disclosure*—that it was in compliance with the Lease covenants—was appropriate, *not* whether the lawyers possessed every fact related to the employee-leasing process. The undisputed facts here demonstrate that from January 19, 2009 through February 19, 2009—when Fonstad approved the very disclosure at issue in this case—he was involved in evaluating Bebo and ALC's conduct vis-à-vis Ventas

and the intent to utilize ALC room rentals related to employees to meet the covenants multiple times each week during that four-week period:

January 19th	He sent his initial email evaluating employee-leasing.
January 20th	He participated on the call with Solari and/or discussions about it.
January 27th	Buono says Fonstad helped him write the Solari Email.
February 5th	He read, printed, and filed in his important records the Solari Email.
February 5th	He read, printed, and filed in his important records Ventas' response to the Solari Email.
February 9th	Received memorandum regarding employee-leasing from ALC's internal auditor.
February 13th	Fonstad chairs the disclosure committee meeting.
February 19th	Fonstad approves compliance disclosure

Thus, the ALJ's primary reliance on Fonstad's *first interaction* and advice in his January 19 email (Dec. 81-83), is misleading and erroneous.[16] And the focus on whether Fonstad knew about or approved every aspect of employee-leasing is largely irrelevant. ALC's general counsel was involved and consulted with at every stage of the *disclosure process* regarding covenant compliance in the immediate aftermath of the Solari Call and Email and the decision to meet the covenants through ALC's room rentals for employees. Indeed, there is no evidence to suggest that *anyone* on the disclosure committee or involved in evaluating ALC's disclosure of compliance with the Lease covenants—all of whom knew that ALC would fail the covenants without including intercompany room rentals related to employees—raised any concerns with Bebo about the *disclosure to investors* at issue in this case. All these facts weigh

[16] In that discussion, the ALJ also focuses almost exclusively on the letter "template" embedded in his email. However, Fonstad never advised that the then-contemplated arrangement of renting units for employees would require a formal Lease modification, and he never advised that a formal notice under Section 33 of the Lease was required. Rather, in describing the draft letter embedded in his email, he stated "the letter we can send can be in the nature of a confirmation of our interpretation of the lease (see template below)." (Ex. 1046.)

heavily against a finding of intent to deceive *investors*, if not dispose of the scienter element in Bebo's favor entirely under applicable law.

E. No scienter where Bebo understood ALC disclosed the basic, key facts to ALC's outside auditors.

The ALJ erred as a matter of law in not concluding that the reliance on outside auditors mitigated the scienter finding and precluded a securities fraud violation. *See SEC v. Bankatlantic Bancorp, Inc.*, 661 F. App'x 629 (11th Cir. 2016) ("Good faith reliance on the advice of an accountant or an attorney has been recognized as a viable defense to scienter in securities fraud cases.").

In *Bankatlantic*, the court held that, for the reliance defense to apply, an executive did not have to provide all documents or information pertaining to the disclosure issue. 661 F. App'x at 634. Rather, the court found it critical that the defendants and the auditors agreed that they had all the information necessary to render the advice, and specifically relied on testimony from one of the audit team members who confirmed that they were provided any materials that were requested from the company. *Id.* at 637. The auditors also acknowledged they understood the "crucial issue" pertaining to the accounting treatment, even if they did not have all of the relevant materials. *Id.*

This case is no different. With respect to GT, they had documents and information sufficient to understand the basic facts and the "crucial issue[s]" pertaining to employee-leasing. The testimony and documentary evidence confirming this fact is abundant. And just as in *Bankatlantic*, GT testified that neither ALC nor Bebo ever refused to provide information or answer questions about the employee-leasing program. (*See* Tr. 3360-61.)

The Decision also found that Bebo misled GT into believing there was an "agreement" with Ventas. But GT understood the "written agreement" was the Solari Email, which further supports Bebo's reasonable belief that it was sufficient. (Tr. 3317.)

Finally, the Division and ALJ rely principally on the management representation letters where Bebo and Buono affirmed that ALC was in compliance with contracts that, if breached, "*would* have a material effect on the financial statements" of ALC. As demonstrated previously and as found by the ALJ (Dec. 100-02), the trial evidence established that a breach of the financial covenants in the Lease would likely *not* have any material effect on ALC's financial statements.

F. No personal financial motive.

Bebo received no personal benefit from the purported fraud and had no motive to commit fraud. This weighs against scienter. *Plumbers & Pipefitters Local Union 719 Pension Fund v. Zimmer Holdings, Inc.*, 679 F.3d 952, 956 (7th Cir. 2012). The ALJ's reliance on a supposed motive to avoid discipline or termination to support an inference of scienter (Dec. 62), is contrary to the law because it is present in every case. *See, e.g. Pugh v. Tribune Co.*, 521 F.3d 686, 695 (7th Cir. 2008); *McIntire v. China MediaExpress Holdings, Inc.*, 927 F.Supp.2d 105, 120 (S.D.N.Y. 2013) (collecting cases).

V. Bebo Did Not Mislead GT.

The ALJ's finding with respect to the misleading auditors claim pursuant to Rule 13b2-2 appears to be premised on management representation letters that affirmed compliance with contractual agreements generally. (Dec. 110.) However, as noted above, the representation was true because it was established that a breach of the Lease's financial covenants would likely *not* impact ALC's financial statements. And for the same reason the reliance defense applies, Bebo cannot be found to have misled the auditors. Finally, GT confirmed it was not misled by Bebo or

ALC even after Milbank reported its investigation findings. Consequently, it is error to conclude that Bebo knew she was signing a false management letter, as required by the law. *See SEC v. Todd*, 642 F.3d 1207, 1219 (9th Cir. 2011) (executive must be "aware of the falsification and did not falsify through ignorance, mistake, or accident.").

VI. No Books And Records Violations Proven.

To find violations of Section 13 of the Exchange Act, the ALJ based his decision on the occupancy reconciliations/employee lists under the false assumption that they were meant to track actual days and stays of employees at the CaraVita Facilities. (Dec. 68.) They were not. (Tr. 1097-98, 1179-80, 3912-13, 3404, 4008-10; Ex. 1685 at 5; 3507.) Thus, the occupancy reconciliation records were not intended to "reflect the transactions and dispositions of the assets of the issuer" within the purview of Section 13, because they were not meant to track actual stays of employees at the CaraVita facilities. In addition, as set forth previously, Bebo did not act with scienter or unreasonably, as required to support a violation. *See United States v. Reyes*, 577 F.3d 1069, 1080 (9th Cir. 2009); SEC Release Notice, No. 17500, 1981 WL 36385 (Jan. 29, 1981). The ALJ found that Section 13(b)(2)(A) nonetheless applied because the employee lists reflected "purported transactions," and because virtually any type of document could constitute a "record." This was error because this claim generally requires a material misstatement of company financials. *Id.*; *see also Ponce v. SEC*, 345 F.3d 722, 726, 737 (9th Cir. 2003).

VII. No Internal Controls Violations Proven.

Pursuant to Section 13(b)(2)(B), ALC possessed sufficient accounting controls—a fact that was affirmed by auditors and reflected in ALC's accurate financial statements. Nonetheless, the ALJ concluded that Bebo violated Section 13(b)(2)(B) because the records related to the employee-leasing arrangement lacked sufficient controls "to ensure that transactions were properly recorded for the purpose of producing GAAP-compliant financial statements."

(Dec. 75.) This reasoning improperly applies the internal controls requirement beyond the realm of the accounting controls the statute was intended to govern, and ignores the fact that ALC's financials indisputably did comply with GAAP.

Section 13(b)(2)(B) prevents issuers from engaging in corrupt internal *accounting* practices that could lead to inaccurate financial reporting *to investors*. In listing the requirements for internal accounting controls, Section 13(b)(2)(B) adopts the language of the American Institute of Certified Public Accountants' (AICPA) *Statement on Auditing Standards* of 1973 ("SAS"). S. Rep. No. 95-114 at 8. These standards—which the ALJ recognizes as persuasive authority on the application of the statute (Dec. 75)—distinguish *accounting* controls, which are subject to Section 13(b)(2)(B), from *administrative* controls, SAS § 320.27, which are not. Administrative procedures help achieve the organization's objectives, but ordinarily do not directly affect financial statements, SAS § 320.11, and so a failure there does not run afoul of Section 13(b).

This limited scope of the internal controls requirement is consistent with the plain language of Section 13(b), which specifies *transactions* and the *disposition of assets*. It also aligns with the intent of the statute, which is to promote accurate records of transactions and reliable financial reporting, *not to control all aspects of a business's management and operations*. *See SEC v. World-Wide Coin Invs., Ltd.*, 567 F.Supp. 724, 747 (N.D. Ga. 1983). Accordingly, courts have attached the internal controls requirement *only* to processes that directly affect the reliability of financial reporting. *See United States v. Jensen*, 532 F.Supp.2d 1187, 1199 (N.D. Cal. 2008); *World-Wide Coin*, 567 F.Supp. at 750.

For ALC's actual accounting procedures, which *did* affect the reliability of financial statements, Bebo implemented sufficient internal controls. Indeed, the use of off-setting entries

in the 997 account ensured that intercompany revenue associated with employee-leasing did not affect ALC's public reporting. Notably, GT audited ALC and issued a clean internal controls opinion at 2012 year-end after receiving a full report of Milbank's internal investigation results. The ALJ dismisses this important fact, saying that GT and Milbank "lacked the full facts at that time and thus were deprived of a meaningful opportunity to reach fully informed conclusions" (Dec. 79), but fails to identify any significant fact regarding internal controls that was unknown *after* the Milbank investigation.

VIII. The ALJ Erred In Concluding That Rule 13a-14 Provided A Basis For A Separate And Independent Violation For Liability And Penalty Purposes.

The ALJ erred in finding an independent cause of action for violating Rule 13a-14 and for imposing penalties for those violations. *First*, because there was no underlying falsity in ALC's filings—they were not misstated *at all* from a financial perspective—there can be no violation of Rule 13a-14 either. *Second*, a violation of Rule 13a-14 does not give rise to an independent cause of action. *See, e.g. In re Radian Sec. Litig.*, 612 F.Supp.2d 594, 620 (E.D. Pa. 2009); *In re Huffy Corp. Sec. Litig.*, 577 F.Supp.2d 968, 1020 (S.D. Ohio 2008).

IX. The Sanctions Imposed By The ALJ Were Excessive, Contrary To the Law, And Unsupported By The Evidence.

A. Public interest factors do not support the imposition of civil penalties.

Before assessment of any penalty, the Commission must find that such an assessment is in the public interest.[17] Section 21B(a) of the Exchange Act requires that the public interest finding support not only the decision to assess a penalty in the first place, but the amount of the assessment as well. *See* 15 U.S.C. § 78u-2(a)(1).

[17] For the same reasons, the officer and director bar imposed is not warranted because the considerations regarding the same substantially overlap.

Here, the ALJ wrongly concluded that the public interest supported the imposition of severe sanctions against Bebo, totaling $1.05 million. Although the ALJ identified the correct factors before deciding to impose such significant sanctions against Bebo, his analysis of those factors was internally inconsistent, unsupported by actual evidence in the record, and contrary to applicable precedent from the Commission and courts. Indeed, although the ALJ paid lip service to the appropriate public interest factors, rather than meaningfully assess each of those factors to arrive at an appropriate sanction, the ALJ simply dismissed (or altogether ignored) any factors that did not support the imposition of penalties, while treating as dispositive the other factors that supposedly did. When each of the public interest factors are appropriately evaluated and weighed, it is clear that the public interest does not support the type of severe sanctions imposed.

Scienter/egregiousness. As established earlier, the Division's scienter-based claims should fail. But even if they stand, the ALJ erred in placing excessive and unfounded weight on the purported "egregiousness" of Bebo's conduct. Even under the ALJ's own findings, the Division never established the conduct had any tangible adverse effect on the securities markets or investors (as reflected by the repeated misplaced reliance on the purported "scheme" directed at Ventas rather than investors).

No harm. The second step of the ALJ's public interest analysis was no more robust than the first; once again, the ALJ simply declared, without any analysis or explanation, that "Bebo's violations resulted in approximately $1 million of losses to ALC and its shareholders." (Dec. 121.) Although the ALJ failed to explain the basis for this conclusion when assessing the public interest factors, later portions of the ALJ's decision suggest that this conclusion was apparently premised on the view that the costs ALC incurred for purposes of *investigating* the allegations raised in connection with the Ventas leasing practices were "substantial losses"

resulting from Bebo's alleged misconduct. In other words, the ALJ concluded that significant penalties were in the public interest, not because Bebo's conduct harmed investors or others (it did not), but merely because when allegations of misconduct were raised, the company investigated them.

By the ALJ's logic, any time a person or company is accused of securities violations, by responding in the way the government desires and indeed encourages (*i.e.,* by carefully investigating and evaluating the allegations and conduct, including for possible self-disclosure) they would actually *increase* their exposure. This is bad law and bad policy. Of course, the ALJ decision does not cite any authority for this sweeping proposition that costs of investigating an allegation of impropriety, alone, warrant the imposition of significant civil penalties, even when there is no actual evidence of harm to investors.

In reaching his conclusion, the ALJ also overlooked the actual results of the investigation that supposedly supported the imposition of penalties. Based on these results of the investigation, ALC's board decided to take no action with respect to ALC's prior filings with the Commission, ALC's internal controls, or adverse employment action with respect to Buono, and affirmatively represented to GT it was aware of no fraud or illegal acts related to Commission filings in 2011 or 2012. (Exs. 1035, 1866; Tr. 3490.) Put simply, the investigation found no wrongdoing by Bebo. The ALJ erred in finding that the costs of investigation that found no misconduct on the part of Bebo were nonetheless losses caused by Bebo's alleged misconduct. *See Dura Pharms., Inc. v. Broudo*, 544 U.S. 336, 343 (2005) ("To touch upon a loss is not to *cause* a loss, and it is the latter that the law requires.").

Beyond the costs of this internal investigation, the ALJ decision cites no other "losses" as a basis for imposing sanctions against Bebo. Nor could it. There is no evidence that Bebo's conduct harmed anyone, including any individual investors or the marketplace more generally.

No personal enrichment. The ALJ also found that Bebo was personally enriched, explaining that "Bebo's concealment of her scheme from the board allowed her to receive" discretionary bonuses and stock options that she would not have received "had the board known of her misconduct." (Dec. 121.) On the very next page of his decision, however, the ALJ acknowledged that "[o]n this record though, it is difficult to conclude that this entire bonus amount constitutes unjust enrichment." (*Id.* at 122.) And he appropriately found that Bebo "provided real and valuable services to ALC for which bonuses were awarded," and the vast majority of those services related to matters that had nothing to do with Ventas or the Lease covenants. (*Id.*) Thus, the ALJ recognized himself that, *at most*, Bebo gained $18,333 per year over three years ($55,000 total) of "unjust enrichment" attributable to the subject of this enforcement action. Of course, the ALJ did not bother to explain how a $55,000 discretionary bonus justifies imposition of civil penalties nearly 20 times that amount.

Similarly, the ALJ claimed that Bebo was personally enriched because she received stock option awards that were not canceled by ALC's compensation committee, although acknowledging no evidence was presented to even measure what that might be. (Dec. 123.) Moreover, the whole theory that ALC's board would have taken these actions is entirely speculative given they did nothing to Buono and later revoked Bebo's termination, accepted her resignation, and paid most of her contractual severance. (Tr. 4513.)

In other words, the ALJ concluded that the public interest warranted imposition of severe penalties against Bebo due to her unjust enrichment, despite the fact that there is no evidence that

she was actually enriched (and in the case of her discretionary bonuses, she clearly was not). This too was in error.

No prior violations or likelihood of future ones. The ALJ correctly found that Bebo has no past record of violations, and that "this factor weighs against the need for penalties," but effectively disregarded it.

Deterrence. Although the ALJ rightly concluded that there was little need to deter Bebo herself due to the cease-and-desist order and officer-and-director bar he simultaneously imposed, he nonetheless found significant penalties necessary "given that she may return to such roles, as well as to punish her for past violations." This is, at best, speculative. There is no evidence that Bebo is likely to be in a position to violate securities laws any time in the future, much less that she is at serious risk of further violations. And nearly a decade has passed since the events at issue.

The ALJ also concluded that significant penalties were warranted to deter "others similarly situated from future violations," explaining that "[a] penalty would also affect general deterrence" by deterring other CEOs from violating securities laws. (Dec. 123-24.) There is no basis for this conclusion either. Given the unique facts at issue here, there is no reason to think that any penalty, including a significant one, would have any deterrent effect on other "similarly-situated" CEOs, or even that any other CEO is likely to face the unique circumstances present in Bebo's case. The fact that the aspect of this case most troubling to the ALJ was conduct directed toward a much larger industry competitor and contractual counterparty to whom no fiduciary duty was owed militates *against* the need for general deterrence. Securities laws have nothing to do with policing such relationships. And more importantly, if the ALJ simply concluded (as it appears) that penalties are necessary to send a message to any other public

company officer or CEO that they should not violate *any* securities law, in *any* situation, that is once again an argument that could apply in any case.

Other Matters as Justice May Require. Although the ALJ correctly observed that reliance upon counsel is a mitigating factor that should be taken into account when determining whether sanctions are appropriate (*see* Dec. 124 (citing *Blinder, Robinson & Co. v. SEC*, 837 F.2d 1099, 1109 (D.C. Cir. 1988)), despite the ample evidence in the record showing that Bebo reasonably relied on the advice of counsel in connection with ALC's Lease compliance disclosure, the ALJ erroneously rejected Bebo's argument that this reliance on counsel mitigated the need for any sanctions.[18]

B. Massive third-tier and second-tier penalties not warranted.

Having already wrongly concluded that the public interest factors supported his imposition of significant penalties against Bebo, the ALJ decided to impose two third-tier penalties of $150,000 each, or a total of $300,000, "to punish Bebo's scheme that violated Section 10(b) of Rule 10b-5(a) and (c)" on the grounds that the "scheme" operated as a fraud against both (1) the general public and (2) Ventas and other potential purchasers of ALC's business. In addition, the ALJ imposed 30 second-tier penalties of $25,000, or $750,000 in total, for each of the four purported securities violations attributed to Bebo during each of seven quarters she pursued her so-called "scheme." Here, again, the ALJ's decision is not supported by the record or applicable law.

The Commission may *only* impose a maximum third-tier penalty of up to $150,000 for each act or omission constituting a violation of the securities laws where a respondent's conduct involved fraud or reckless disregard of a regulatory requirement *and* resulted in substantial losses

[18] This should also have been considered in determining the amount of any penalty imposed, which the ALJ did not do. *See In re Coxon*, Release No. 140, 1999 WL 178558, at *10 (Apr. 1, 1999).

or created a significant risk of substantial losses to other persons.[19] 15 U.S.C. § 78u-2(b)(3); 17 C.F.R. § 201.1001. Second-tier penalties are appropriate in cases involving fraud or reckless disregard of regulatory requirements, without any substantial losses or risk of loss. 15 U.S.C. § 78u-2(b)(2).

The ALJ imposed two third-tier penalties based on the theory that Bebo committed fraud, resulting in substantial losses in the form of costs of an internal investigation into the wrongdoing alleged against her. (Dec. 129.) But for the same reasons discussed above, it would be inappropriate to permit the imposition of significant third-tier penalties based only on the costs of investigating allegations of securities violations, particularly where, as here, that internal investigation turned up no wrongdoing. Were it otherwise, third-tier sanctions could be appropriate in every case where a company or individual appropriately responds to allegations of misconduct by investigating their merit. It would discourage such investigations.

And more fundamentally, because the ALJ erred in finding that Bebo's conduct rose to the level of fraud or deceit in the first place, there is no basis for the imposition of third-tier *or* second-tier penalties.

C. At most, Bebo should be subject to a single penalty for her single course of conduct.

Based on his erroneous findings that Bebo's conduct amounted to fraud and resulted in "substantial losses" to others, despite all evidence to the contrary, the ALJ imposed 32 penalties against Bebo (two third-tier penalties of $150,000 each, and 30 second-tier penalties of $25,000 each), totaling $1.05 million. The ALJ's decision to calculate and impose penalties based on

[19] A third-tier penalty may also be imposed where the fraud resulted in a substantial pecuniary gain to the respondent, but this is not at issue in this case.

32 "violations," rather than Bebo's single course of conduct, was contrary to the usual standards applied by the Commission or courts when calculating an appropriate penalty.

Although the Exchange Act provides that a penalty can be imposed for each act that constitutes a violation of the law, it leaves the precise manner of calculating the violations undefined. *See* 15 U.S.C. § 78u-2(a), (b). And while it is true that there is no uniform rule for calculating the number of violations, the Commission and Federal courts have largely followed the principle that a single course of conduct should constitute a single violation for purposes of calculating penalties. *See, e.g., In re Mohammed Riad & Kevin Timothy Swanson*, Release No. 34-78049, 2016 WL 3226836, at *46 (June 13, 2016) (affirming the imposition of one third-tier penalty in the amount of $130,000 because, although there were multiple Commission filings containing misrepresentations, it was a single "course of action resulting in one unit of violation."); *SEC v. Blackout Media Corp.*, 2012 WL 4051951, at *2 (S.D.N.Y. Sept. 14, 2012); *SEC v. Garfield Taylor, Inc.*, 134 F.Supp.3d 107, 110 (D.D.C. 2015) (reasoning most "courts have assessed only a single penalty where the violations arose from a single scheme or plan"); *SEC v. Riel*, 282 F.Supp.3d 499, 528–29 (N.D.N.Y. 2017) (rejecting the SEC's request for 5 separate violations "[s]ince the violations here arose out of a single scheme or plan"); *SEC v. BIC Real Estate Dev. Corp.,* 2017 WL 1740136, at *6 n.2 (E.D. Cal. May 4, 2017) ("the weight of authority favors interpreting each violation to mean each scheme in which the defendant was involved" as opposed to each victim).

Based on this extensive authority, Bebo argued that even if her conduct warranted penalties (it does not), those penalties should be calculated based on a single course of conduct, rather than assessing a penalty for every alleged violation of the various securities laws cited by the Division based on identical behavior during the course of that conduct. Indeed, the reason

courts and the Commission (and the ALJ himself) often prefer to calculate penalties on the basis of a course of conduct is because in many cases (including any case involving regular public filings like those at issue here), the very same behavior could be the predicate for numerous alleged violations of different securities laws, and therefore trigger massive double-, triple-, or in this case quadruple-counting.

The ALJ recognized that in many cases, the Commission, courts, and other ALJs have calculated penalties based on a course of conduct, rather than each technical "violation," but refused to follow that approach in this case because it was not the "dominant trend" (whatever that means). (Dec. 127.) But Bebo does not argue that the precedent (or a "dominant" trend) *compels* the calculation of penalties based on a single course of conduct in every case, regardless of the nature of the claims raised or misconduct alleged—only that, under the facts of this case, it would be *more appropriate* to calculate damages on the basis of one course of conduct, just as the Commission and courts have done in similar cases in the past.[20]

The ALJ's decision failed to articulate any justification for departing from that approach, beyond the fact that, in the ALJ's view, those prior cases "simply do not show why that rationale applies here." (Dec. 127.) Of course, the ALJ failed to explain why it would be *more* appropriate to penalize Bebo multiple times over for the exact same conduct (essentially *five* times for each of seven quarterly filings). Instead, the ALJ explained that "[i]n a case like this, where there is repeated fraud, significant harm, and unjust enrichment, I am concerned that adopting a one-penalty approach would compromise deterrence." (*Id.*) The ALJ cannot justify his decision to depart from the applicable precedent and impose massive penalties on Bebo by

[20] Even the other approaches identified by the ALJ would result in a calculation of far fewer violations/penalties imposed. The Decision identifies approaches looking at the number of misstatements—here there was only one repeated in several filings; or the number of "victims"—the ALJ identified at most two (Ventas and the public); or the number of *statutes* violated—the ALJ found five.

simply repeating the same erroneous determinations discussed above. *See Steadman v. SEC*, 603 F.2d 1126, 1139 (5th Cir. 1979) ("We subscribe to the common-sense notion that the greater the sanction the Commission decides to impose, the greater is its burden of justification.").[21]

In short, the ALJ's decision to impose drastic civil penalties, totaling $1.05 million, was erroneous not only because the factual criteria for civil penalties does not warrant them, but also because the ALJ utilized a method for calculating penalties which effectively punished the same conduct multiple times over and resulted in an excessive monetary sanction.

THIS ADMINISTRATIVE PROCEEDING IS UNCONSTITUTIONAL AND MUST BE DISMISSED

X. The Federal Law Enabling This Proceeding, Dodd-Frank Section 929P(a), Is Facially Unconstitutional.

For the first fifty years of the SEC's existence, it had no authority to obtain monetary penalties at all, much less from ordinary citizens who were not regulated members of the securities industry, and any action had to be brought in federal court. *See* Carole B. Silver, *Penalizing Insider Trading: A Critical Assessment Of The Insider Trading Sanctions Act of 1984*, 1985 Duke L.J. 960, 960-63, 966 (1985).

Although Congress expanded the SEC's enforcement authority over time, until passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, the level of process afforded to the citizen being charged by the SEC tracked the punitive gradient of the remedy sought; more severe and punitive remedies were allowed in federal court where the defendant is entitled to robust procedural safeguards.

[21] Even if there was actual evidence that Bebo committed fraud, harmed others, and was personally enriched (there is not), that would not distinguish this case from the numerous other cases where penalties were calculated based on a single course of conduct—most of which involved allegations of fraud that caused far more significant harm to *investors* than was ever alleged here.

Section 929P(a), destroyed that balance when it granted the SEC authority to obtain civil penalties against any citizen in an administrative proceeding. As the ALJ found, the remedies the SEC can seek administratively are now functionally identical to the remedies it can obtain in federal district court. (Dec. 4.) By granting this parity of remedy, Congress upset the balance that the Supreme Court had approved and in a manner not permitted by the Constitution. The fundamental constitutional deficiency of the new structure is that the government has the sole power to provide or withhold a citizen's right to a jury trial. And the SEC will only grant the citizen her constitutional right to a jury trial when it, in consultation with the Division of Enforcement attorneys who conducted the investigation, concludes it is an advantageous litigation tactic to file in district court. As the Chief of the Market Abuse Unit of the Division, stated that "[i]n every case you make judgments about which forum is most advantageous for the interests of your client [the SEC]" and before deciding on a forum, the SEC performs "an extensive risk analysis" that takes into account the "trade-offs" associated with each option. Phyllis Diamond, *SEC's Hawke Defends Admin. Forum for Insider Cases*, Corp. Couns. Wkly., Oct. 22, 2014, at 323.

As set forth in more detail below, the legal scheme established by Dodd-Frank is facially unconstitutional under the equal protection and due process guarantees of the Fifth Amendment. A successful "facial attack means the statute is wholly invalid and cannot be applied to anyone." *Ezell v. City of Chicago*, 651 F.3d 684, 698 (7th Cir. 2011). Consequently, this proceeding must be dismissed.

A. Dodd-Frank Section 929P(a) violates Fifth Amendment equal protection.

The Supreme Court's consideration in *Baxstrom v. Herold*, 383 U.S. 107 (1966), is instructive as to improper statutory classifications like that created by Section 929P(a). The petitioner in *Baxstrom*, a New York prison inmate, challenged the state law that allowed for

inmates at the end of their sentences to be committed to a mental hospital without the jury review available to all other persons civilly committed. *Id*. at 110. Applying rational basis scrutiny,[22] the Court found "no conceivable basis for distinguishing the commitment of a person who is nearing the end of a penal term from all other civil commitments." *Id.* at 111-12. Where the question to be determined by the tribunal (sanity) and the potential outcome (commitment) was the same for both classes, equal protection required that both classes be given the same jury trial right. *Id.* The Court explained that "the State, having made this substantial review proceeding generally available on this issue, may not, consistent with the Equal Protection Clause of the Fourteenth Amendment, arbitrarily withhold it from some." *Id.* at 111; *see also Humphrey v. Cady,* 405 U.S. 504, 512 (1972) (holding where a person "was deprived of a jury determination, or of other procedural protections, merely by the arbitrary decision of the State to seek his commitment under one statute [which did not permit a jury] rather than the other" that did, an "equal protection claim would seem to be especially persuasive….").

Applied here, *Baxstrom* and *Humphrey* stand for the proposition that when the alleged wrongful conduct and the remedy sought are the *same*, a law that allows the government arbitrarily to choose its forum (and thereby choose whether the defendant will receive a jury trial) violates the Constitution's promise of equal protection. Such is the case with Dodd-Frank Section 929P(a), which grants the SEC authority to obtain civil penalties against any citizen in either district court, where the defendant can elect to be tried before a jury, or an administrative proceeding, where she cannot.

[22] Because a facial attack is directed at the Congressional action and legislative classification, that action is assessed under a rational basis standard. *Baxstrom v. Herold*, 383 U.S. 107, 111-12 (1966). The "class-of-one" equal protection standard has no application to a facial challenge to legislation. *Monarch Beverage Co. v. Cook*, 861 F.3d 678, 682-83 (7th Cir. 2017).

B. Dodd-Frank Section 929P(a) violates Fifth Amendment substantive due process.

Section 929P(a) of Dodd-Frank also violates Bebo's right to substantive due process because it allows SEC prosecutors to punish her for her prospective exercise of a constitutional right (electing to be tried by a jury) by subjecting her to an administrative proceeding instead where she cannot exercise that right. When the principal objective of a statutory scheme or government practice is "to discourage the assertion of constitutional rights[,] it is patently unconstitutional." *Chaffin v. Stynchcombe*, 412 U.S. 17, 33 n.20 (1973) (internal citation omitted). Courts have on many occasions invalidated statutory provisions that penalize citizens for possessing or exercising their constitutional rights.

The Supreme Court's decision in *Blackledge v. Perry*, 417 U.S. 21 (1974) is instructive. There, the Court found unconstitutional the prosecutorial discretion authorized by a law that permitted the prosecutor to obtain a felony indictment after the defendant exercised his right to have a jury determine his original misdemeanor charge for the same conduct. *Id.* at 23. The Court held that the *mere risk* of prosecutors punishing defendants for exercising their right to a jury determination violated due process. *Id.* at 28-29. The Court required no actual evidence of foul motive because the statute itself permitted such an improper motive to enter the government's decision-making. *Id.*; *see also United States v. Jackson*, 390 U.S. 570 (1968) (striking law that punished exercise of jury trial right); *United States v. Alvarado-Sandoval*, 557 F.2d 645, 645-46 (9th Cir. 1977) (preemptive punishment of the citizen's prospective exercise of a constitutional right no less a constitutional violation).

Dodd-Frank allows the government to penalize a citizen for possessing the right to a jury in federal court and her anticipated exercise of the same by bringing its claims administratively.

By the reason expressed in *Blackledge* and *Jackson*, this grant of authority is facially unconstitutional.

XI. The SEC's Chosen Forum Violates Article II Of The Constitution.

Under the Supreme Court's decision in *Free Enterprise Fund v. Pub. Co. Accounting Oversight Bd.*, 561 U.S. 477 (2010), Article II's vesting of the executive power in the President and the Take Care Clause, requires that inferior officers of the federal government cannot be separated from the President by multiple layers of protection from removal. *Id.* at 483-84.

The ALJ conceded that Commission ALJs are protected by multiple layers of for cause removal, but declined to find this violated Article II. (Dec. 11-13.) None of the factors the ALJ claims distinguish Commission ALJs from the board members in *Free Enterprise* has merit. Each factor was persuasively rejected by the thorough, well-reasoned partial concurrence/dissent in *Fleming v. USDA*, 2021 WL 560743, *15-25 (Feb. 16, 2021). *First*, their adjudicative function is not a distinguishing factor based on other Supreme Court precedent, and the fact that they still exercise *executive* power. *Id.* at *17-18. Second, although ALJ's are not new, the two layers of for-cause removal is of recent origin (dating only to 1978). *Id.* at *18-19. That recent vintage puts them squarely within *Free Enterprise*. *Id.* Finally, the purported "other means of control" (Dec. 12), is just a re-casting of the argument that ALJ's exercise adjudicatory functions with appeal rights to the Commission. Whatever the process in individual cases, the double layer of for-cause removal protection means the President and Commission lack the accountability to have officers carrying out the administration's preferred policies. *Id.* at *22.

XII. The Initial OIP Was Legally Invalid, And So This Case Must Be Dismissed With Prejudice.

Lucia required that Bebo receive a new hearing because the hearing set by the OIP in this case was conducted in violation of the Appointments Clause. *See Lucia v. SEC*, 138 S. Ct. 2044,

2055 (2018). However, the Court did not consider whether a new OIP needed to be issued or even could properly be re-issued in accordance with the law.

However, the constitutional infirmity determined by the Supreme Court rendered the OIP in this case legally invalid and statutorily defective because the original OIP never "commenced" an action. Thus, a new OIP needed be filed to proceed administratively against Bebo. To legally initiate administrative proceedings under the Exchange Act, the Commission must include in the OIP required by 17 C.F.R. § 201.101 a notice of hearing before a valid officer of the Commission, the Commission itself, or members thereof. *See* 15 U.S.C. § 78u-3; 15 U.S.C. § 78v.

Here the "officer" who the Commission noticed Bebo would preside over her hearing was not an officer of the Commission because none of the ALJs employed by the agency at the time of the OIP had been constitutionally appointed. *Lucia*, 138 S. Ct. at 2049. Simply put, an OIP noticing a defective hearing is a defective OIP. *See Pereira v. Sessions*, 138 S. Ct. 2105, 2110 (2018) (holding that a notice to appear that did not specify the time and place of the hearing as required by statute was ineffective); *United States v. Virgen-Ponce*, 320 F. Supp. 3d 1164 (E.D. Wash. 2018). Thus, the OIP never instituted valid proceedings and was itself a nullity.

However any new OIP would also be invalid because the statute of limitations has long since passed. The Commission was required to validly commence claims against Bebo within five years of when the claim accrued. 28 U.S.C. § 2462; *see also Kokesh v. SEC*, 137 S. Ct. 1635, 1640 (2017). Since the original action was never "commenced" by law, and the claims accrued at the latest in 2012, any new OIP that would validly

commence an action against Bebo would be time-barred unless the original OIP somehow tolled the statute of limitations.

It is well-established, however, that a government charging document that contains such a legal or constitutional defect as the one present here, *does not* toll the limitations period.[23] *United States v. Gillespie*, 666 F. Supp. 1137 (N.D. Ill. 1987) (holding a valid indictment tolls the statute-of-limitations, but an earlier indictment that is legally invalid does not); *United States v. Crysopt Corp.*, 781 F. Supp. 375, 378 (D. Md. 1991) ("only a *validly* pending original charge will save an untimely superseding indictment"). Similarly, the invalid OIP in this case could not toll the statute of limitations here, and this case must be dismissed.

XIII. This Administrative Proceeding Has Deprived Bebo Of Her Right To Procedural Due Process.

There is no dispute that Bebo satisfies two of the three *Matthews v. Eldridge*, 424 U.S. 319, 334-35 (1976), factors for evaluating a procedural due process claim—Bebo has a significant private interest at stake in this case and the government has no significant interest in depriving the process set forth below that would be available in federal court. Thus, the third factor—evaluating the risk of an erroneous deprivation of the private interest due to the procedures employed—is dispositive. (Dec. 14-16, evaluating only this factor.)

A. The SEC's choice of forum prevented Bebo from compelling testimony from or cross-examining key witnesses.

Due process generally requires that a citizen subject to an administrative adjudication have the right to present evidence, call witnesses on her behalf, and cross-examine adverse witnesses. *Jenkins v. McKeithen*, 395 U.S. 411, 429 (1969); *Washington v. Texas*, 388 U.S. 14, 19 (1967); *Lonzollo v. Weinberger*, 534 F.2d 712, 714 (7th Cir. 1976).

[23] The result is no different when a civil complaint is legally invalid because it was originally filed before a court with no authority to adjudicate the claim. *See Woodson v. Allstate Ins.*, 855 F.3d 628, 633 (4th Cir. 2017); *Shofer v. Hack Co.*, 970 F.2d 1316, 1319 (4th Cir. 1992).

The SEC's choice to bring its case administratively instead of in district court meant that Bebo was unable to cross-examine or call key witnesses on her own behalf, even though the Division compelled testimony from them in the investigation. (Exs. 1982, 1984.) David Hennigar, ALC's Chairman and principal owner, and Ng, the chairwoman of the Audit Committee, are Canadian citizens residing outside the Commission's subpoena power; Bebo could not compel their testimony at the hearing. *See* 15 U.S.C. § 78u(b). The Division chose to deny Bebo the procedural and other protections applicable in federal court, where she would have been able to obtain deposition and document discovery from both of these witnesses to be used at trial. *See Gulf Oil Corp. v. Gulf Can. Ltd.*, 2 S.C.R. 39, 57 (Can. 1980) (letters rogatory from the United States are almost always enforced).

Their testimony would have informed the issue of scienter, the critical inquiry in most securities fraud cases. Disclosure of the alleged fraudulent conduct to the company's Board (among others inside and outside the company) is obviously inconsistent with intent to deceive investors, and both witnesses could have provided material exculpatory evidence, particularly Ng, as other witnesses testified that she was well-informed about employee-leasing.

B. Other due process violations.

Bebo was treated unfairly throughout these proceedings, including:

- The Division influenced witnesses with suggestions of criminal prosecution from the outset of its investigation. (*See, e.g.* Exs. 1967, 1970.) And two ALJ's precluded Bebo from exploring the effect these interactions had on the witnesses' credibility (as well as the Division's decision regarding forum selection) when they precluded Bebo from discovery or calling a Division witness with knowledge.
- The Division was permitted to admit declarations from sixteen witnesses without having to subpoena the witnesses or make them available at trial for cross-examination.

- Ventas witnesses were permitted to testify regarding their routines and practices, but Bebo was denied by two ALJ's from obtaining discovery from Ventas regarding these same practices.
- The preponderance of the evidence standard is insufficient to protect a respondent's private interest in light of the significantly greater punitive remedies available to the Commission than when *Steadman v. SEC*, 450 U.S. 91 (1981), was decided.

Dated this 11th day of March, 2021.

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CERTIFICATE OF COMPLIANCE

Pursuant to Commission Rule of Practice Rule 450(d), I hereby certify that the Respondents' Opening Brief In Support Of Her Appeal To The Commission complies with the length limitation set forth in Commission Rule of Practice 450(c). According to the Word Count function of Microsoft Word, this brief contains 20,709 words, exclusive of the table of contents, table of authorities, cover page/caption, and this certification.

Dated this 11th day of March, 2021.

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